BANK OF ENGLAND

# Speech

Speech given by

The Rt Hon Sir Edward George, Governor of the Bank of England

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This time of the year – between the end of summer holidays and Christmas – is always a particularly busy time for me: it's the season of annual dinners and international meetings. This year it's been even more hectic than usual. And it's been a particularly gloomy period – characterised by global economic uncertainty, financial market volatility and a pervasive sense of pessimism in business and financial circles, not to mention of course the media. That won't have escaped the notice of most of you here.

So, in the middle of it all, I took time out a few weeks ago to go to Covent Garden to see one of my favourite operas – Turandot. And I thought it might be more agreeable for all of us if I talked about the opera this evening, rather than the prospect for interest rates.

I'm sure you all know the story. The beautiful, but somewhat frigid, Princess Turandot decided to set her many suitors three tests. Turandot's tests were in the form of riddles – and she would only marry the man who could solve all three riddles correctly. But if the suitor got any one of the three riddles wrong, then he would be put to death, as indeed dozens of her suitors already had been.

But as I sat there enjoying the opera, it slowly began to dawn on me that it isn't really a love story at all – it is an allegory about the state of the global economy. Turandot clearly represents the present international situation – potentially very attractive but immediately somewhat chilling. And her unfortunate suitors are obviously the world's woefully misunderstood and under-appreciated central bankers!

Turandot's first riddle was "What is the ghost, which all the world invokes and is constantly renewed?"

As I sat there it seemed obvious to me that the answer must be the US economy.

For some years in the late 1990's "all the world" has looked to the US to keep it afloat – through the Asia crisis, then Russia and Long-Term Capital Management, with Latin America intermittently thrown in. And the US did a great job. But then two years or so ago the US began to fade – or give up the "ghost" if you like – with an investment-driven slowdown associated with the bursting of the ICT bubble and correction of over-exuberance in equity markets. But the ghost has shown clear signs of renewal over the past year; in fact US output in the third quarter was 3% up on a year earlier.

This turn-around from recession was helped initially by the inventory cycle, but it has been underpinned by resilient consumer spending, which itself has been encouraged by the strength of the housing market, offsetting some of the negative wealth effects of lower equity prices. Meanwhile manufacturing output recovered – notably in the semiconductor, computer and communications equipment sectors – and investment appears at least to be no longer contracting.

Certainly the macro-economic data are mixed – they almost always are, but on the whole they remain reasonably positive.

More fundamentally, the financial system – notably the commercial banking system – has held up well, far better than one might have expected through the slowdown. Market interest rates have fallen – where they were pointing higher earlier in the year. And perhaps most importantly, although there has been some deterioration in the labour market, average annual productivity growth has remained strong – at around 2½% since 1995, well above the 1.5% rate averaged over the preceding 20 years.

At current growth rates that means there is no inflationary pressure – and both monetary and fiscal policy remain supportive, indeed US monetary policy was eased quite sharply further last week to underpin the expansion.

All in all, we – along with many other macro-economic forecasters – expect that after somewhat slower growth in the 4th quarter – US GDP will continue to expand at an annual rate of 3-3½% over the next two years.

That's not a massive rebound, but it is a positive picture – even allowing for downside risks. So we are, in fact, seeing – in terms of Turandot's first riddle – the renewal of the US economy. And of course it is immensely important for the global economy that we should, because the prospects in some of the other major industrial economies, notably Japan and Germany, are rather more uncertain.

Surprisingly in the light of all this, Turandot's own answer to her first riddle was not "the US economy." Her answer was HOPE. I suppose I would settle for modest EXPECTATION.

Her second riddle was "What flickers like a flame when man dreams of conquest?"

And again, as I sat there, the answer seemed obvious – it had to be business and financial confidence – or perhaps the global equity market.

Given the macro-economic prospect in the US – which is expected to contribute to a recovery to near-trend growth in the world economy as a whole in the course of the next year or two – the recent pessimism of business leaders and the renewed nervousness of global equity markets over the summer seemed somewhat puzzling. Fear seemed to have taken over from man's dream of conquest!

There was a real puzzle before the equity markets started to decline. Price/earnings ratios had risen to dizzy heights at their millennium peak, and most of what we've seen since then has been a normalisation of the equity risk premium - allowing for lower real interest rates. The underlying question is, is that normalisation complete? I don't know the answer to that question. But I am impressed that on some measures of earnings P/E ratios are back to their longer-term averages, and on most measures they are closer to the levels of the mid-1990's before they began their ascent to their 1999-2000 heights.

But in any event that's not the whole story.

In part the apparent disconnect between the macro-economic prospect and business and financial sentiment over the summer can be explained by successive non-macro-economic shocks – 9/11, geo-political concerns, and recurrent concerns about the reliability of corporate accounts in the wake of the governance and accounting failures we saw, notably in the US.

