Mr George takes a look at recent developments in the UK economy against the background of global influences in the international financial environment

Speech given by The Rt Hon Eddie George, Governor of the Bank of England, at the City Council Dinner hosted by the Glasgow Chamber of Commerce on 18 January 2000.

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Mr Chairman, my Lord Provost, Ladies and Gentlemen,

I always enjoy my visits to Scotland. And I've been particularly looking forward to this visit since I read a Business Comment headline, in one of your newspapers on Friday, referring to the warm welcome I could expect on this occasion - following last week's decision by the Monetary Policy Committee to put up interest rates!

It has to be said that some of the rest of the article, and some other press comment on Friday was less welcoming! We - the MPC - were variously accused of "ignoring the pain suffered by firms north of the Border", of "being willing to sacrifice Scotland's economy just to cool the overheated London property market"; and of causing the Scottish economy once again to suffer because South-East England is overheating.

Well I'm a great believer in free speech, but let me give you some relevant facts.

The MPC sets interest rates to achieve the Government's target for retail price inflation in the UK economy as a whole consistently over time. Those are our marching orders.

In fact for the past seven years - starting well before the MPC came into existence - the UK economy as a whole has enjoyed the longest period of sustained low inflation that we've known in over a generation. Retail price inflation on the Government's target measure has averaged 2.7% over that time (or only 2.1% on Europe's HICP measure).

Alongside low inflation we've also had the lowest nominal interest rates that most of us can remember. Short-term rates have averaged some 6¼% (fluctuating between 5 and 7½% over the period), compared with some 11¼% (fluctuating between 7 and 15%) over the previous decade. And ten-year government bond yields have fallen from nearly 9% on average in 1992 to around 5½% at the present time.

But more than all that, we have also over the past seven years or so enjoyed the longest period of uninterrupted, quarter-by-quarter, economic growth in the UK as a whole since quarterly records began in 1955. Annual growth since 1992 has in fact averaged 2.8%, which is between ¼ and ½% above most estimates of our long-term underlying trend rate.

Equally important, we have also enjoyed an almost continuous month-by-month fall in the rate of unemployment, on a claimant count basis, from a peak of some 10½% at the end of 1992 to the present rate of just over 4%. That is the lowest rate of unemployment on this measure since early 1980. And, finally, the number of people in employment - and let's never forget we are talking about people here - is currently around the highest number on record.

Now we don't have fully comparable data for Scotland within this overall picture. Interest rates are of course identical, and as far as we can tell, the inflation story over the past seven years is pretty much the same as in the rest of the UK. So, too, is the story of sustained economic growth. On the basis of annual data Scotland's economy, too, has grown year by year over the period - at an average rate of 2.6%. And on the basis of the new quarterly GDP data series for Scotland, produced by the Scottish Executive, Strathclyde University's Fraser of Allander Institute concluded that, while the Scottish economy is somewhat more volatile than that of the UK as a whole on a quarterly basis, it moves broadly in line with the UK over longer periods.

We do have consistent data for the labour market. And this shows that Scotland too, like the UK as a whole, has enjoyed a steady fall in the rate of unemployment, from a peak of some 10% at the end of 1992 to just over 5% now. In the case of Scotland, this is the lowest rate since the middle of 1976. (It compares with the truly grotesque Scottish rate of unemployment of close to 14% in the mid-1980s.) And, at just over 2.3 million, the number of people in employment in Scotland is, as in the UK as a whole, currently around its all-time high.

Of course it is for you to decide what interpretation to put on these facts. But I don't find a shred of evidence in them to suggest that low inflation - monetary stability - need be at the expense of growth and employment in the UK economy as a whole. Indeed they are more obviously consistent with the view that monetary stability is good for sustained growth and employment. And there is nothing in the facts about the Scottish economy to suggest that the pursuit of monetary stability in the UK as a whole is in any sense at the expense of growth and employment north of the Border. Indeed it seems clear on the facts that over time the Scottish economy prospers very much in line with the economy of the UK as a whole. So let's keep the national conflict where it belongs - on the rugby field!

