**Mr George elucidates the new monetary policy arrangement in the United Kingdom and in the euro-zone**

Speech by the Governor of the Bank of England, Mr E A J George, at The Chartered Institute of Bankers in Glasgow on 18/1/99.

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Mr President, Secretary of State, Lord Provost, my Lords, Ladies and Gentlemen.

It would be a masterly understatement to describe the past two years, since the last CIB Scotland Dinner, as eventful.

Here in Scotland, following the referendum and last year's legislation, you are now actively preparing for the elections to the Scottish Parliament in May.

In my own neck of the woods, we have seen responsibility for the implementation of monetary policy devolved upon the Bank's new Monetary Policy Committee.

And elsewhere in Europe, 11 countries have merged their separate currencies into the single euro, thereby passing responsibility for monetary policy from national authorities to the new European Central Bank.

These are truly historic events.

I have no wish to become embroiled in the matters of Scottish politics this evening – I'm more than happy to leave that to the Secretary of State. I simply wish you all well, and look forward to developing a constructive dialogue with the new Parliament as we have with the Scottish banking and business communities. But let me say a few words about the new monetary policy arrangements here in the United Kingdom and in the euro-zone.

The real significance of those arrangements – in both cases – is that in introducing them the respective governments confirmed their common commitment to achieving and maintaining effective price stability in their respective currency areas. That role for monetary policy is not simply an end in itself, in some abstract, doctrinaire way. On the contrary it recognises that consistently and reliably low inflation, into the medium and longer term, is a necessary means to the end of sustainable growth of output and employment, which are, of course, the truly good things of economic life that we are all seeking to achieve.

Our own new legislation defines the MPC's objective as to maintain price stability and, subject to that, to support the Government's economic policy, including its objectives for growth and employment. The Maastricht Treaty defines the primary objective of the European Central Bank as to maintain price stability, and without prejudice to that objective to support the general economic policies of the European Union.

There are significant differences between the two statutory frameworks. In our case, for example, the precise definition of the stability objective is determined by the Government; and there are much more rigorous requirements for transparency of the MPC process and public accountability for MPC decisions. I am convinced that our arrangements are wholly appropriate to our particular circumstances. But the essence of what we and the ECB Governing Council are mandated to do is very much the same.

It involves in effect aiming to keep overall, aggregate demand in the economy (as a whole) more or less continuously in line with the underlying overall capacity of the economy (as a whole) to meet that demand. Effective price stability is essentially a measure of our success in achieving economic stability in that much broader sense.

It is a limited role. Neither we nor the ECB can do very much directly to affect the underlying supply side of the economy which depends upon its structural characteristics, and above all, in today's world, on the efficiency and flexibility of goods, capital and labour markets. Monetary policy cannot substitute for supply-side reform, but by maintaining price stability we can, indirectly, help markets to function more effectively.

Nor can either the MPC or the ECB do much directly to influence the pressures on particular firms or particular sectors or regions of the economy; we and they can only influence the monetary situation in the economy of our respective currency areas, as a whole. We have essentially one instrument: the short-term interest rate. But, again, if we are successful in achieving overall stability, that will also contribute over time to a more rather than less favourable operating environment for the different component parts of the economy. But that is the most that either we in the MPC or the Governing Council of the ECB can hope to do.

The fact that we both have essentially the same objective – and are subject to the same limitations – does not, of course, mean that we can adopt the same policy stance – the same level of short-term interest rates, as some commentators have recently, and oversimplistically, suggested. We start from different positions, and our respective economies are subject to many different, as well as many of the same, influences. That was an important economic reason why the Government decided, rightly in my view, not to participate in the first wave of monetary union – despite the attraction, in the right circumstances, of nominal exchange rate certainty across the European continent. It was, I know, a matter of regret to many of our European partners; but there was also a sense of relief, because many of them recognised that our different economic situation would have complicated European monetary management had we joined from the outset, as it would have complicated monetary management in this country.

