The Rt Hon Sir Edward George GBE: Recent UK economic developments against the background of world economic activity

Speech by The Rt Hon Sir Edward George GBE, Governor of the Bank of England, at the Chartered Institute of Bankers in Scotland Biennial Dinner at the Exchange, held on 15 January 2001.

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Mr President, Lord Provost, my Lords, Ladies and Gentlemen,

This is the fourth occasion on which I have been honoured to be invited to speak at this great biennial dinner of the oldest Institute of Bankers in the World; and it gives me particular pleasure this evening to join you in celebrating your 125th anniversary.

On the three previous occasions I have been able to report to you steady progress of the overall UK economy, but then, as a central banker brought up to look for the dark side of the moon, I've gone on to discuss the prevailing risks and uncertainties and to pose the question: can that steady progress be maintained? I will adopt the same format this evening.

Since your last dinner in 1999, we have in fact, come through the short, sharp, shock to the world economy, associated with the emerging markets financial crisis, relatively unscathed. Our own economy has now grown continuously quarter by quarter for over 8½ years at an average annual rate of 3%, which is well above most estimates – at least until recently – of a longer term trend rate of 2¼-2½%. Retail price inflation (on the Government's target measure) has averaged 2.7% over this period, and has in fact been marginally below the 2½% target for much of the past two years. Short- -term interest rates – which went up to 12% (and tentatively even to 15%) before we left the ERM in 1992 - have been stable at 6% for the best part of a year. Helped by a decline in inflationary expectations, UK 10 year Government bond yields have fallen, to around 4¾% which, apart from a brief period at the beginning of 1999, is the lowest they've been for nearly 40 years. They are now just about as low as in any major industrial country with the exception of Japan.

And the number of people in work has recently been at an all-time high in the UK as a whole - and close to its high point in Scotland; while the rate of unemployment, on a claimant count basis, is at a 25-year low, both in the UK as a whole and in this country.

The question remains – can we keep it up? The answer to that question depends on developments both at home and abroad, but let me comment first on the international situation which is currently the focus of a great deal of attention.

The bounce back from the world economic slowdown in 1998/1999 was such that in the year just ended world economic activity grew at a rate of some 4½% which equals the fastest rate for 16 years – and compares with an average rate of some 3¼% over the last 10 or 20 years. In large part this recovery was underpinned by unusually strong growth in the US, averaging some 4½% over the past 4 years and surging to a peak of some 5½% at an annual rate in the first half of last year – compared with an average rate of 2¾% over the preceding decade. This remarkable strength of the US economy was possible, without overheating, against the background of unusually rapid productivity growth as investment in IT spread through the US economy improving its supply-side capacity. These developments together implied higher corporate earnings growth in the US pushing up the stock market and at the same time attracting massive direct and portfolio capital inflows into the US – substantially from the Eurozone – which comfortably over-financed a burgeoning US current account deficit and underpinned the strong dollar.

However helpful all this was in supporting the world economy it clearly could not continue for ever or without limit. At some point – and no-one could know at all precisely at what point – demand in the US would begin to outstrip supply and the growing external imbalance between the US and the rest of the world would become unsustainable; relative asset prices – including the dollar's exchange rate – would over-discount prospective US corporate earnings growth and both equity and foreign exchange markets would then become vulnerable to abrupt correction.

Against that background it has been clear for some time that there needed to be a slowdown in the growth of the US economy to a rate which was more sustainable, both in the US itself but also in terms of the imbalance within the global economy – and the debate turned to whether it would come as the “soft landing” we would all welcome or a more disruptive “hard landing” which we could all well do without.

And slowdown, of course, is what we have seen over the past six months. In the third quarter US GDP growth fell to an annualised rate of some 2¼% - less than half that in the earlier part of last year, and much of the more recent data suggest a further weakening. This slowdown has been reflected in a fall in equity prices – including a sharp fall in the previously hugely overblown “tech-heavy” NASDAQ index; and this in turn has contributed to a typically rapid escalation in the florid language of commentators, from slowdown, to downturn or recession, to possible slump (though I haven’t yet seen meltdown as we did in 1998), which many of the commentators appear to regard as near-synonyms.

