Speech

Speech given by

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

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Let me open my defence by trying to explain to you what we at the Bank – through the MPC – are tasked to do, and why.

The task sounds straightforward. It is to set short-term interest rates with the consistent aim of hitting the Government's symmetrical 2½% inflation target (on a precisely defined measure of retail price inflation – RPIX). Now the reason we've been set that task is not – as some people imagine – because either we or the Government think that consistently low inflation is the be all and end all of economic life. It is because we've learned from long experience that consistently low inflation is a necessary (though not in itself sufficient) condition for the sustained growth of output of the economy as a whole, for high levels of employment, and for rising living standards, which are more fundamentally the things that we are all seeking to achieve.

Carrying out our task is not as straightforward as it sounds because there is not, of course, a simple, direct link between interest rates and the rate of inflation.

Interest rates essentially affect the demand side of the economy. They do not directly influence the supply side, which depends upon a whole host of structural characteristics of the economy which are largely beyond the direct reach of monetary policy. What we have to do in managing short-term interest rates is to keep overall demand growing broadly in line with the underlying – sustainable – supply-side capacity of the economy as a whole to meet that demand. In other words we are trying to maintain overall, macro-economic, stability in a much broader sense, in the medium– and longer– and not just the short-term; and the Government's inflation target is the criterion against which our success, or otherwise, in achieving that broader macro-economic stability is to be measured.

Our problem is that we don't know with any great precision or confidence exactly what is happening on the supply-side – that's to say precisely what rate of growth we can hope to sustain. We don't know precisely either what is currently happening, or what is likely to happen looking forward over the next couple of years or so to overall, aggregate, demand. And we don't know precisely what the full impact of a change in interest rates will be on aggregate demand, or how long it will take before the full impact is felt.

Ours is not a precise science. In fact it's more of an art than a science. And, although we bring as much economic and statistical science to bear as we can, we know that our forecasts, and indeed our policy judgements, are subject to a range of error. They cannot be accurate to every last digit. We can't expect to hit the target all the time, but by consistently aiming to do so (and we do consistently aim to do so looking 2 years or so ahead – whatever you may have read in some recent media commentaries) we can hope to get reasonably close to the target on average over time.

Given the uncertainties, which are well illustrated by the sudden – and no doubt to some extent erratic – jump in the RPIX inflation rate in the year to January of 2.6% announced this morning, the overall results over the past decade since the recession of the early 1990's have been encouraging. Whether that's a result of good luck or good judgement I leave to others to decide – I'm more interested in the outcome.

Since the Summer of 1992, inflation, on the target measure has averaged just 2.6% - and has been more stable than at any time in our history. And it has been consistently remarkably close to target over the past 5 years.

But the even better news is that stable, low, inflation has been accompanied by steadily increasing overall output and employment, and by a progressive fall, until very recently at least, in the rate of unemployment.

Over the same period, to the fourth quarter of last year, GDP growth averaged just under 3% a year – which is well above most estimates of our trend rate of 2¼%-2½%. GDP has in fact grown for 38 successive quarters which is the longest period of sustained quarter–by-quarter growth we have enjoyed since quarterly records began in the UK in 1955.

Employment has increased steadily from a low point of 25 ½ mn people in the Spring of 1993 to its current level of 28 mn. And the rate of unemployment fell from a peak of over 10½% on the LFS measure to around 5% last summer; while on the claimant count measure it fell from some 10% to just over 3%, which meant that the number of people claiming unemployment benefit, at under 950,000, was the lowest for 26 years.

Now some of you – given what's happening to your own businesses – are probably thinking that I must come from a different planet. And yes, we do have a problem. Once you look beneath this apparently benign surface of the economy as a whole, you find very substantial differences between many internationally-exposed sectors of the economy – including particularly many manufacturing businesses – which have recently been having a really tough time, and other businesses largely serving our domestic market which have been doing pretty well.

There are two main reasons for the pressures affecting the internationally-exposed sectors: the synchronised economic slowdown over the past year or so in all major industrial countries, on the one hand, and the puzzling persistent weakness of the euro in foreign exchange markets not just against sterling but even more against the dollar, on the other.

What that has meant for the UK manufacturing sector is that output in the year to November (the latest month for which we have internationally comparable data) fell by 5.7% and employment fell by 153,000 people, or by nearly 4%. For what it's worth, we were not alone. Comparable figures show that manufacturing output fell by over 13% in Japan, by 6.7% in the US and by 4.3% in Germany, while manufacturing employment fell by 5% in Japan, over 6½% in the US and around ¾% in Germany.

The frustrating thing is that, with the best will in the world, there was not much that either we at the Bank or the UK Government could have done to ward off the pressures on UK manufacturing, which had their origins abroad.

