The Rt Hon Sir Edward George: Global economic recovery - where to from here?

Speech by The Rt Hon Sir Edward George, Governor of the Bank of England, at the Lord Mayor's Banquet for Bankers and Merchants of the City of London, Mansion House, 26 June 2002.

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My Lord Mayor, Mr Chancellor, my Lords, Aldermen, Mr Recorder, Sheriffs, Ladies and Gentlemen.

On this great annual occasion last year I spoke about the problems that confronted us in keeping the UK economy on course in the face of the cold winds blowing from abroad. I drew attention to the risk that in seeking to avoid being sucked down into the Charybdis of adverse external influences, by lowering interest rates in this country, we could find ourselves thrown onto the Scylla of excessive domestic exuberance.

In the event, the cruel terrorist attacks on New York and Washington on September 11th - had a damaging short term impact on economic conditions everywhere. We were drawn irresistibly towards Charybdis despite the resilience of domestic consumer demand, which we sought to sustain by steering towards Scylla, with further reductions in interest rates. The economy as a whole became becalmed over the winter.

That of course, was disappointing after 37 successive quarters of relatively steady growth. But the economy as a whole still managed to grow in the year to the first quarter - by 1% on the present data - which was somewhat faster than in a number of other G7 countries. The labour market held up well, with the number of people in employment (on the LFS measure) rising by 184,000 in the year to April, to an all-time high; and while the number of unemployed people on the same measure rose somewhat over the year, it fell on the claimant count basis, to 945,000 in May, a 26 year low. And inflation, though rather more volatile from month to month, averaged 2.2% over the past year very close to our 2½% target, although it fell to 1.8% in May. For only the third time in the past nine years the rate of growth in the year to the first quarter fell below the rate of inflation.

So we have much to be thankful for, despite the hostile external environment we have had to contend with. We can also be grateful that the difficult international environment has not seriously undermined the stability of the global financial system - though that's another story.

The key question now is where are we going from here.

Well, the relatively good news is that the external economic storms seem to be beginning to abate.

The US in particular, which experienced negative growth in the middle of last year, saw a surprisingly strong recovery on the back of a reversal of falling stocks, over the winter; and while this may not have continued on the same scale through the spring, consumer spending has remained encouragingly resilient. The uncertainty looking forward relates primarily to the prospects for a recovery of investment spending as we move into the second half of the year. Most economic analysts - including ourselves in the Bank - are reasonably optimistic, pointing in particular to the continuing underlying strength of US productivity growth despite the economic slowdown and evidence that demand for computer hardware has picked up. The consensus economic forecast is for overall growth in the US - perhaps after something of a lull in the second quarter - to pick up steadily to around trend - to 3% or perhaps somewhat more - through the second half of the year into next. But it has to be said that many US businesses themselves seem less convinced about future earnings prospects; and financial markets, too, remain uncertain, notably about equity valuations - partly as a result of the recent spate of corporate governance and accounting failures.

The outcome in the US, of course, is fundamentally important to the prospects elsewhere. But on the reasonably optimistic consensus view for the US, the outlook is for recovery to around trend growth in the eurozone and for modest positive growth even in Japan. And there are encouraging signs of stronger growth elsewhere in Asia - though parts of South America have problems of their own.

If global economic recovery seems likely to provide a more hospitable international environment for our own economy, so, too, do recent developments in foreign exchange markets. Last year I pointed out that sterling's exchange rate was at a 15 year low against the dollar, but close to its peak against the euro. In overall terms sterling's effective Exchange Rate Index against currencies generally had been relatively stable - at around 105 plus or minus 5% - for most of the past 2-3 years. That pattern of exchange rates made life particularly difficult for the euro-exposed sectors or our economy, and, given that the eurozone represents over 50% of our external trade, contributed significantly to the imbalance within our economy.

Happily, from our point of view, and indeed in the context of the global external imbalance, we have recently seen a significant strengthening of the euro against the dollar, and to a lesser extent against sterling, which will help to ease some of the earlier tensions. Sterling's exchange rate has recently moved to two year high against the dollar and nearly a three year low against the euro. Sterling has consequently also weakened in overall, effective, terms, from some 107 some months ago to currently around 103 - which is still within the earlier range.

