Speech

Speech given by

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

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Mr President, My Lord Dean, my Lords, Ladies and Gentlemen,

May I begin, Mr President, by thanking you and the members of the Council for your great kindness in conferring the Honorary Fellowship of the Institute on me this evening. I very much appreciate the honour it represents – and it is indeed a great honour for a sassenach.

But even more than that, for me it symbolises the broader – and very longstanding – fellowship between the Bank of England and the banking community here in Scotland – a fellowship, and indeed a friendship, which I myself have so much enjoyed ever since I first began my regular visits here over 25 years ago. As I move towards my retirement this evening will serve as an enduring reminder of the warm personal and professional relationships – with the bankers in Scotland, including many of you here this evening – that I have been privileged to develop over that time. And I will wear your – in fact I can now say our – splendid new tartan with both pleasure and pride.

This is the fifth occasion in just the past eight years on which I've had the pleasure of giving this biennial report on the state of the UK economy to our Scottish stakeholders. On each previous occasion I have been able to report to you relatively steady growth of overall output, a continuing fall in unemployment and stable low inflation. But I've then gone on to discuss the risks and uncertainties ahead and to worry out loud as to whether or not we could keep it up. On each occasion I have concluded – usually somewhat tentatively – that we could. And indeed we have in the UK - as a whole, though I have to admit it was a close run thing last winter in the wake of the unexpectedly sharp economic slowdown that hit the whole of the industrial world from the beginning of 2001.

Despite that global economic shock – which produced near-simultaneous recession in the world's three largest economies, the US, Japan and Germany – we in the UK – at the overall, aggregate, level have now enjoyed continuous quarter by quarter growth at an annual average rate of 2¾% throughout the past 10 years. That is far and away the longest period of consecutive quarterly growth since quarterly estimates began nearly 50 years ago – and the annual average growth rate has remained somewhat above most estimates – at least until recently – of the longer term trend rate of some 2¼% - 2½%. The number of people in employment has recently reached an all-time high in the UK as a whole; and it is very close to its all-time high also here in Scotland. And the number of people claiming unemployment benefit is at a 27-year low both in the UK as a whole and, again, up here north of the border. Meanwhile retail price inflation – on the Government's target measure – has averaged 2.5% over the past 10 years. That is exactly in line with the present inflation target which recognises that consistently low inflation is a necessary – though not in itself a sufficient – condition for sustainable growth. And that of course is the universal central banker's mantra!

That's the good news. The bad news, of course, is that over the past two years the imbalance within our overall economy which I referred to when I last spoke to you – between the internationally-exposed sectors including much of manufacturing industry, and more recently some parts of the financial services industry, which have been under intense pressure, and the more domestically-oriented sectors, where I don't say things have been easy but where the pressures have been less severe – that imbalance has persisted, and indeed it has got worse. The grim fact is that there is nothing that we in the UK can do directly to address the global economic weakness which has been at the heart of our problem. In order to keep overall demand in the economy moving forward in the face of the slowdown overseas, which has depressed both financial sentiment and business investment in this country, as well as net external demand, we had no choice but to seek to buoy up the other elements of domestic demand. Without that we, too, would have seen negative growth in this country.

In terms of monetary policy that in effect meant cutting interest rates – to 4% - their lowest level for 40 years – in order to sustain the growth of consumer spending. And we were subsequently helped by the Chancellor's decision to increase public spending. That's something which, as a central banker, I'm supposed to frown upon – and it clearly is important for the stability and efficiency of the economy that it is kept within bounds over the medium and longer term in line with the Chancellor's Golden Rule. But I must confess to you that it is something that I positively welcomed in the immediate situation with which we were confronted. Without it we would have been even more dependent upon consumer demand than we have been.

In the event domestic consumption growth has continued to hold up pretty well; but it has done so – inevitably – on the back of a rapid build-up in household indebtedness, including mortgage debt, which in turn was associated with a sharp acceleration in the rate of increase in house prices – to some 25% on average across the UK over the past year. And that is something that, as we've been pointing out for some time, clearly can't be sustained for ever.

So that's the background against which I turn once again to the question of whether we can continue to maintain reasonably steady growth of output, with high levels of employment and continuing low inflation over the next two years or so.

Now there is no denying that we are – as we always are – faced with significant uncertainties and potential risks in the period ahead, even without the possibility of imminent war with Iraq.

