

Mr George reports on the overall economic situation in the United Kingdom

Speech given by the Governor of the Bank of England, Mr E.A.J. George, at the Institute for Manufacturing in London on 12/1/99.

I am only too well aware of the pressure currently facing large parts of the manufacturing sector of the economy and I welcome this opportunity to explain the macro-economic context and say something about the prospect.

Let me begin with the overall economic situation.

Since the trough of the last recession in 1992 – that's 26 quarters up to the third quarter of last year – total economic output in this country has grown at an average annual rate of around 3%. That is well above any plausible estimate of the underlying rate of growth of capacity in the economy as a whole – which is typically estimated at some 2-2½% - so that what we were in fact doing over this period was steadily reabsorbing the economic slack created by the earlier recession. In the labour market, this was reflected in a rise in employment of some 1.6m to an all-time high of 26.5m, on the latest LFS figures. It was reflected, too, in a fall in the rate of unemployment, from a peak of 10.6%, again on LFS figures, to the current level of 6.2%, which is the lowest rate for about 20 years. These developments in the labour market produced a fairly gradual pick-up in pay settlements compared with past periods of labour market tightening; and underlying retail price inflation – measured by the Government's target inflation measure, RPIX – has averaged 2¾% a year through the expansion, and is currently precisely on target at 2½%.

By around the beginning of 1997, it was becoming clear that overall output growth needed to moderate if we were not to run up against overall capacity constraints. In fact, output growth actually picked up during the course of 1997, from a rate of close to 3% to around 4%, partly under the impact of the windfall effect of building society demutualisation on consumer spending. Aggregate demand growth, in other words, needed to slow if we were to avoid overheating.

That essentially was the background to the tightening of monetary policy during 1997.

But there was, of course, a major complication. In the autumn of 1996 sterling's exchange rate against the core European currencies started to strengthen, and by early 1997 it had already appreciated by some 17% against the deutschmark. Although sterling appreciated rather less against the dollar – which also strengthened against the core European currencies over this period, sterling's effective exchange rate index (ERI) still rose by some 13.5%. Sterling went up further against the deutschmark right up until the spring of last year.

It was never entirely clear just why sterling – and the dollar – strengthened in this way – or more appropriately why the core European currencies weakened – when they did.

It appeared to have little to do with relative monetary conditions between the Anglo-Saxon countries and the Continent. It may have had more to do with market perceptions – or market misperceptions – about the future prospects for the euro. Financial markets appeared at that time to take the view that European Monetary Union was being driven increasingly by political determination – even if that meant softening the interpretation of the economic convergence criteria; that this implied a broad rather than a narrow initial euro membership; and that this, in turn, implied a weak rather than a strong euro.

But whatever the reason – and whether it was valid or not – the effect of sterling’s appreciation was to introduce a pronounced imbalance into the UK economy. It dampened net external demand, and had a restraining exchange rate influence on cost and price inflation, at a time when domestic demand growth remained unsustainably strong, and when we were approaching full capacity.

On the one hand, we understood very well that, after a relatively favourable exchange rate environment following our exit from the ERM, the abrupt appreciation meant that the internationally exposed sectors of the economy, including large parts of manufacturing industry, were now suddenly confronted with much harsher trading conditions. That, as I say, had a dampening effect on the UK economy. But we couldn’t just rely on that to cool the economy for us. Clearly at some point the exchange rate would stop appreciating, and this external dampening effect would have worked its way through. In the meantime, we needed to slow the rate of growth of domestic demand sufficiently to avoid overheating in the economy as a whole. The strong exchange rate gave us somewhat more time than otherwise to bring about the domestic slowdown – it meant that monetary policy did not need to be tightened as much as would have been necessary otherwise. But we could not avoid tightening policy altogether – even though we realised that this would be likely to increase the pressures on the internationally exposed sectors, because in anything other than the short term that would have put the whole economy – including the internationally exposed sectors we were trying to shelter – at risk of accelerating inflation. And I would remind you that right up until the spring of last year we were seeing signs of increasing pressures in the labour market, even in the manufacturing sector – reflected in increasing skills shortages and recruitment difficulties as well as pay pressures. The uncomfortable reality, as I’ve said very often before, is that monetary policy can only target the economy as a whole – it can’t seek to protect individual firms or sectors, or regions, however much we might wish it otherwise. That – as I’ve discovered – is not exactly a popular idea, but there’s no question that it is the reality of it.

Over the past year the world – and I mean the world – has changed very substantially.

In point of fact, the strong exchange rate against continental Europe – whatever effect it had on margins and profitability, and I don’t underestimate that – had puzzlingly little effect on our trade with the rest of the EU. And goods trade volumes – both exports and imports - to the rest of the EU have in fact continued to grow fairly steadily over the past two years.

But, of course, over the past year or so the internationally exposed sectors of the economy have been dealt the further massive blow of global economic slowdown. This started with financial turmoil in Asia in the latter half of 1997, but even as late as last summer it was possible to argue that it would have limited impact on the overall world economy. In May, for example, the IMF was still looking for world economic output growth of over 3% in 1998 and over 3¾% in 1999. That certainly was a slowdown compared with average expected growth of around 4¼% only six months earlier – but it was not catastrophic.

Through last summer though, it became increasingly clear that things would be much worse than that. The financial collapse in Russia, deepening recession in Japan and increasing nervousness about the situation in Brazil, coupled with fears of the possible knock-on effects on major industrial countries’ financial markets and hence on their economies, all created a sense of panic by around the time of the IMF Annual Meeting such as I’ve rarely experienced – and don’t much wish to experience again!