Now, Mr Chairman, what certainly is true is that recent upheavals in the world economy have had a damaging impact on particular businesses and particular sectors of the UK economy - including particular businesses and sectors of the Scottish economy, which has greatly complicated our conduct of monetary policy.

You are all of course familiar with the global financial shock which hit Asia in 1997 and spread to other emerging market countries and transition economies through 1998 and the early part of last year.

This shock impacted the UK economy in two main ways.

First, the withdrawal of external finance from the immediately affected countries meant that they had no option but to rein back their domestic economies, resulting in a sudden, sharp, slowdown in world demand - including demand for industrial countries' exports. That in turn had the effect of dampening aggregate demand in the industrial countries. Had the industrial countries - led by the United States and the United Kingdom and closely followed by the Eurozone and subsequently also by Japan - not acted to stimulate their own domestic demand, we could indeed have seen the serious world downturn which many were anticipating only a year or so ago. In the event, the global slowdown was contained, but at the expense of the build-up of substantial external imbalances within the world economy, and at the expense, too, of substantial imbalance between strong domestic and weak net external demand in a number of industrial countries - most notably in the US and here in the UK.

Second, these developments in the world economy had a major impact on the international pattern of exchange rates. In the first place, many of the countries most adversely affected by the interruption of international financial flows saw their currencies fall dramatically in foreign exchange markets. But there were also important secondary effects on the relationships between the major industrial countries' currencies. The dollar and sterling - which have in fact been reasonably stable against each other since we came out of the Exchange Rate Mechanism - strengthened, notably against the euro, notwithstanding reductions in our relative interest rates, perhaps on the expectation that an earlier or stronger pick-up in domestic demand would keep our economies operating closer to capacity than in the Eurozone. And the yen, which had been notably weak on the back of Japanese recession, has subsequently picked up as the prospect of economic recovery there improved. It is the strength of sterling's exchange rate which gives rise to the most vociferous complaints.

I am only too well aware that for many of the internationally-exposed sectors of the UK economy - most of agriculture, much of manufacturing industry, and some services sectors - these developments came as a series of hammer blows - of varying intensity depending on the particular international orientation of the business. Companies trading with, or competing against, much of East Asia, but also other emerging and transition economy markets, saw their markets collapse and prices fall dramatically given the massive falls in many partner-country exchange rates. Trade with the Eurozone - by far our largest trading partner - was also adversely affected, until recently, by sluggish domestic demand in the major Continental countries and by the weakness of the euro. And even those who look mainly to the United States - where both the market and the currency relationship have been more stable - faced intensified competition from the rest of the world.

These effects were not, of course, peculiar to Scottish businesses. They applied equally to all similarly internationally-exposed businesses throughout the UK. Each region has its own particular business characteristics so that some were affected more than others - with some English regions worse affected than the overall economy here in Scotland. But the effects were just as damaging to similar businesses wherever they were located, so that the differential impact was felt within regions throughout the UK not just between them. These cries of pain from the most severely affected businesses and sectors right across the UK I really do understand.

The question is what can we do about it through the operation of monetary policy?

The problems - as I have explained - derive essentially from developments abroad, and there is not much that we can do directly about them, although both the Bank and the Government are very actively involved in the wider international debate on how to bring about greater stability and better balance in the global economy.

Of course we take full account, in our forecasts and in our policy judgements, of the implications of the international environment for our own economy. That is why we moved aggressively to cut interest rates from the autumn of 1998 and early last year. Even though we could not change the international environment (and as I say the exchange rate actually rose despite our interest rate cuts), we could cushion its negative effect on the economy as a whole by providing an offsetting stimulus to the domestic economy. Had we not done so, we might well have suffered recession in the UK. But the hard question for us is could we - and should we - attempt to shelter internationally-exposed businesses even if that were to mean putting our objective of sustained low inflation at risk. In fact I've not heard anyone argue openly for that - and I would be surprised if they did. The reality is that if we were to put the economy as a whole at any significant risk of accelerating inflation - notwithstanding our mandate - we would not succeed in providing the intended protection to the internationally-exposed sectors other than possibly in the very short term; and in the medium to long term our overall economic performance would almost certainly be worse.