The worry then was that markets, and business sentiment, were threatening to overshoot on the downside, just as they clearly had on the upside, and that that would blow back onto the convalescent macro-economy.

Happily, while these non-macro-economic concerns have not completely gone away, in the past month or so equity markets have recovered most of the losses they suffered in the further downwards lurch in September and while they remain somewhat fragile they do seem to have a better underlying tone. So it may be – just may be – that we are moving on to somewhat firmer ground.

Disappointingly, Turandot's answer to the flickering flame was not "confidence" as I had thought it would be. Her rather chilling answer was BLOOD – which could no doubt flow if confidence were to fail. But you have to remember that I was watching the opera over a month ago. Perhaps today she would come up with a somewhat more positive answer.

Turandot's third riddle was "What is the frost that burns…… and makes a king of the one it accepts as a slave?"

Well for a time that stumped me completely! Not that it mattered much by then – I'd already failed the first two of Turandot's tests, so I knew I was for the chop anyway!

But then I began to reflect on the implications of it all for our own economy here in the UK. And I even recalled that previous occasion on which I had dined with you here at the ACT dinner.

At that time we'd had just 2½ years of growth with low inflation – after the 1990/91 recession. I told you that we were determined to maintain price stability as a necessary condition for sustainable growth of output and employment. You all hooted with laughter! Your President said it had been the best joke of the evening – even though you'd heard it many times before! Well we've now had 10 years of low inflation – with continuous, quarter-by-quarter, GDP growth, and the number of people in employment is at a near-all-time high.

What I confess I did not anticipate at that time was the difficult international environment in which we've had to operate over the past four years – including both the global economic slowdown and the persistent strength of sterling against the surprisingly weak euro.

It must be that external environment – which has clearly had a dampening effect on demand and output in this country – that is, for us, the frost that burns.

There was nothing that we could do ourselves directly to address the causes of these problems which had their origins abroad. What we could do – and indeed have done – is to offset as best we could the effects of the external frost by turning up the domestic heat in our economy, cutting interest rates to their lowest level for 40 years – which is where they've been for the past 12 months – consciously encouraging consumer spending on the back of rising house prices and a rapid build up of household debt. So although we've been reasonably successful in maintaining stability in the UK economy as a whole, we've had to live with a painful imbalance within the economy – between the internationally exposed sectors, including much of manufacturing, which have been having a torrid time, and the domestically-oriented sectors which have been doing relatively well. Essentially, faced with the external frost we've turned up the domestic heat – without that we'd all have felt cold!

But this approach is not without risks. Clearly in principle the colder the external frost, the higher we need the internal temperature: the danger is that we overload the domestic boiler, with households becoming reluctant to take on more debt, or pay higher house prices, so that consumer spending growth moderates regardless of the outside temperature.

Earlier this year in fact things seemed to be moving in the right direction: global demand appeared to be picking up quite well, and there appeared to be a reasonable prospect that consumption growth would moderate largely of its own accord. There was at that time a question of whether that moderation might need to be encouraged by higher interest rates. With the downward revision – over the summer – to the expected pace of global demand growth, the emphasis of our policy debate has shifted. The questions now are how far we need to try to sustain domestic demand growth by lowering interest rates, in order to maintain overall stability; and how far we can sensibly do so without excessive risk of overloading the domestic boiler.

The best outcome for us of course would be if the external frost would continue to melt, with the global economy maintaining its gradual recovery and the euro continuing to strengthen in foreign exchange markets. And that is in fact in my view the most probable outcome. But until things become clearer we are very much on the spot.

And perhaps, I thought, 'on the spot' was not a bad answer to the opera's third riddle. In fact the answer was Turandot. Well at least it rhymed.

Mr President it is at this point in the opera that they sing the wonderful aria "Nessun Dorma" – "None shall sleep." As I look around me, I see that that message has not yet got through to some of your guests here this evening.

So let me conclude. I share the view of most macro-economic forecasters that the rate of growth in the US and world economies will remain modestly positive. I recognise the downside risks from the fragility of business and financial confidence internationally – though I expect that to improve with the gradual improvement in macro-economic data. And I assure you that like the Federal Reserve Bank, we at the Bank of England, remain vigilant, and ready to ensure that monetary policy remains supportive to the extent that we sensibly can.

So my message in a nutshell is: HOPE, even modest EXPECTATION; No further BLOOD in financial markets – though I'm not sure whether that's hope or expectation; meanwhile we remain "On the spot with TURANDOT." And you'll all be pleased to know that the opera itself has a very happy ending.

Mr President, on behalf of all your guests this evening may I thank you for your very generous hospitality; and I invite everyone to join me in a toast to the continuing prosperity of the ACT, coupled with the name of the Association's President, Mr Anthony Stern.

Ladies and Gentlemen the Association of Corporate Treasurers.