

## **The Rt Hon Sir Edward George: Macro-economic developments in the UK and its effects on the West Midlands**

Speech by The Rt Hon Sir Edward George, Governor of the Bank of England, at the West Midlands Conference "20-20 Vision", Birmingham, 20 September 2002.

\* \* \*

Your conference title is "20-20 Vision" - which I thought initially - and not unreasonably - meant it was to be all about hindsight. And I happily accepted the invitation to speak on that basis, because, as we all know, 20-20 hindsight is very easy - as a lot of commentators have demonstrated just recently in their criticisms of US policy-makers in the light of the economic and financial market bubble which built up in the late 1990's! It was only later that I realised you intended that we should look forward to the year 2020 - that the conference was to be a foresight saga - and at that point I began to get cold feet! Central bankers are jolly lucky if they feel at all confident looking ahead 18 months, let alone 18 years - and sometimes recently - given the volatility in financial markets - its been difficult to predict what was likely to happen over the next 18 minutes!

But here I am, and what I thought I would do this morning is to try to provide some sort of UK macro-economic context for your discussion of the challenges facing the West Midlands by first looking backwards at some of the trends that we have seen over recent years and then trying to anticipate how those trends might evolve.

People often tell me that retrospection is a sign of old age. But as I reflect on my 40 years at the Bank of England I am increasingly conscious of the remarkable change that has occurred over that time - in fits and starts certainly, but in the same general direction - from a heavily administered economic and financial system to one which is much more market based.

Post-war controls on resource allocation had been largely dismantled before I started at the Bank. But the financial system was still governed by all kinds of direct controls - exchange controls, credit ceilings on bank lending - coupled with directional guidance, the queuing of equity issuance and business restrictions - on the activities of building societies, for example; and there was direct intervention in the wider economy through prices and incomes policies and public ownership of large parts of industry, and so on. But all of that has now gone. It's true that plenty of regulation remains - reflecting public policy concerns relating to competition and consumer and environmental protection, employment conditions, health and safety standards, and so on - indeed it has intensified in these areas. The business opinion survey conducted here in the West Midlands earlier this year by the Institute of Chartered Accountants and the IOD - which had over 85% of respondents agreeing that red tape and bureaucracy are stifling business - suggests that some of you have noticed! But for the most part such regulation doesn't tell us what activities we can and cannot undertake, rather it sets the criteria we must meet and the standards we must observe in doing whatever it is we choose to do. It leaves more room for both consumer and producer choice, and more room, and more incentive, therefore for competition and innovation.

Our experience in the UK is, of course, just part of a very much broader and continuing evolution internationally - often associated with increasing political democracy - from varying degree of centralised administration to an increasingly open, market-based, approach in all parts of the world reflected also in increasingly free international trade and investment.

At the macro-economic level the economic advantages of freer market competition are familiar. No one could claim that it's perfect - especially in the light of the current volatility! But profitability is the best means that we have so far discovered for directing resources - whether human or material or financial resources - into those activities in which they can be most productively employed. It provides a powerful incentive to increasing economic efficiency - and the higher sustainable growth rate that we need to satisfy our aspirations for improving living standards - by encouraging the concentration of production on those businesses, or regions, or countries, which have, or are able to develop, a comparative advantage in particular products or services.

That's not necessarily how it seems at the micro-economic level. Individual businesses and their employees, or regions, or even countries at the international level, tend to think of competition and market-driven resource allocation as a zero-sum game: if one side wins the other necessarily loses. So it's not surprising that existing producers are tempted to resist the opening of their markets to

greater competition and look for protection where they can. But attempting to stem the tide by acquiescing in protection would be to ignore the benefits which increased competition, and more efficient and innovative production would bring to society at large, including consumers, as well as potentially more efficient producers and their prospective employees, wherever they are located. It is those benefits which make market competition a positive-sum game at the macro-economic level. I don't at all underestimate the pressures on businesses, and their employees and surrounding communities, that struggle to retain their comparative advantage in a market economy. But standing still is not an option in today's world - nor will it be going forward. The one thing you can be reasonably sure of as you look ahead to 2020 is that you will be confronted with a continuing challenge to keep ahead of the competition in your existing industries and that you will need to be able to respond to changing demands and embrace new activities to replace those where your present comparative advantage becomes impossible to sustain - as is unfortunately bound to happen in some cases.

So my first point is that the market economy is with us to stay, with all that that implies.