The mood has improved since that low point. Financial markets have recovered much of their nerve – helped by monetary policy easing in the US and Europe; the Yen has appreciated, easing

some of the pressures on the rest of the Asian region; the IMF has organised support for Brazil and seen its resources substantially replenished. Even so, the forecasts of world economic activity continue to be revised downwards, so that the IMF's latest (December) forecast for world growth in 1998 and 1999 has been cut to under 2¼% – barely half the trend rate. And the risks probably remain on the downside.

We are still not talking, in these forecasts, about global downturn or recession – though that is exactly what we are seeing in a large part of the world economy. The expectation is that the US and Europe will sustain domestic demand to accommodate the flood of goods imports from the rest of the world which is necessary if the suffering economies, now facing substantially reduced capital inflows, are to see any kind of recovery. That means a prospective imbalance between domestic and external demand in the industrial world as a whole, which is somewhat similar to that which we were already seeing in this country – but on a mega scale. In the UK there has been a sharp deterioration in the overall balance of trade in goods, to a deficit of £18.3bn in the past four quarters – about a 50% increase on what went before. This deterioration was almost entirely with countries other than the EU and North America. This picture has been mirrored in the US, where the deficit on trade in goods has risen to around \$65bn (3% of GDP). And this picture of a weakening trade balance in goods is reflected in falling manufacturing employment in both the UK and US.

In continental Europe the trade picture looks rather better at first sight, but that really reflects the fact that these economies are at a different point in the cycle. But, here too, the outlook is not particularly promising; in Germany, for instance, downward revisions to growth forecasts have reflected a sharp fall in the forward-looking survey measures of export expectations in the manufacturing sector.

So the pressures on manufacturing are not confined to this country – cold comfort though that may be.

This global economic slowdown represents, as I say, a further blow to the internationally exposed sectors of the UK economy, particularly the commodity and goods-producing sectors. Even though the strength of sterling has tended to ease since last spring as the euro became a reality, what this means for us is that external demand will be even weaker – and remain weaker for longer – than we'd previously expected, and that there will be a further dampening effect on inflation from weak world prices. So we have even more time than before to bring about the domestic slowdown – in fact we could afford for the time being to act to sustain domestic demand. So the worsening global economic situation, and the related further weakness of external demand that became apparent through last summer, pointed to an easing of our monetary policy stance.

But it was not the only factor. Domestic demand, too, particularly consumer goods spending, also weakened more sharply in the latter part of last year than we expected, for reasons that we do not fully understand. Continuing growth of employment, and higher pay settlements than last year, suggested that labour income was also continuing to increase – and after a wobble in the autumn, financial asset prices remained buoyant. At the same time consumer borrowing and the growth of households' money holdings remained fairly robust. So it's not easy to explain the sudden drop in consumer confidence reflected in retail spending – and not easy to predict how long it will in fact last. In any event, given the further weakening of external demand we surely didn't need such a sharp, simultaneous, slowdown in domestic demand, so the evident weakness of consumer spending, too, pointed to an easing of policy.

The arguments were not in fact entirely one way – they rarely are. The imbalance in the economy remained a major complication, with the much larger services sector holding up much better than manufacturing, and this dichotomy was neatly reflected in the fact that while overall inflation was on track – at 2½% – this outcome included 3½% inflation of services prices and only just over 1% inflation of goods prices. There has been a similar divergence between services and goods price inflation for some time now in all the major economies. Moreover, the UK labour market remained tight, although there have recently been some tentative – but not conclusive – signs that it may now be beginning to ease. We have, of course, been unsighted for some months as to what this has meant for average earnings in the economy.

But taken altogether the evidence was becoming pretty clear through the summer that we were seeing the slowdown in the economy as a whole that we needed to see to keep inflation in line with the target. And as we moved through the autumn the downside shocks to the world economy – and to consumer spending in this country – meant that we were at risk of undershooting the inflation target. And that explains why we have moved quite aggressively to reduce interest rates over the past few months.

So that's where we are. What you'd like to know is where we go from here.

There is no doubt that we are currently seeing a slowdown in the overall economy – as I say, a necessary slowdown. The effective choice was always between an earlier – and hopefully more moderate – deceleration or a later, but almost certainly sharper, decline.

The issue is about the extent – and the duration – of the slowdown, which is much more difficult to assess. In fact, given the uncertainties about the global economic situation, and given the extent of the imbalance between the different sectors of the domestic economy, that assessment is about as difficult as at any time that I can remember. Of course there are plenty of people who claim to know with great confidence – and who put their money, or their mouth, on more extreme possible outcomes. And it's true that outside bets do sometimes win.

Our own approach is to attach varying degrees of probability to alternative possible outcomes, which we reflect in our quarterly Inflation Report. I can't predict what our next Inflation Report – which we publish next month – will in fact show, but frankly I'd be surprised if our central projection were to suggest that the economy as a whole was falling into steep or protracted recession. But I can repeat to you the assurance that I have given elsewhere – which is that we will respond symmetrically to the prospect as we see it. If, on the balance of risks, we see a probability that inflation will undershoot the Government's target, we will not hesitate to ease policy further, just as we moved to tighten policy when the risks to inflation were in the other direction.

That is in fact what we have been doing, and it should provide some reassurance to you. But there is not a lot more that we can do directly – through monetary policy – to affect the current global economic weakness which is adversely affecting the prospect for manufacturing both in this country and more generally in the industrial world. It remains the case that, if we were tempted to go further in easing monetary policy and take significant risks with inflation on the upside, we would be likely simply to make matters worse for you in anything but the short term.

I hope that I have provoked you to a lively discussion!

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