Mr. George assesses how sustainable the current rate of growth of the UK economy is Speech given by the Governor of the Bank of England, Mr. E.A.J. George, at the Chartered Institute of Bankers in Scotland Biennial Dinner in Edinburgh on 20/1/97.

Mr. Chairman, the last time we came together for this great occasion, two years ago, I was pleased to be able to report to you that the British economy was making encouraging progress. We had, already then, seen very nearly three years of continuous and reasonably steady economic growth, which had produced a gradual fall in unemployment. And this steady expansion had brought few of the usual tell-tale signs of emerging imbalance between overall demand in the economy and our supply-side capacity to meet that demand. Our external current account was close to balance. And underlying retail price inflation was then lower than it had been for a generation. Even so, we had - as you will recall - begun to apply a touch on the monetary policy tiller to avoid being blown off course by rising world commodity prices at a time when domestic activity had already gathered pace.

I am delighted to be with you again this evening and to be able to report that this encouraging progress continues.

Output has now been growing, continuously and reasonably steadily - at an annual rate of 2.2% - for very nearly five years. Unemployment has continued to fall, almost without interruption month by month, and is now down to 1.9 million (or 6.7% of the workforce) compared with nearly 3 million (or 10.5%) at its peak, and 2.5 million (or 8.6%) two years ago. It is of course still intolerably high - we are talking about people here not just numbers. But unemployment is at least a great deal lower than in any other major country in Europe; and it is falling in the UK whereas elsewhere it is all too often still rising. Our external current account remains close to balance. And although our rate of inflation has edged up since we were last together, from below 2½% to just over 3%, and is, it must be said, somewhat higher than in most of the rest of the industrialised world, it is still relatively low by our own standards of the past 30-odd years.

The key question now - as it was last time - is can we keep it going?

Things have moved on over the past two years. We did in fact successfully weather the commodity price squall, which blew itself out quite quickly - though oil prices have recently been something of an exception. And the economy slowed during 1995. But we are now seeing a new and freshening wind blowing in particular from the household sector of the domestic economy.

A sharp pick-up in the rate of growth of the money supply in 1995 provided an early indication that demand growth was likely to accelerate. And money supply growth has remained strong throughout the whole of the past year.

Faster growth of consumer spending became evident in the first half of 1996 and has been sustained. And from the middle of last year this began to feed through into output - which was initially held back, and is possibly still being affected by a run-down of stocks.

Now the fact is that no-one can tell you with any great confidence just when the increase in demand is likely to begin to create economic imbalance and spill over into rising inflation. But we can be reasonably certain that money supply growth at around 9-10% a year, as we have seen it now since the beginning of last year, and growth in consumer spending at nearly 4% a year, as we have seen over the last year, cannot be sustained for long consistently with the Government's inflation target in the medium term. And there are signs - in the recently more rapid tightening of the labour market and in the gathering recovery in the housing market, for example, that demand may be strengthening.

That, essentially, is why the Bank has been arguing that we will need at some early stage a modest pre-emptive tightening of monetary policy. It is true that there is no immediate sign of cost or price inflation at the early stages of the production-distribution chain; and it is true in particular that the tightening labour market has not yet resulted in an acceleration of pay settlements or earnings. But these are backward-looking data. If we are to maintain that happy position, we need to anticipate what is to come, and begin to moderate the pace of the upswing before the evidence of imbalance comes through into the statistics. Two years ago my message to you was that we needed a stitch in time to save nine, which indeed we did. I bring you the same message again this evening.

The position is however complicated on this occasion by the recent strength of the exchange rate. Since the summer sterling has appreciated by just over 13% in effective terms - by rather more against the major European currencies and the yen (+15-16%) but rather less against the dollar (+7%). The speed and the size of sterling's appreciation is, of course, causing understandable anxiety, particularly for those sectors of manufacturing industry exposed to international competition. Already this is beginning to affect export orders. Given that those sectors account for perhaps half of total manufacturing, which in turn accounts for nearly a quarter of total output, it is clearly a serious issue.

