The Rt Hon Sir Edward George: The economic prospect

Speech by The Rt Hon Sir Edward George, Governor of the Bank of England, at the JiJi Press London Top Seminar, London, 30 May 2001.

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Mr Chairman, I am delighted to join you today for this Jiji Top Seminar and to have this opportunity to meet with so many senior representatives of the Japanese business – and financial–community here in the UK.

I have chosen to speak in my opening remarks on "The Economic Prospect", which today more than ever means the international economic prospect. But before I come to the immediate situation, let me say just a few words about what it is that we are all trying to achieve through our overall approach to economic management, which can perhaps best be summed up as "macro-economic stability and supply-side flexibility" – though that characterisation needs elaboration.

On the macro-economic side we have learned – and it has taken some countries longer than others – that you cannot achieve what we are all trying to achieve – sustained growth, high levels of employment and rising living standards – simply by pumping up demand in our economies through expansionary monetary and fiscal policies without proper regard to the underlying supply-side capacity of our economies to meet that demand. Short-term demand management through monetary policy too often led instead to accelerating inflation, and increasing external deficits, which had then eventually to be brought under control through recession – an absolute recipe for short-termism in both financial and business behaviour. Equally, excessive public expenditure – which had ultimately to be financed through higher taxation – imposed burdens on the private sector which weakened its capacity to generate employment and income and wealth.

So the emphasis now, throughout the industrial world but increasingly too in the developing, emerging and transition economies, is on effective price stability as the immediate objective of macro-economic policy – not simply as an end in itself but as a measure of the balance between aggregate demand and underlying supply in the economy as a whole. In effect the aim of monetary policy in particular is to moderate, rather than aggravate, the economic cycle, and so to provide the basis for sustainable growth at around the underlying rate of growth of productive, supply-side, potential. And the emphasis now in relation to fiscal policy is to limit public sector borrowing, and the outstanding level of public sector debt, to levels that can be sustained into the medium and longer term without the need for increasing tax burdens or the imposition of rising real interest rates on the private sector.

Of course on occasion the flesh proves to be weaker than the spirit – and achieving these macro-economic objectives is not easy in practice even as a technical matter. But the intention – the international commitment to macro-economic stability – is clear.

Acceptance of the aim of macro-economic stability served to bring into sharper focus the structural, supply side, of the economy – that is the whole raft of influences that can affect the underlying growth rate of capacity and thus the growth rate of aggregate demand that can be sustained.

And here, too, there has been a strengthening international presumption in favour of open markets and free competition – both domestically and internationally – with a continuing strong presumption against predatory trade or exchange rate manipulation. The justification is that undistorted competition contributes to potential global economic growth through increased efficiency and the more effective allocation of productive resources. Faster growth in turn provides a more favourable context for addressing social concerns, including the issue of poverty.

The international presumption in favour of free markets in itself is somewhat remarkable, given that, at the micro-economic level, increased competition invariably constitutes a threat to established producers – and their employees – who might well be tempted to urge protection in one form or another on their national governments. Consumers, who benefit from such competition, tend to be less vocal or well organised. The threat of protectionism is never, therefore, far away. But in fact the presumption in favour of competition has proved encouragingly robust. And that is not just in relation to international trade. There is a parallel presumption in favour of freedom of capital movements, and much greater openness around the world to foreign investment.

Among other things on the supply-side, there is a shared emphasis on the need to direct public spending to developing human resources through education and training, to effective health care, and affordable social safety nets. There has been a global trend to privatisation through which governments have increasingly returned essentially commercial activities, in which they have no necessary comparative advantage, to market disciplines. And there is a common recognition of the need for reforms in labour and product markets designed to remove unnecessary regulation, and to reduce distortions, which impede the efficient allocation of resources.

But broad agreement on the principles, does not make them any easier to apply in practice. This is evident from the imbalances which have built up within and between the major industrial countries in recent years. It is uncertainty as to how those imbalances are likely to be corrected that underlies much of the current concern about the prospects for the global economy.

The major uncertainty relates to the situation in the United States which has experienced a period of exceptionally strong economic growth with relatively low inflation until quite recently. Briefly – and no doubt oversimply – this very strong performance is widely seen as driven largely by exceptional productivity gains, as the application of new information and communications technologies spread through the economy. This development promised a higher sustainable rate of growth in the US economy and higher corporate earnings growth. That expectation contributed to a rapid rise in equity prices, especially in the "high tech" sectors, which in turn helped stimulate both business investment in the US and consumer demand causing the private sector to move into financial deficit. It also attracted massive direct and portfolio investment inflows from abroad which over-financed an increasing current account deficit in the US and caused the dollar to strengthen against other currencies. By the first half of last year the US economy was expanding at a rate of over 5%, which even on the most optimistic view of underlying productivity growth was clearly unsustainable. The pace of demand growth in the US needed to slowdown – as of course it has.