The more hopeful news is that we have more recently seen strong signs of recovery - of both economic activity and exchange rates - in a number of emerging markets and transition economies. And we are seeing a strengthening of domestic demand and of output in the Eurozone, where the currency is commonly acknowledged to have considerable potential for appreciation. These trends, 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, particularly in manufacturing output growth and to the more encouraging news in some 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.

Mr Chairman, most people, as I say, accept in principle that sustained monetary stability is good for the economy as a whole in the longer term - though it is accepted with varying degrees of enthusiasm by adversely affected sectors at any particular time. But there is, nevertheless plenty of room for debate about the operation of monetary policy in practice. Specifically at present the MPC is often accused of being overzealous - and it is suggested that we don't in fact need to raise interest rates at this point in order to achieve the inflation target. That is a more technical question.

Changes in interest rates take time to have their full effect, so our decisions have to be forward looking.

We start from a position in which inflation is in fact running - and has been running for some months - slightly below the Government's 2½% target. The November figure was 2.2% and within this goods price inflation was running at around only ½%, while retail services price inflation was running at nearly 4%. On Europe's HICP measure, inflation in November was running at 1.3%.

In part this out-turn reflects the abnormal international developments I have already discussed. The slowdown in the world economy reduced external demand in the UK. Weak world demand was

accompanied initially, too, by falling commodity and manufacturing input prices. And sterling's strong exchange rate had a direct, dampening, impact on our domestic price level. It is clear that world demand has now started to strengthen and commodity prices generally have stopped falling. And the oil price has already recovered strongly - which may benefit the Scottish economy but puts upward pressure on inflation. But sterling's exchange rate remains uncomfortably strong.

Looking ahead, there are a number of unusual factors that might help to hold the rate of inflation down, at least in the short term. Some of these are one-off administrative measures rather than broader economic influences: they include the unusually large price reductions imposed by utilities regulators to come into effect in the spring as well as the Chancellor's decision to end automatic over-indexation of excise duties on fuel and tobacco. But there is also evidence, which is harder to evaluate, of more intensive retail price competition, squeezing retail margins, and that could hold down prices at least for a time. And this last effect could intensify and extend further into the future as a result of the spread of e-commerce.

Meanwhile we are faced with familiar uncertainties about the prospective strength of domestic demand and about overall demand pressure. Final domestic demand growth, including the growth of consumer spending, did apparently moderate in the middle of last year - as it needed and still needs to do. But there is plenty of evidence to suggest that consumption growth will in fact remain quite buoyant: the strength of the equity market; rising house prices - certainly led by London and the South-East but followed, not all that far behind, by Edinburgh, and spreading out across the UK; strong borrowing, including mortgage equity withdrawal, by the household sector; and rising incomes from employment. Meanwhile, on the supply side of the economy, there is little evidence as yet in the overall productivity data that would suggest an imminent, abnormal, pick-up in the underlying rate of capacity output growth such as they have seen in the US, however fervently we might hope to become infected by what is happening there!

Now none of this means that we have closed our minds to the possibility of a more benign relationship between the demand and supply sides of the economy, which would allow us to sustain for a time stronger growth consistently with meeting our inflation target. But we can't afford to bet the Bank on that happy state of affairs either. When people approach me with the sound-bite "give growth a chance" what I hear them saying is "take a risk with inflation". But equally when they say "you must take no risks with inflation" I hear them saying "the world will never change". The truth is that nobody knows with any great confidence. The important thing is to keep an open mind and to monitor intensively all of the data as it becomes available to us, and draw what inferences we can as to how those data affect the balance of risks around the inflation target looking ahead.

What is encouraging, Mr Chairman, is that for all these uncertainties and complications the broad prospect for the UK economy - including the Scottish economy - over the next couple of years is for 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's a very long time since any of us could describe the debate in that way with any degree of confidence.