This creates a tension between the domestic and the external, or exchange rate, dictates of policy - a dilemma which, in one direction or the other afflicts most countries from time to time, and which we ourselves have experienced at times in the past, though not during the past few years. The trouble in this instance is that the stronger exchange rate does not directly affect the build-up of domestic demand pressure, which is the problem we start with. It will, if it persists, have a one-off downwards effect (directly or indirectly) on the prices of perhaps a quarter of all goods covered by the retail price index, which will reduce the RPI during the course of this year; but this effect will gradually drop out of the 12-month calculation during 1998. The stronger exchange rate will also, if it persists, cause the external trade balance to weaken, and by relieving to this extent the pressure of overall demand, that may have a more lasting effect on the rate of inflation. We, of course, take these factors into account as best we can in making our forecasts of future inflation and in giving our policy advice, though there is inevitably a great deal of uncertainty over the timing and scale of their effects. That can, nevertheless, still leave room for tension between the need to moderate the upswing in domestic demand in order to meet the Government's inflation target (of 2½% or less) not this year, but in 1998 and beyond on the one hand, and unwanted strength of the exchange rate on the other.

There is no easy monetary policy answer to this dilemma. How far it persists depends upon just why the exchange rate suddenly strengthened as it has; and that is not easy to explain in terms of developments in the UK alone. Some of the suggested influences may well prove to be exaggerated or indeed reversible. This may be true, for example, of the rise in the oil price. It may be true, that expectations about a prospective relative rise in UK, and US, interest rates, reflecting the relative strength of our cyclical positions compared with those in Japan or continental Europe, are overdone, and they should in any event reduce as recovery takes hold in those other countries. And present market perceptions of the euro as a potentially weak currency if the Maastricht convergence criteria are not rigorously enforced, may also come to be seen to be exaggerated. There is in fact some suggestion, in currency options prices, that markets see a larger downside than upside risk to sterling against the DM in the course of this year. In the meantime, policy judgments are likely to remain unusually difficult.

When we confronted a similar dilemma in the 1980s, the domestic expansion was allowed for some time to continue unchecked, but in the end we were driven to bring it to a jarring halt. I do not suggest for a moment that we are anywhere close to that situation now. Our aim is precisely to avoid that. But that experience does illustrate that, in the final analysis, there could be real dangers in allowing justified concern about the exchange rate to deflect us for too long from moving gradually to moderate the upswing. I emphasise the words "gradually" and "moderate". The choice ultimately in this situation is not whether or not; it is sooner or later, less or more.

Our present dilemma - and it is a real dilemma - serves to illuminate the debate about the economics pros and cons of European Monetary Union, and the difficult decisions that will face all EU countries in little over a year from now. On the one hand, the real attractions - to manufacturers in particular - of exchange rate fixity within the euro area, are amply apparent. On the other hand, our dilemma - and we are not alone in this dilemma within Europe - points up the problem that would arise if the single European monetary policy - the single interest rates - does not meet the domestic monetary policy needs of all the euro-member countries. This could happen for a number of reasons - related to different cyclical positions, different fiscal positions, or as a result of external shocks or structural changes.

The famous Maastricht criteria for sustainable convergence that are to be met, according to the Treaty, before a country qualifies for the Single Currency were designed precisely to reduce the risks of tensions of this sort arising after the start. I should like to think that the political leaders across Europe, who will take the decisions, all really appreciate the crucial importance of sustainable convergence to the success of the venture and that they do not see it just as a technical obstacle to their wider aspirations - I should like to think that.

So, Mr. Chairman, some difficult decisions lie ahead. The period up to your next biennial dinner will be momentous. But that should not obscure the fact that our immediate economic prospects remain encouraging. I do not know of any serious economic forecaster who does not expect the economy to continue to grow over the next two year, or unemployment to continue to fall. The challenge is to ensure that we can still say that in two years' time.