

## **Mr George discusses national and regional economic prospects in the light of the external environment**

Speech given by Mr E A J George, Governor of the Bank of England, to the Northern Ireland Chamber of Commerce & Industry and Prince's Trust on 26 January 2000.

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Mr President, Ladies and Gentlemen,

It seems only a very short time ago that I last had the pleasure of visiting Northern Ireland - in fact it was in May 1998. Time flies when the world about us is changing fast as it certainly has been in so many respects in the intervening period.

Let me start with the world economy. We were already then in the grip of the financial shock that had started in emerging markets in Asia in 1997. But that shock intensified through 1998 - spreading to Russia and parts of Latin America and elsewhere - and at one point, following the collapse of the US hedge fund LTCM, threatening to engulf the financial system of the industrial world.

The economic consequence of this financial turmoil was a sharp slowdown in the world economy to around half its longer-term trend rate of growth. It could have been far worse. The slowdown could have turned into an actual downturn had the industrial countries - led by the United States and the United Kingdom and closely followed by the Eurozone and Japan - not succeeded in stimulating their own, domestic, demand. In the event, the damage was contained, and world economic activity is now recovering far more quickly than anyone could have expected. But, encouraging though it is, the recovery is taking place in a context of large external imbalances within the world economy and large imbalances between strong domestic and weak external demand in a number of industrial countries - most notably in the US and here in the UK. The challenge now for the major industrial countries - as we discussed at the G7 meeting last weekend in Tokyo - is to secure a more balanced pattern of growth among our economies in order to help sustain the global expansion.

This chain of international events has also had a major impact on the pattern of exchange rates. Many emerging countries and some transition economies saw their exchange rates fall dramatically; but there were also important effects on the relationships between the currencies of the major industrial countries. The dollar and sterling have in fact remained reasonably stable against each other for most of the time since sterling withdrew from the ERM. The yen, which had been notably weak on the Japanese recession, has since picked up strongly as the prospect of recovery in Japan improved. But the most puzzling development in the exchange markets has been the disappointing weakening of the euro since its historic introduction at the beginning of last year. Initially this appeared to be related to the impact of the global slowdown on some of the larger Eurozone economies, which seemed likely to cause them to run further below capacity than had earlier been expected. But the more recent signs are that the Eurozone economy is now picking up relatively strongly, and it is harder to understand the euro's continuing weakness in the present context: it may just be a matter of time - for there is no doubt that the euro has considerable scope for appreciation.

Taken together, Mr President, these various international developments since I was last here in Belfast have greatly complicated the task of monetary management here in the UK - in fact it has been just about the most difficult external environment that I can recall.

At that time monetary policy was still aimed at moderating the pace of domestic demand growth to prevent the re-emergence of inflationary pressure - including wage pressures in the labour market. We actually raised rates by ¼% to 7½% shortly after my visit - but I promise you that was not a direct result of my visit here.

But we reversed engines fairly aggressively when evidence of the effect of global slowdown on our own economy began to appear in the autumn - cutting interest rates from 7½% to 5% between October 1998 and last summer. You might have supposed that this would have weakened the exchange rate,

shielding us in some degree from weakening external demand growth - but not a bit of it - the exchange rate actually strengthened! But the easing of monetary policy may have helped to reverse the sharp fall in domestic confidence evident throughout the UK economy in the second half of 1998, and to avert the widely predicted slide into recession. In any event, after coming to a virtual stand-still in the fourth quarter of 1998, the economy as a whole bounced back last year, driven largely by domestic demand growth. And, for the economy as a whole, we can now, since 1992, point to the longest period of sustained low inflation - averaging 2.7% on the Government's target measure, with relatively steady annual growth averaging 2.8% - well above most estimates of our long-term trend rate, together with a sustained rise in the number of people in employment - to an all-time high and an almost continuous month-by-month fall in the rate of unemployment to the lowest rate for about 20 years.

But if the performance of the economy as a whole has been relatively encouraging over this period, that is clearly not the case for every sector of the economy. And I am only too well aware that the internationally-exposed sectors - most of agriculture, much of manufacturing industry and some services sectors - wherever they are located within the UK, have suffered. In many instances, depending on the particular international profile of the business, they are continuing to suffer, as a result of the global economic developments that I have already described. The resulting agony continues in many cases notwithstanding the present pick-up in world demand, and is particularly acute for those businesses and sectors most exposed to the continuing weakness of the euro. They no doubt include some of your own businesses.

I realise that to say that I sympathise with those of you in this situation - and I really do sympathise with you - is scant consolation. But I want to assure you that we do not ignore the exchange rate in either our inflation forecasts or in our monetary policy judgements. The strong exchange rate in itself has both a direct dampening effect on our domestic price level and an indirect effect through lowering net external demand - and both of these effects we take into account as best we can. Absent those effects of the strong exchange rate - other things equal - policy would have needed to be correspondingly tighter. But while we do - and will continue to - try to make full allowance for the strength of the exchange rate there are limits to just how far we can sensibly go. The really hard question for us is could we - or should we - attempt to protect those businesses most affected by the strong exchange rate even if that meant putting the economy as a whole at significant risk of rising inflation. The reality is that, were we to do so - notwithstanding our specific mandate from the Government - we would not succeed in protecting even the suffering sectors except possibly in the very short term; and in the medium to long term our overall economic performance - in terms of growth and employment would - on all past experience - almost certainly be worse.