We've also learned that one of the conditions that are necessary if a market economy is to function effectively is a framework of macro-economic stability. For much of the post-war period macro-economic policy - not just in this country, but including in this country - focussed heavily on the short-term management of aggregate demand in the economy. It paid too little attention to the underlying, supply-side, capacity of the economy to meet that demand. Faced with slow growth and rising unemployment both fiscal and monetary policy were used, in combination, to stimulate demand until accelerating inflation and a worsening balance of payments threatened to run out of hand, when the brakes were slammed on and everything went into reverse. The go-stop policy cycle in other words produced the familiar boom-bust business cycle. Over time this experience induced a pervasive short-termism in economic decision-making on the part of both businesses and consumers. That increasing short-termism in turn led to the increasing amplitude of the business cycle, so that inflation rose progressively higher from economic peak to peak and unemployment rose progressively higher from economic trough to trough.

I am convinced that, with others, we really have taken on board the lessons of that experience. The requirements that public debt to GDP is kept at a stable and prudent level, with borrowing over the economic cycle limited to finance investment spending, constrain the use of fiscal policy as a short-term instrument. And monetary policy has been given the distinct role as the primary instrument for short-term aggregate demand management, with a target for retail price inflation, not simply as an end in itself, as some people still seem to imagine, but as a measure of the extent to which the growth of demand is held consistently broadly in line with the underlying - sustainable - growth of supply-side capacity.

The past ten years have in fact been a period of unusual stability in that broader sense for the UK economy as a whole. Inflation has been consistently low throughout that time - close to, and recently modestly below, our present 2½% target. But that has not been achieved at the expense of consistently high interest rates, and weak growth and high unemployment, as many people initially feared that it would. In fact nominal interest rates have been as low as most of us can ever remember; the overall economy has grown consistently for 40 successive quarters without interruption at an average annual rate of some 2¾%, which is comfortably above its long-term trend; and the number of people in employment has risen fairly steadily to close to an all-time high, while the rate of unemployment has fallen to a more than 25-year low.

The overall picture is much the same for the West Midlands region. I don't have regional data for real economic growth, but using the deflator for the UK economy, your region grew from 1992 to 1999, at an annual average rate of 2.7% - very close to the rate for the UK as a whole.

The number of people in employment in the region has also increased, with the employment rate now close to a 10 year high and in line with - in fact marginally above - the average for the UK of 74.6%. And the rate of unemployment - on the claimant count basis - at 3.5% is very close to its 25 year low. That's still a bit above the UK average rate, of 3.1% but it's very much better than the 10% rate of a decade ago.

Now I know it hasn't felt like that for everyone - particularly for internationally exposed businesses and their employees and for the regions in which such businesses are more heavily concentrated - including the West Midlands with its relatively high concentration of manufacturing businesses. I am well aware that many of them - perhaps many of you - have been having a rough time over the past few years.

Although the UK economy as a whole managed to avoid recession, UK manufacturing output fell from a peak nearly two years ago by around 7% and employment in UK manufacturing fell by 225,000 people, or some 6%.

To put that into perspective, manufacturing output fell from peak to trough over much the same period by over 16% in Japan, by 7½% in the US and by 6½% in Germany; and manufacturing employment fell by 7¼% in Japan, 9½% in the US and nearly 3% in Germany. So the pressures on manufacturing were not confined to, nor did they originate in this country.

There are two main reasons for the pressures on the internationally-exposed sectors of our economy. The first is the weakness of much of the global economy as a result of the Asia crisis and its aftermath in the late 1990's, and then, more recently, as a result of the sharp, synchronised, slowdown in the major industrial countries - as reflected in the figures I've just given you. The second reason is the strength of the sterling exchange rate, or more particularly the weakness of the euro for most of the time since its introduction some 3½ years ago.

The frustrating thing for us has been that that there was very little that either we at the Bank or the UK Government could do directly to address the problems at source.

That's fairly obvious when we are talking about the weakening of domestic demand in other major countries. It's perhaps less obvious that we couldn't have done more to affect the exchange rate. It's not that we didn't care - as has sometimes been suggested. In fact we've repeatedly made it clear that we'd welcome a stronger euro because that could help to restore a better balance to the UK economy. The problem has been that we didn't know how to bring it about, certainly without destabilising the overall economy. Many people think it's simply a question of reducing our interest rate by more than the ECB reduced theirs. But it really isn't as simple as that makes it sound. We did indeed do precisely that last year but sterling continued to strengthen - though it has in fact fallen back somewhat against the euro since as the euro has staged a moderate recovery.

What we were able to do - given that inflation was somewhat below target - was to try to compensate for the external weakness by stimulating domestic demand here in the UK. In a situation where business confidence - and therefore investment - was weak, that essentially meant stimulating consumer demand. It was not without risk - in terms of the build-up of household debt and of a possible house price bubble - but without it we, too, would have faced recession.

Looking forward, there is a reasonable prospect that global demand will pick up gradually, and we may see a more sustainable pattern of exchange rates beginning to emerge with the albeit hesitant strengthening of the euro. There are in fact already signs that manufacturing output has started to recover. But there are downside risks to that prospect associated with the renewed volatility of international financial markets over the summer, which we are monitoring very closely.