The global economy may not pick up gradually – as we certainly hope that it will – and some real gloomsters still talk of the possibility of a double dip back into recession. Domestically the gloomsters talk of the risk of a sudden sharp fall in the rate of growth in consumer spending – often related to a "crash" in house prices generally. That's to say not just a sharp moderation in the rate of increase in house prices but a fall in their actual level generally. And the real pessimists argue that the longer the fall is delayed the more dramatic it will be. Now it is certainly true that if these risks were to materialise then we would indeed be hard pressed to keep the economy moving forward.

But such risks need to be kept in proper perspective. The question is – are these possible developments a necessary – or even the most likely – outcome? I don't think that they are.

It's entirely understandable – in the light of the global industrial slowdown and generally weak export markets, and after a third year in a row of sharply falling equity prices, that business and financial market confidence should remain subdued. And people seem sometimes surprised to be told that, on the macro-economic data, we passed the trough a year or more ago. The US economy, in particular, on which so much of the rest of the world depends actually expanded by just over 3% in the year to the third quarter of last year – which is well above its long-term annual average rate until the surge in the later 1990s. The Eurozone also grew – though only by around 1% over the same period, and there was even positive growth in Japan. Now that's not exactly a strong recovery after the slowdown, but it follows only a relatively mild recession.

More recent data certainly have been somewhat mixed – perhaps reflecting Alan Greenspan's predicted "soft-patch" through the winter; and we're in the shadow of uncertainty over Iraq. But, looking beyond that, the US economy is underpinned by its robust financial system, by continuing rapid underlying productivity growth, and by strongly supportive monetary and fiscal policies, so that most forecasters anticipate US growth of 2 ½ - 3% this year and somewhat more next. There's even been a better tone in equity and credit markets since mid-October, and some signs of a recovery in ICT investment.

On that basis – and notwithstanding the recent disappointing performance of the Eurozone – particularly the German – economy – that suggests a reasonable prospect of a continuing but relatively slow pick-up in the rate of growth in our major export markets. And we should also be helped by the recovery of the euro against both sterling and the dollar through the past year.

This moderately positive external environment should, looking forward, bring a gradual pick up in external demand and help to stabilise, and subsequently improve, the prospects for business investment in the UK. So the key question on the domestic front remains what is likely to happen to consumer demand: will it fall away abruptly – as some people fear – or will it moderate more gradually as others expect? The truth is that no-one can know the answer with any great confidence – those who claim to know with certainty are always the ones to be wary of in the forecasting business.

Those who look for a sharp downward adjustment typically point to the ratio of household debt to income, and to the ratio of house prices to earnings. They discount the relatively low debt-service to income ratio on the grounds that it could rise sharply if interest rates went up, and ask what might happen if unemployment were to start to rise sharply.

To my mind those arguments have a degree of circularity. The possibility of a sharp rise in unemployment depends substantially on a sharp slowdown in consumer spending rather than the other way round. Similarly a sharp rise in interest rates is less likely if consumer spending is slowing down. So it is not all obvious to me at least that the household sector will suddenly run for cover in the current environment, where the labour market remains remarkably robust, and the prospect for inflation – and hence the prospect for interest rates – remains relatively benign, remaining somewhat above target in the near term but moving down gradually as we move into next year.

I don't say that things could not turn out rather worse than that – and there are other uncertainties, like development of the exchange rate, or the effect of the upcoming increase in National Insurance Contributions, which I have not touched upon this evening. Uncertainty is a fact of economic life. But I do say that it would be unwise – as some have implied – to set monetary policy on the basis of the worst possible outcome, even if one knew what that would actually mean in policy terms.

At the time of our last Inflation Report published in November the MPC's collective view of the most likely outcome for the UK, looking over the next two years, was for growth at around trend with inflation close to target. But we were – and we remain – acutely conscious of the uncertainties and risks around that prospect. And we review the position intensively both at our regular monthly policy meetings and in the context of our quarterly forecasting round. And in that context, I give you my assurance that, despite the fact that we have not changed interest rates now for over a year, we stand ready to do so at any time if and when we see the risks to our central expectation beginning to crystallise in either direction.

Mr President, let me conclude by suggesting once again this year that yes, we can keep the UK economy moving forward, but I don't pretend that it will be easy. Sadly I am attending this dinner for the last time as Governor this evening, so I will not be accountable to you for how we get on. But I will leave the Bank of England in the good hands of my successor, Mervyn King, when I step down in June, and I have every confidence that he will, by the time of your next dinner, have a positive story to tell.