That's fairly obvious where we are talking about the global slowdown – with negative growth last year of about 1¾% in Japan (fourth quarter on a year earlier) and roughly zero growth in the US and Germany. We can go to international meetings and encourage the respective authorities there to stimulate their economies, but there is nothing that we can do about it directly ourselves.

It's perhaps less obvious that we cannot control the exchange rate. Many people think that we could weaken sterling against the euro quite simply by cutting our interest rate relative to the interest rate in the eurozone. But it's not as simple as that. The US has reduced its interest rate far more aggressively than the ECB over the past year or so, but the dollar is actually stronger against the euro than it was to begin with; and the same is true, to a lesser degree, of ourselves, here in the UK, with sterling also stronger against the euro (though weaker against the dollar) than it was a year ago.

So there was nothing much – as I say – that we could have done directly to affect the weakness of the global economy and the resulting weakness of external demand on the UK.

But what we were able to do – given that inflation was marginally below target – was to try to compensate for that external weakness by stimulating domestic demand here in the UK. The Bank sought to do this by cutting interest rates to buoy up consumer spending. And the Government has stepped up its own spending, which is helpful in the present international environment. Although we couldn't avoid an overall slowdown altogether we have managed to keep the UK economy as a whole moving forward despite the recession in the internationally-exposed sectors of manufacturing.

In fact overall GDP growth in the year to the fourth quarter of 2001, at 1.9%, was by some margin, the highest among the G7 countries, and the rate of UK unemployment is currently the lowest, on a comparable basis, in the G7. And interest rates are the lowest they've been in this country in a generation.

Of course we'd all have been much happier with better balanced growth. Stimulating domestic demand to offset the external weakness – the only option available to us – was very much a second best option, and not without its own risks, but it was better than doing nothing at all. That would have meant a much sharper slowdown, and probably recession, in the economy as a whole. And, given what was happening on the inflation front, it would have meant a quite unnecessary loss of overall output – and income and employment. In effect we took the view that unbalanced growth was better than no growth.

The question now, of course, is where do we go from here.

There have recently been encouraging, but tentative, signs that the worst of the global slowdown may now be behind us, and that the US and Eurozone economies are now beginning to bottom out and are likely to pick up as we go through this year, perhaps to around trend. And the euro, which has, as I say, been puzzlingly weak since soon after its introduction 3 years ago, still seems likely to strengthen eventually. As it becomes clearer that the international environment really is improving, and that external demand really is picking up, then we can look forward to better balanced and generally stronger growth in our own economy.

That will in due course mean that domestic demand growth – and consumer demand growth in particular – will need to moderate if we are to avoid a build up of inflationary pressure. But let me be quite clear – that's not a warning, still less is it a threat, as some more excitable commentators suggested earlier this year. It is – as I explained elsewhere recently – essentially a matter of arithmetic! It's quite possible, even quite likely, that the necessary moderation of consumer demand – and I emphasise the word moderation – will come about of its own accord, given the gradual increase in unemployment we are currently seeing, and the build up of household debt. And provided it does not happen too abruptly, that would be the best possible outcome. But if consumer spending were not to moderate of its own accord, we would, in the context of strengthening external demand, clearly need at some point to consider raising interest rates to bring that moderation about. I don't suggest that the timing of any such move is imminent – that would obviously depend upon the timing and the strength of the recovery abroad.

But for the time being, and whatever the precise numbers, the overall prospect for the British economy over the next couple of years is for output growth picking up to around trend and inflation to around target. And it was against that background that we left interest rates unchanged at our MPC meeting last week.

I gather that the EEF was "deeply disappointed" at that decision, having been hoping for a cut. And I really do understand why, seeing things from the perspective of the manufacturing sector in particular, you might take a somewhat more pessimistic view of the prospects than did the MPC. We are – as I have explained – well aware of the degree of uncertainty inherent in any forecast, and do not pretend we have a crystal ball. But I can assure you that if, as we move forward, it seems likely that the overall economy will be weaker than we currently expect, and inflation lower, then we are prepared to reduce interest rates further, just as we stand ready to raise them if the overall economy, and inflation, appear likely to be stronger than we currently anticipate.

Mr President, the past year or so has been a difficult time for the world economy which has made life increasingly difficult for the internationally-exposed sectors of our own economy – including large parts of manufacturing. And things could remain difficult for a time. But it won't last for ever. I am "cautiously optimistic" that the overseas environment will improve as we move through the year, and that by this time next year we here in the UK will have seen a return to somewhat stronger and better balanced growth, with unemployment not far above its recent lows, and with continuing low inflation. If that is indeed how things turn out, we will have weathered the international storm as well as anyone could reasonably have expected.

So it is in the hope – and indeed the expectation – of improving prospects for the internationally – exposed sectors of British manufacturing that I ask you all now to rise and to join me in a toast to the Engineering Employers Federation, and it's President, Mr Paul Lester.