The big questions now are about the extent of the slowdown and how long it will last. And the reality is that no one can be confident that they know the answers.

What we do know is that the US data on the whole have not so far been as weak as many commentators predicted. Consumer spending in particular has held up reasonably well, though there has been a fall-off in investment growth, as well as a sharp downwards stocks adjustment and an associated decline in US imports. On an optimistic view, if consumption continues to hold up, and assuming that the recent underlying productivity gains can be maintained, investment spending will recover as the spread of ICT through the economy resumes, and the downward stock adjustment will come to an end.

On this view we can look forward to a pick up in US activity as we move, say, into next year. But the pessimist is inclined to point to the weakness of private sector saving, which could induce more cautious consumer behaviour especially if unemployment continues to rise; he points to a possible overhang of past investment excesses; and he points to the US external deficit which will at some point need to be corrected. These adjustments might take place gradually over time, in which case the US might face a more protracted period of relatively slow growth; or, if you are really pessimistic, the adjustments might be more abrupt implying a possible period of negative growth and global financial instability. The recent somewhat erratic recovery of US stock markets from their earlier gloom suggests that they are beginning to side with the optimists; some of the survey evidence of consumer and business confidence on the other hand still supports a rather more pessimistic view. For what it is worth, and given the strong policy response in the US, I am modestly optimistic, but I recognise the downside risks. The outcome is obviously the major uncertainty surrounding the global economic prospect, and policymakers elsewhere can only monitor, continuously and very closely, the emerging evidence and react to that in the light of its likely impact on their own situation.

The US slowdown comes at a particularly bad time for Japan which is already suffering from a combination of weak domestic demand – particularly consumer demand – and supply-side constraints reflecting pressures on the banking system, heavily burdened with non-performing loans, and an acknowledged need for restructuring parts of the non-financial sector. Japan has pretty well exhausted the scope for macro-economic stimulus. Successive fiscal packages focussed on public works, and a sustained period of attempted monetary expansion, at near-zero interest rates in the face of deflation, have failed to overcome a high rate of precautionary saving by an ageing population facing an uncertain economic future. The policy emphasis of the new Japanese administration appears to be shifting towards firmer action to bring about supply-side reform in the belief that this will help to engender greater confidence. The danger is that, to the extent that more aggressive restructuring

results in bank ruptcies and higher unemployment in the short term, that in itself might tend to weaken consumer demand for a time before the benefits of the restructuring come through. I make no judgement about the prospects in Japan. You certainly are better placed to do that than I am!

Closer to home in this country, the Euro area economy is a good deal better placed to withstand the US slowdown, although we are all bound to be affected to some degree. For most of last year the Euro area economy performed relatively strongly, with overall output growth well above trend, and unemployment in the area as a whole continuing to fall from its earlier chronically high level.

A problem, of course, was the persistent weakness of the Euro in foreign exchange markets, despite strong "fundamentals" in terms of conventional analysis. This was largely the result of an outflow of capital, much of it drawn into the US by the magnetic attraction of prospective corporate earnings growth – and apparently continuing despite the US slowdown.

The euro's weakness gave rise to widespread – but in my view unjustified – criticism of the ECB. The task of a central bank operating an independent monetary policy is necessarily a limited task, not least because it effectively has only one instrument – its control over short-term interest rates. Its role – as I said earlier – is essentially, to use that instrument to influence aggregate demand in the economy, with the aim of keeping demand broadly in line with the supply-side capacity of the economy. The measure of its success is consistently low inflation. Against that criterion the ECB has been relatively successful. The Euro area economy has grown, above trend, with core inflation nevertheless remaining within the tolerance range of 0-2%, even though on the headline measure, influenced by rising oil prices and the weaker exchange rate, inflation has for the time being moved above the top of that range. The ECB would have put that internal stability of the Euro area as a who le at risk if it had attempted at the same time to use monetary policy to target the euro's exchange rate, which is what implicitly many of its critics were effectively suggesting that it should do.

The more recent criticism has been that the ECB has been slow to respond to the weakening of the US economy. Implicit in that criticism is no doubt a judgement about the extent and duration of the US slowdown and its likely impact on the euro area. As I have said there is a great deal of uncertainty about that.