It is frankly anyone's guess whether the recent pattern of exchange rate movements will be extended, but what has happened so far, taken together with the improved prospect for global demand, suggests that the adverse external factors weighing down the UK economy over the past two years or so should now diminish. That offers the prospect of both stronger and more balanced demand and overall output growth. Indeed we are already seeing - in surveys but also now in actual data for the past month or so - increasing signs of a recovery in overall output growth, including a recovery in the manufacturing sector which was the most hard hit by the global environment last year.

But our policy dilemma has not simply gone away. In fact trying to weigh up the prospects for the various different components of demand in order to decide what we need to do with interest rates to keep overall, aggregate, demand growing broadly in line with the underlying, supply-side, capacity of the economy to meet that demand, is a perpetual dilemma.

In the present context what that means is that, in order to accommodate the expected improvement in external demand, we are likely to need a moderation in the recent strength of domestic demand growth - particularly the consumer spending growth which has sustained the overall economy through the period of global weakness - if we are to avoid a build-up of inflationary pressure further ahead.

The necessary moderation of consumer demand growth could come about of its own accord, if, for example, consumers become more reluctant to take on additional debt. It is perhaps not surprising that as they have become more acclimatised to a low inflation/low nominal interest rate environment, households have been prepared to incur more debt relative to incomes, and the debt to income ratio has indeed risen to an all-time high over recent years. But that adjustment cannot go on indefinitely and will at some point come to an end.

In the meantime many commentators have recently focussed on accelerating house price inflation - which is closely related to the build-up of debt - as worrying evidence of a bubble that will eventually burst. And we, on the MPC, agree that the current rate of house price increases is unsustainable, although it is less obvious that that necessarily applies also to the present level of house prices, though of course it may. In any event, while, of course, we pay close attention to what is happening to house prices, as we do to other asset prices, our principal concern, in this part of the equation, is with consumer demand as a whole - and that depends on a range of other factors, not just on house prices.

What is clear is that if external demand does improve as we expect, and if consumer demand growth does not moderate to accommodate it, then we will need at some point to raise interest rates to bring that moderation about. It is important that both borrowers and lenders should understand and take account of that possibility in their decision-making. But you will note the qualifications. It is not a threat - if anything it is a promise. It's what our mandate from the Chancellor requires us to do for the very good reason that low, stable, inflation is both a necessary condition for and a reflection of overall macro-economic stability over the medium and longer term, which is clearly what we all want to see.

Given the qualifications, it is not a promise on which we will necessarily deliver immediately. We start from a position in which inflation is somewhat below our symmetrical target, and there is little evidence at this point of significant inflationary pressure; wage pressures, in particular, remain relatively benign - despite the robust labour market - and it is crucial that that should continue. That gives us a certain amount of time to assess the unfolding evidence on the evolution of both the external situation and the strength of overall domestic demand, though one can legitimately debate just how much risk we can afford to take by waiting. But if and when we do decide to act, you should see that as a sign of the strength of the economy rather than as evidence of weakness. Indeed my message to you this evening is that, after a difficult passage over the past twelve months, we can reasonably now look forward to more favourable offshore winds in the period ahead, opening the way to somewhat stronger and better balanced overall output growth, but with inflation remaining close to target. Few things are certain in life - the distance between Scylla and Charybdis has not widened, but it is a more comforting prospect than I was able to offer you last year.

My Lord Mayor, I'm not sure how much comfort that message will bring to the Merchants and Bankers of the City of London here this evening. But they will certainly have enjoyed, as I have, your very generous hospitality, which has been in the very best tradition of the occasion. And on behalf of all your guests I thank you - and the Lady Mayoress - for that. I thank you, too, for your sterling efforts - throughout your mayoralty - in support of the City, in its civic affairs, in its business activity, and in its increasing engagement with our neighbouring communities. And I thank you not least for the role that you have played - on behalf of all of us - in helping to celebrate so splendidly Her Majesty's Golden Jubilee.

I invite all your guests, now, to rise and join me in a toast to your good health.

My Lords, Ladies and Gentlemen, the Toast is:

"The Lord Mayor and Lady Mayoress - Michael and Sally Oliver"