Of course it is always possible that it will come to this – no-one has a crystal ball – and it goes without saying that we are all watching what’s happening very carefully. But that is not my own view of the most likely outcome, nor that of my central bank colleagues from around the world when we met in Basel a week ago. We met in the wake of the Fed’s move to cut interest rates which was widely welcomed as timely and appropriate, demonstrating sensitivity to the possibility of a spiralling decline in financial market and business and consumer confidence. We noted, too, that in announcing its move the Fed had made a point of emphasising its expectation of continuing relatively strong productivity growth, giving it more room for manoeuvre than it would otherwise have. Against that background, the view was that, while the US economy might be in for a bumpy ride over the next few months, associated for example with inventory adjustment in the motor industry, the likely outcome for this year as a whole is that the US economy will continue to grow by perhaps 2-3%, and that the overall world economy – helped by steady growth in the Eurozone – would again this year grow probably somewhat above its longer-term average rate. That, certainly, is a slowdown in the recent rate of growth – and a downward revision of earlier expectations of growth for the current year; but it is not a downturn in the sense of contracting activity. On this view, the slowdown in prospect would have relatively benign effects in terms of the longer term sustainability of the global economic expansion; and developments so far have already had positive effects both in terms of their impact on the world oil price, and in terms of their impact on the pattern of exchange rates, notably by reducing the exaggerated weakness of the euro.

On that basis the global economic environment should provide a reasonable background for our own economy. We – and our partners in the European Union – would be relatively little affected by the US economic slowdown. The world economy as a whole would certainly be helped by the somewhat softer oil price – though I appreciate there may be mixed views on that up here in Scotland. And the recovery of the euro – including its recovery against sterling – will help to ease the severe imbalance within our own economy between the domestically-orientated sectors which have typically been doing relatively well and those businesses and sectors that are most exposed to competition from the Eurozone and which have been having a rough time. That imbalance is, I know, a real concern up here north of the border, and it has more generally for some time been one of the most difficult issues confronting us in conducting monetary policy.

But there are, of course, also major domestic uncertainties. What – as I have often explained before – we are seeking to do through monetary policy – in order to achieve the Government’s inflation target – is to keep overall nominal demand growth more or less continuously in line with the supply-side capacity of the economy to meet that demand. That is a necessary condition for maintaining our steady economic progress. But we cannot directly observe supply-side capacity in either product or labour markets, nor therefore anticipate just how it will develop, with any great precision, nor do we know precisely what is currently happening or is likely to happen to the rate of growth of aggregate demand in the economy anyway. Our forecasts and policy judgements are based upon very careful scrutiny of all the latest data available to us, informed by the best technical analysis we can muster. But they necessarily remain our best judgements and that, of course, leaves us vulnerable to assertions that we do not give sufficient weight to this or that factor.

For what it is worth, at the time of our last forecast in November, our central projection – on the assumption of 6% interest rates – was for output growth of around 2½% over the next couple of years, with RPIX inflation remaining modestly below target this year but rising to 2½% in 2002. There was, of course, a good deal of uncertainty around that central projection, as there always is, for the reasons that I’ve tried to explain. But on the basis of that forecast the short answer to the question: can our steady economic progress be maintained over the next couple of years is a cautious “yes”.

Since that forecast was completed things have gone in different directions. The prospect for external demand has somewhat weakened and so too has the oil price. There are mixed messages relating to tightness in the labour market, but earnings growth has so far remained reasonably well contained - as it must continue to do. On the domestic demand side, private consumption growth has remained stronger than we had supposed, while the growth in private investment has been weaker; meanwhile it is not clear that underlying public sector demand has – at least yet – picked up as rapidly as planned. The exchange rate has fallen, and so, too, have market interest rates.

I would not venture to suggest how these – and all the other developments we look at – will influence our next forecast in February; and it would be pointless to anticipate possible future policy decisions. I would be surprised if they radically altered the broad prospect of relatively steady progress over the next two years. But I can assure you of one thing: if the prospect – or the balance of risks around it - were to change significantly – either in the context of our February forecast or subsequently – we will promptly react to that change. Despite the fact that we left interest rates on hold again last week, we have certainly not gone to sleep! We cannot guarantee that we will always remain as close to the symmetrical inflation target as we have been in recent years – the uncertainties as I have explained are too great for that degree of confidence. But that remains our aim. And I will be happy to report back to you again at your next dinner.

Let me, Mr President, just conclude by congratulating you and the Chartered Institute on your achievements – not just over the past two years though I do congratulate you on that, especially, if I may, on your introduction of your new Chartered Banker qualification. But I congratulate you more broadly on your achievements over the whole 125 years since your foundation. And let me invite all your guests now to rise and to join me in wishing you well over the next 125 years.

Ladies and Gentlemen, please join me in a toast to the continuing achievements of the Chartered Institute of Bankers in Scotland.