But abstracting from these recent global and largely cyclical, effects, the more fundamentally important point, looking further ahead, is the likelihood that we - alongside other countries - will continue to operate within a framework of overall macro-economic stability - as a necessary condition for the effective functioning of the market economy. Those presumptions may well mean that manufacturing continues its gradual, long-term, relative decline - as a share of total output, and in terms of the number of people employed - in all developed industrial countries, including the UK. But it does not mean that manufacturing output as a whole will contract in an absolute sense; on the contrary, past experience suggests that it will continue to increase, though the composition of output and techniques of production will continue to evolve. In that sense I very much share the view, of course, of the 49% of those surveyed by the ICA/IOD who disagree that manufacturing industry is in irreversible decline. It is entirely consistent with that view, of course, that other sectors, particularly the services sectors, will grow more rapidly and continue to increase their share of total output.

The precise form of the macro-economic stability framework may well continue to evolve, and it would in particular be affected in some degree by the decision on whether or not we join the euro. Were we to do so, the nominal exchange rate certainty with our European partners, representing roughly half our international trade, would - depending partly on an appropriate entry rate, whatever that might be - be of considerable longer-term benefit to many of the internationally-exposed businesses, in whatever sectors, that have suffered from the volatility, and particularly the weakness, of the euro in the past few years. And the greater transparency of prices and costs vis à vis other Eurozone members would enhance competition and the effective functioning of the single European market. There would also be benefits from the integration of our financial markets with those of the Eurozone. The potential downside risk - and one can debate just how big a risk it is - is that the macro-economic stability

framework - while based upon the same general philosophy as here in the UK - would in this case be directed to stability in the Eurozone as a whole. Monetary policy would be decided collectively by the ECB, and fiscal policy would be constrained by the European Stability and Growth Pact - so that the policy stance may not always necessarily be consistent with the particular macro-economic policy needs of individual member states. The essential purpose of the Chancellor's assessment of the famous five tests is of course to weigh the balance between these potential benefits and possible risks, and it will then be for the Government and ultimately the people of this country to decide. The outcome could have a bearing on the macro-economic context both for the UK as a whole and here in the West Midlands, but it is very difficult to predict what the effects might be.

Whatever the outcome of the euro debate, you will be operating in a market economy within a stability-oriented macro-economic framework.

The crucial point then is that the overall rate of growth that we can hope to sustain - which is the key to our future prosperity - will depend upon the vigour and flexibility of the supply-side of the economy. And improving our supply-side capacity is the major challenge confronting us all - at the national level but also here on the ground in the West Midlands. That's not something which monetary policy - which operates - as I say - on the demand side of the economy can do much about - at least directly.

Government in all its forms - at the European, national, regional and local levels - has a vital role to play in this, by helping to improve the transport infrastructure, for example, and I know that you will be discussing that subject later this morning; or by raising the standards of education and training, which are critically important in terms of the available skills of the workforce; and by providing the right business incentives and encouraging investment.

But the private sector, too, has a vitally important part to play - including at the regional level.

Private sector businesses clearly have a strong commercial interest in the prosperity of the communities in which they operate. And I find increasingly as I travel around the country that local businesses and their representative organisations - including both commercial and industrial sectors and the professional services sectors - are working together, with the local academic community, and with the regional and local authorities, to identify - on the basis of their local knowledge - the particular obstacles, and the particular opportunities, they face, recognising that there is a great deal that they themselves can do through partnership - including public-private partnership - to help create a more positive supply-side environment at the regional and local level. That partnership typically embraces not only issues facing the mainstream economy but extends to direct involvement in activities designed to draw into the mainstream economy communities which for one reason or another are liable to be left on the sidelines, but which, if they are given the right opportunities, clearly can contribute to both the economic prosperity and the social cohesion of the region.

And I find that positive approach here too in the West Midlands. It's very much the purpose of this conference - organised by AWM - Advantage West Midlands - alongside the IOD and the ICA. It's the purpose, too, for example, of the West Midlands Regional Finance Forum organised by AWM and bringing together the banks and accountants, representatives of the ethnic minorities and community finance organisations - including Aston Reinvestment Trust, as well as academics and the Small Business Service, with the aim of improving access to finance for business at all levels.

You've already come a long way in the West Midlands. You have weathered the international storm in your more traditional industries far better than might have been expected, and you have been relatively successful in diversifying into higher value-added and more knowledge-based industries. I wish I could claim that life will get easier looking forward to 2020 - but I can't promise that and you wouldn't believe me anyway! But what I do say is that working together, with your "can-do" attitude, you are as well placed as anywhere to overcome the challenges ahead - and I wish you all possible success.