BANK OF ENGLAND

Speech

Speech given by

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

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Mr Chairman, my Lords, Ladies and Gentlemen,

I must confess that I was surprised when I discovered that it was seven years since I last spoke at this Finance and Leasing Association Annual Dinner.

I'm delighted to be with you here this evening.

On that earlier occasion – in 1996 – I emphasised the corrosive and debilitating effect of high and variable inflation that we had experienced in this country over much of the previous 50 years.

I stressed the damage that this had done to our economy – the pervasive uncertainty and unpredictability, and the short-termism that it induced, in personal and business as well as financial behaviour, the incentive to borrow and spend rather than save and invest, the masking of real price signals as the guide to efficient resource allocation, and the masking, too, of productive inefficiency that was too easily covered up by generally rising prices and earnings.

But I suggested that the tide had already then finally begun to turn. I drew attention to the growing constituency in support of stability in this country – as a necessary condition for sustainable growth – after our particularly bitter experience of boom and bust in the late 1980's and early 1990's.

I was able to point to the preceding four years – during which inflation had averaged just under 3¼%, compared with almost 10% over the previous 20 years. I was able, too, to point to sixteen consecutive quarters of positive economic growth. And I was able to point to a continuing, relatively steady fall in unemployment from its peak – in terms of the claimant count measure – of almost 10% in 1993.

Then I held out to you the prospect of continuing stability – with low inflation and sustained economic growth – as far ahead as I could see.

You didn't believe a word of it! You listened – very courteously, as I would expect from the members of your very professional association – but you listened with a good deal of scepticism, which, I confess, I could perfectly well understand. As I left that evening, one of your members said to me "I do hope you're right, Eddie, but we've heard it all before. We'll believe it when we see it!" I suspect he spoke for most of the rest of you.

Well, tonight I can tell you that inflation – on the Government's target measure – has averaged just 2.5% over the past 10 years. We have now had 42 consecutive quarters of positive economic growth – which is much the longest period of continuous growth since quarterly data became available in 1955. And unemployment has continued to decline fairly steadily to just over 3% - its lowest rate for more than a quarter of a century.

Now don't get me wrong. I'm not for a moment suggesting that we have finally reached the promised land. I'm very well aware that there are many people in this country – no doubt including many here tonight – for whom economic life is still pretty tough. My post bag never let's me forget that!

For most of the time since I last spoke to you we have in particular been confronted with a very difficult international economic and financial environment. This began with the Asia crisis. But it was followed a couple of years later by a sharp economic slowdown, into mild recession, in the major industrial countries. And that was accompanied by a sustained fall in global equity markets from their “irrationally exuberant” peaks – aggravated and protracted by the threat of terrorism following 9/11 and by corporate governance and accounting failures in the United States. Most recently, of course, uncertainty surrounding the possibility of war with Iraq has weighed heavily on sentiment.

All of this, together with the persistent weakness – until relatively recently – of the euro exchange rate, has made conditions intensely difficult for internationally-exposed business in the UK, including much of the manufacturing sector; and that, in turn, has been reflected not just in weak net external demand but also in declining business investment in this country and elsewhere in the industrial world.

It’s made life pretty difficult, too, I have to say for those of us involved in macro-economic management!

Macro-economic policy – that’s to say monetary policy and overall fiscal policy taken together – operates, directly, on the demand side of the economy, aiming essentially to keep aggregate – external and domestic – demand growing broadly in line with the underlying supply-side capacity of the economy to meet that demand. Stable, low, inflation is in fact essentially a measure of how far we are successful in that.

There has been very little, quite frankly, that either we at the Bank, through monetary policy, or the Chancellor could do to influence the international environment. The problems originated abroad and we could not avoid their effects. What we could do – and what we have tried to do – was to seek to offset those effects, and compensate for the external weakness, by stimulating domestic demand here in the UK. Given weak business confidence, that meant essentially, in the case of monetary policy, encouraging the growth of consumer demand – by cutting interest rates to their lowest level in 40 years.