As it is, Mr President, the recovery in the world economy, and the extraordinary efforts of UK businesses themselves to cope with the hostile international environment, are already resulting in a stronger net external trade performance. That in turn is contributing to the recovery in our own economy, particularly in manufacturing output growth, and to the more encouraging news in recent surveys. To the extent that this improvement in external demand persists, it will help to ease the exceptional pressures on the most internationally-exposed sectors, and contribute to a better balance within the UK economy. But it needs, of course, to be accompanied by corresponding moderation of the growth of domestic demand - after the offsetting stimulus of a year ago - if we are to maintain overall stability. That essentially is why interest rates have had to rise since last autumn.

The broad prospect now for the UK economy as a whole over the next couple of years, which is the extent of our forecasting horizon, is one of continuing relatively strong growth, with continuing relatively high employment and continuing relatively low inflation. The monetary policy debate is a narrow one: it is about just how strong the growth, just how high the employment and just how low the rate of inflation. It is as good a prospect for the economy as a whole as we have known for some time.

And much the same is true of the overall economy here in Northern Ireland. You know better than I do. But from the data, you, too, have enjoyed a sustained period of relatively steady growth - in fact you largely avoided the recession that hit the rest of the UK at the beginning of the 1990s. The number of people in employment here too is at its all-time high. And unemployment is at a 25-year low. As far as I can tell - from the Northern Ireland Economic Research Centre forecast of last autumn and from

the regional CBI's recent business confidence survey - that progress looks set to continue; indeed you may well out-perform the UK economy as a whole.

That is an encouraging macro-economic background to the challenges facing Northern Ireland's new Executive and Assembly. Huge progress has been made towards implementation of the Good Friday agreement since I was last here in Belfast - the Referendum, the elections and the introduction of devolved government. It is an immense tribute to the extraordinary efforts of the many people involved in keeping an inevitably difficult process on track. The economic prize of permanent peace and political stability is potentially very substantial. It will make Northern Ireland more attractive as a place in which to invest and in which to live and work; it will make it more attractive, too, as a place to visit. And devolved government will allow the fundamental supply-side issues, which are what determine the underlying sustainable growth rate of the economy, to be addressed within the local community. That process has already begun with the report last year of the Economic Development Strategy Review Steering Group - Strategy 2010. And, I agree with their conclusion - that if you play to your considerable strengths and tackle the structural weaknesses which they identify, then Northern Ireland can have a prosperous future.

We all have a part to play in this. The Bank of England's primary role is to help to maintain the stable macro-economic environment - in the interests of the UK economy as a whole but in the interests also of Northern Ireland. The specific purpose of my present visit is in fact to open, officially, our Northern Ireland Agency, which is a direct result of my earlier visit. This completes our network of 12 regional agencies across the UK - with the purpose of keeping ourselves more closely informed of regional economic developments. Previously Neil Kemsley covered Northern Ireland from our Agency in Liverpool and is here to make his farewell - and I am grateful to him for all that he did in reporting on developments here. But Nigel Falls - one of our most experienced regional Agents - is now established here in Belfast itself. He is also with us today. I very much hope that many of you will establish regular contact with him so that he can inform our Monetary Policy Committee each month of the particular problems that exist in Northern Ireland, so that we can take them into account in our monetary policy process. His reports will complement those which Roy Bailie, our Non-Executive Director here in Ireland, gives regularly to our Court of Directors.

In our monetary policy role the Bank operates essentially on the demand side of the economy - aiming to keep aggregate demand in line with the supply-side capacity of the economy to meet that demand. But we can also contribute directly on the supply side, by helping to ensure that the financial system properly supports the needs of the wider economy. We have in fact for some years now been working with the banks and small business representative organisations at the national level, seeking to restore the relationships between the small business sector and its main finance providers - which came under severe strain during the recession in the early 1990s. I believe that we have made substantial progress in that - though we continue to monitor the position - and I hope that Nigel will play a role in this process here at the local level. We are now turning our attention to the provision of finance in more specific areas - to ethnic minority businesses, for example, and to businesses that have hitherto been financially excluded. It is in this latter area that the Bank has been strongly supportive of the Prince's Trust - and particularly of the Prince's Youth Business Trust, with its aim of "helping young people who would not otherwise have the opportunity to develop self-confidence, fulfil their ambitions and contribute to the community through the medium of self-employment". I am delighted that the Prince's Trust have joined with the Chamber in organising today's lunch. We all - as I say - have a part to play and the Prince's Youth Business Trust fills an important gap.

Mr President, as I said at the outset, a great deal has happened in a very short time since I was last here - in the world economy, in the UK economy, and here in Northern Ireland, both economically and politically. It has been in many respects a particularly testing time, but we have I believe come through it all quite successfully and are now well placed to continue moving ahead. It will require sustained commitment from all of us - but the people of Northern Ireland have never been lacking in commitment!

I wish you every possible success.