But the ECB has to take account, too, of domestic demand pressures in the euro area, and of the fact that even on the core measure Euro area inflation has been moving up gradually towards the top of the ECB's 0-2% range. Frankly I don't see how anyone can be confident whether the ECB has it precisely right or wrong – it is perfectly normal for even the best-informed people to disagree on these judgements, as anyone who reads our own Monetary Policy Committee meeting minutes will tell you. But, as it showed just recently in making a modest reduction in interest rates, the ECB is sensitive to changes in the balance of risks around those judgements.

So, too, are we in the United Kingdom. In our case we have been fortunate, since being driven out of the ERM in 1992 and moving to a symmetrical inflation target, in enjoying a sustained period of relatively stable economic growth. In fact we've experienced the longest period of continuous quarter by quarter growth since quarterly records began, with average annual growth at around 3% over the whole period compared with our long term trend rate of 2¼-2½%. Employment has steadily increased, and unemployment has fallen to its lowest level for 25 years. Meanwhile the rate of inflation has been consistently relatively close either side of the Government's 2½% target – the lowest and most stable rate of inflation that most of us in this country can remember. Domestic demand growth in the UK has remained relatively robust into this year, but we too are affected by the US slowdown and by the associated weakening of equity prices. And we have had a new problem of our own in the form of Foot and Mouth Disease, the effects of which have gone a good deal wider than just the agricultural sector. These new developments were likely to have a dampening effect on overall demand pressure within the economy, both through their direct impact and through possible damaging effects on confidence. Given the fact that we started from a position in which inflation was below target (and expected to remain so for some period ahead); and given only modest upward pressure – at least so far – on wages and earnings growth, despite the continuing tightness in the labour market; we have judged, on the information so far available to us, that we needed to reduce interest rates by ¾% in order to cushion the impact of the global slowdown and meet the inflation target further ahead.

Of course I am well aware that a stable overall macro-economy does not – and cannot – mean equally stable economic conditions for every individual sector or individual business. A particular complication over the past few years has been the surprisingly persistent strength of sterling's exchange rate against the euro, itself a reflection of the puzzling more general weakness of the European currency. This has contributed to an uncomfortable imbalance within the UK economy primarily between the

euro-exposed sectors, which have been under consistent pressure, and the domestically-oriented sectors, which have by and large been doing relatively well. Understandably the suffering sectors and businesses – and I know that they include some Japanese companies operating in this country – tend to complain that monetary policy takes too little account of their position, often pointing out that inflation has for the past two years fallen somewhat below the target. The implication is that monetary policy has been tighter – interest rates have been higher – than was necessary, which, they say, in turn at least helps to explain the behaviour of the exchange rate.

I have genuine sympathy with their concerns, and I very much admire the huge efforts that many of the adversely affected businesses have made to overcome the disadvantage coming from the strong exchange rate. If it's any comfort, I can assure you, that the resulting imbalance within the economy has been a persistent pre-occupation also for us on the MPC.

We necessarily, of course, take account of the exchange rate in trying to predict the future course of the economy. Its strength against the euro has been a factor which has dampened both external demand and the rate of inflation, so that interest rates have certainly been lower than they would have been if the exchange rate had been weaker. It is nevertheless true that, in common with most other analysts, we have not fully anticipated the persistence of euro weakness.

We don't of course have a crystal ball – but even if we had, it is important to recognise that the link between relative interest rates and exchange rates is much more complicated – and indeed more unpredictable – than is often suggested. Our own exchange rate against the euro today, for example, is stronger than it was before our reductions in interest rates this year; and the dollar, too, is substantially stronger against the euro than it was before the much larger cuts in US interest rates. So, in setting interest rates, we can – and do – make allowance in our projections for what has happened, and, on a best guess, for what is likely to happen, to the exchange rate, and that may cause the exchange rate to soften or it may cause domestic demand growth to strengthen, thereby offsetting the exchange rate's dampening effect on the economy. But what we cannot do – any more than the ECB – is to target the exchange rate, without putting the stability of the economy as a whole at risk of re-emerging inflation. That would not be in the interests even of the internationally-exposed sectors of the economy except possibly in the short term. They operate in the same labour market as more domestically-oriented businesses; and what matters to them is the real, rather than the nominal exchange rate, and it is not at all clear how that would be affected.

Mr Chairman, given the uncertainties, I am reluctant to speculate as to how, precisely, the present imbalances within and between the major industrial economies will work themselves out, as they necessarily will over time. But, notwithstanding the current difficulties, I am convinced that the best prospect for a relatively happy ending is for all of us to persist in our attempts to achieve the macro-economic stability and supply-side flexibility which I identified as our common goal at the outset of my remarks.

I am very happy now to take your questions.