In the event we managed – just about – to avoid recession over the winter of 2001/2002 but we did so but at the cost of growing imbalances within the economy between domestic and external demand on the one hand and, domestically, between consumption and investment on the other. Essentially we took the view that unbalanced growth was better than no growth at all – which was the only other option we had.

This “two speed” economy has, I know, been reflected in the pattern of your own activity as FLA members, with consumer finance volumes growing strongly in recent years where business volumes have been relatively flat. In the past year alone new business written to consumers was nearly three times that written to business customers.

Now clearly the imbalances can’t go on increasingly indefinitely. The build-up of household debt and the related strong rise in house prices we saw last year in particular must begin to moderate at some point. So much of the recent debate has been about whether the eventual adjustment will occur gradually, within the context of continuing overall expansion, or more abruptly in which case the overall expansion could prove more difficult to sustain.

On the macro-economic data it seems clear that the global economy in fact bottomed out around a year or so ago, and that we have since seen the beginnings of a recovery, notably in the US, on which so much of the rest of the world currently depends. And it is also clear that monetary policy generally – and in some countries also fiscal policy – remains supportive. On that view, and given the recent moderate decline in sterling's effective exchange rate, it is reasonable to look forward to a gradual improvement – and I emphasise gradual improvement – in the external environment which would clearly be very helpful from a UK perspective.

I don't deny that there are downside risks to this scenario. The Eurozone has for example recently put back its projected expansion until later this year. And financial markets, and both business and consumer sentiment, have recently been severely affected by uncertainty over Iraq – though financial markets, certainly, now that the war has started, have factored in its rapid conclusion. I hope they prove to be right – for more than purely economic reasons.

Notwithstanding these risks, I still think that the most likely outcome is that we will see a gradual pick-up in the pace of global recovery over the next year or two – which is the view shared by the Monetary Policy Committee in our February Inflation Report and by most other economic commentators.

On that basis we would also expect to see a gradual recovery in domestic business investment as we go through this year and into next. And, while fiscal prudence is clearly important for the stability and efficiency of the economy over the medium term, the Chancellor's projected increase in public spending is in my view positively welcome in the immediate situation confronting us. Taken together, these developments should accommodate the moderation in the rate of growth of consumer spending, which we anticipate and may now be beginning to see.

In the meantime we have seen a rise in the rate of inflation – to 3% on the target measure – driven notably by last year's sharp rise in house prices and by the rise in the oil price in the run up to the invasion of Iraq. And it may well rise somewhat further, for example, as a result of the prospective rise in Council Tax and the somewhat weaker exchange rate. But most of these influences at this stage seem likely to be largely one-off effects on the level of retail prices, rather than persistent influences on the rate of inflation. There is no significant evidence at this point of continuing, second-round, effects, for example in the labour market, so that inflation seems likely to fall back to the 2½% target rate in the course of next year.

On this basis – and although the MPC will of course be monitoring the inflation prospect very carefully – we concluded at our most recent meeting that policy should remain on hold.

Mr Chairman, you can see that I meant it when I said earlier that we haven't yet reached the promised land! We have in fact been going through a difficult patch, and we remain heavily dependent upon developments abroad which are beyond our control. Certainly we face risks and uncertainties in the short term. But it is important that we don't exaggerate those risks and allow them to cloud our judgement. The more likely outcome in my view – looking ahead over the next couple of years – and reflected in the Inflation Report – is for inflation close to target with growth close to trend – and with the imbalances within the economy beginning to adjust.

In any event I am totally confident that Mervyn King, my successor from July, with his Deputies, Andrew Large and Rachel Lomax, and with the MPC, will be ready to adjust policy in either direction as the prospect changes, and that they will be as totally committed as I have been to maintaining stability and hitting the Government's inflation target, as a necessary condition for sustainable growth. That will provide the best possible context for the continued development of your business, and the important contribution that you make to the economy.

I, myself, of course, will be looking for a new lease of life in retirement! I'm not aware that it's a lease product any of you actually provide. Given our ageing population perhaps you should develop one – though you'd better be careful how you market it! In any event I wish you well.

ENDS