Eddie George: A snapshot of developments in the global economy

Speech by The Rt Hon Eddie George, Governor of the Bank of England, at the Lord Mayor's Dinner for Bankers and Merchants of the City of London at the Mansion House, on 15 June 2000.

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I spoke last year - somewhat hopefully, even optimistically for a central banker - about the still nascent global economic recovery from the Asian crisis and its aftermath. But, more characteristically, I worried about the international imbalances affecting the major industrial countries, and the related imbalance within our own economy.

The good news, my Lord Mayor, is that the global recovery has turned out to be rather stronger than we dared to hope a year ago. The world economy is currently growing at around its long-term trend rate - of 4% or rather more - and is expected to continue to grow close to that rate over the next couple of years. Although global inflation has meanwhile so far remained generally subdued, monetary policy in the major industrial countries - which had been directed to stimulus during the period of sharp world economic slowdown - has, to varying degrees, reverted to being less accommodating with the equally sharp recovery.

The less good news is that the worrying international imbalances within and between the industrial countries persisted through most of the past year - though just between you and me, my Lord Mayor, and so long as you don't breath a word to the Chancellor, there is a glimmer of a suggestion - no more than that - that those imbalances may now be becoming somewhat less worrying.

In the United States evidence of a sustained improvement in the rate of productivity growth has persisted. We, in this country, must fervently hope that the seeds of this technological modification are blown in our direction and find a receptive environment here. There is no obvious reason why we should be immune from this highly desirable infection - though sadly the symptoms of contamination are still hard to detect. In the meantime its supply-side effects in the United States imply that the US economy can sustain faster growth than seemed possible before, without necessarily overheating - at least for a time and up to a point. But the same developments have also helped to raise the temperature on the demand side of the US economy, and the Federal Reserve has been administering monetary sedatives at intervals throughout the past year. But finding exactly the right dosage, and the right timing, to keep the body temperature near normal in present circumstances really does demand the wisdom of Solomon - or at least the wisdom of Greenspan. Notwithstanding some more encouraging recent signs, there is still a possibility that continuing imbalance between domestic and external demand will need additional sedation or that it will eventually precipitate a sharp fall in the dollar and US asset prices. But the dollar has come off its recent peak and some of the exuberance may now have gone from equity prices - including some of the froth from the "new economy" sector, so the risks of sharp correction may be less than they were.

Elsewhere, in Japan, after a long convalescence, there may now at last be some better prospect of a gradual but self-sustaining recovery in private sector demand. And there has been more substantial evidence in recent months of strengthening domestic demand and output growth across the Eurozone. That fully justified the European Central Bank's gradual shift away from its earlier accommodating monetary policy stance; it may also have contributed to the beginnings of a recovery of the euro exchange rate towards a more comprehensible level.

We are certainly not yet out of the woods - there is a long way to go before anyone can feel confident that we are in fact in sight of a more sustainable balance between the major industrial economies. But I am more hopeful that we are now at least moving in the right direction.

And that is encouraging news for the UK.

On a macro-economic overview, our own economy remains in pretty good shape. In the year to the first quarter total output grew by just over 3% while prices rose by 2.7% measured by the overall GDP deflator or by 2.1% on the Chancellor's RPIX target measure. That is the fifth time in the past seven fiscal years that output growth has exceeded the rate of inflation.

Since the recession of the early 1990s both output growth and inflation have averaged around 2¾%. The number of people in employment - as we saw from yesterday's figures - is at an all time high. The rate of unemployment, on a claimant count basis is as low as it has been for 25 years. And interest rates over the past few years have been more stable and just about as low as anyone can remember.

Now it's true that there are uncertainties ahead - as there always are - which could make for a bumpier ride. The welcome weakening of sterling - which had risen to quite unrealistic levels against the exaggeratedly weak euro - will tend to reverse the downwards pressure that it had previously been exerting on retail prices. Domestic demand growth will need to moderate to compensate for that - although there are some tentative signs in the recent data that it may be beginning to do so. The sustained tightness in the labour market could still put upwards pressure on earnings growth and pay settlements - though the latest data are somewhat reassuring for the time being. We can't be confident about the effects in this country of the new economy - though we remain open-minded. Nor can we be confident of either the extent or the likely persistence of what appear to be exceptional downward pressures on retail margins. We don't know for sure what is likely to happen to the oil price - and so on.

We will - in the best central banking tradition - need to be eternally vigilant. But for all the uncertainties, the overall prospect for the economy as a whole over the next couple of years - in my view, but it is a view that I think is broadly shared by most of the other members of the Monetary Policy Committee, is for continuing steady growth, at or a bit above its longer-term trend, for continuing high employment, and for continuing low inflation at around the Chancellor's target.

And that, too, my Lord Mayor, is not a bad prospect either.

Our problem - and it has been a persistent headache over the past two or three years, as I have repeatedly tried to explain on earlier occasions - is the imbalance between the domestic sectors of the economy, which have by and large been doing pretty well, and those that are heavily internationally exposed. Those sectors have had a tough time over the past few years - what with the global economic slowdown and particularly more recently with the seemingly remorseless rise of sterling against the euro. That went well beyond constructive pressure to improve efficiency to destructive agony. We've been only too well aware of that - we could hardly not have been; and we've not been insensitive to it either. We have consistently taken account of the unexpectedly persistent strength of the exchange rate in both our forecasts and in our monetary policy judgements. But when you come right down to it, for as long as economic conditions between one country and another diverge, whether for cyclical or structural reasons, there is a choice. Countries can either aim to stabilise their respective domestic economies, accepting that that may mean exchange rate volatility, or they can aim to maintain exchange rate stability, accepting that that may destabilise their respective domestic economies. These are the horns of the uncomfortable dilemma we have been on.

I have no doubt, in terms of the macro-economy as a whole, that we have been right to persist in aiming to stabilise our domestic economy - the facts speak for themselves. It is possible - even perhaps likely - that our dilemma may now become less acute, at least for a time as the euro strengthens to a more sustainable level. Our best chance of maintaining that happier position - if indeed it occurs - is to persist in domestic stabilisation and structural reform alongside our European partners, but it is difficult to be confident at this stage that the dilemma will not re-emerge.