In our case, the UK economy has grown at an average annual rate of around 3% now for the past six and a half years (to the third quarter of last year). 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 what we were in fact doing over this period was steadily reabsorbing the economic slack created by the recession of the early 1990s. In the labour market this was reflected in a rise in employment of some 1.65 million to an all-time high on the latest figures (for the three months to last November) of 26.6 million. It was reflected, too, in a fall in the rate of unemployment from a peak of 10.6% (on LFS figures) to the current rate of 6.1%, which is the lowest rate for almost 20 years. As far as the regional impact is concerned, I would note that over this period unemployment in Scotland – though still higher than in the UK as a whole – has also declined – to 7.6% on the latest LFS data, compared with a peak of 10.8%; and on a claimant count basis it, too, is currently lower than for 22 years.

These developments in the labour market produced only a fairly gradual pick up in pay settlements and earnings growth compared with past periods of labour market tightening – though we have, of course, been unsighted on what has happened to earnings growth more recently. And underlying retail price inflation – on the Government's inflation target measure (RPIX) – averaged some 2¾% a year through the expansion, and is currently exactly on target at 2½%.

By the time of your last dinner it was already becoming clear that overall output growth needed to moderate if we were not to run into overall capacity constraints and a pick-up in inflation. The exaggeratedly strong exchange rate against the core European currencies – reflecting inter alia market misperceptions about the prospective strength, or rather weakness, of the euro – was itself moderating external demand, especially for manufacturing output, while at the same time exerting a restraining price effect on domestic inflation. But domestic demand growth – including demand for services – continued to accelerate through 1997, and that was the background to the tightening of monetary policy in 1997. We could not avoid that tightening, despite the uncomfortable sectoral imbalance within the economy. To have done so would, as I have said elsewhere, have put the whole of the economy – including the internationally exposed sectors we would have been trying to shelter – at risk of accelerating inflation, so it would not have helped even those sectors in anything other than the short term.

Meanwhile, in the euro-zone things were very different. Demand and output growth in the major continental economies remained generally fairly sluggish for much of the period, only really starting to pick up towards the end – helped by relatively weak exchange rates. Unemployment, which is much the most urgent and important issue confronting Europe, actually increased; and, despite some improvement over the past year or so, it remains at or close to double digit rates in all the largest euro-zone countries. Inflation against this background remained low, tending lower – as did interest rates. The position is complicated in the euro-zone by a reviving political debate about just how much of the unemployment reflects supply-side weaknesses requiring structural reforms, and how much it reflects inadequate overall demand. The outcome of that debate will be crucial to the future evolution of the euro-zone. But in the immediate situation there was no reason to suppose that continued growth of demand and output was inconsistent with effective price stability in the zone as a whole.

So much for our different starting points. But over the past year, the world – and I mean the world – has changed quite dramatically for both of us in that we have both been affected by the international economic slowdown.

This started, in fact, with the financial disturbances in Asia in the latter half of 1997, but even as late as the beginning of last summer it seemed as if it might have only limited impact on the overall world economy. The IMF, for example, was still then projecting 3–3¾% world growth in 1998 and 1999 respectively – which was certainly a setback compared with their forecast of over 4% just six months before – but it was hardly catastrophic.

Since last summer it has become increasingly clear that things are likely to be significantly worse than that. The financial collapse in Russia, deepening recession in Japan, the long battle – then sudden defeat last week – in Brazil's attempt to hold its exchange rate, and fluctuating fears of possible knock-on effects on the major countries' financial markets all contributed to an increased sense of financial fragility, which has not been easy to contain. We can, I believe, still avert a more general international financial upheaval (and the financial markets' response to the latest developments in Brazil, as well as the beginnings of a recovery in capital flows to some countries in Asia, are reasonably encouraging in this respect). But, we are nevertheless bound to see a pronounced slowdown of world economic activity. The IMF has cut its latest (December) forecast for world growth to less than 2¼% in 1998/1999. And the risks almost certainly remain on the downside. That's still not global slump or recession. But large parts of the world economy are in fact in recession and the prospect for the world as a whole turns very much on what happens in the major industrial countries.

In essence, what we are seeing is a sharp cutback in capital flows to much of the emerging world and to some of the transition economies, enforcing on those countries a corresponding cutback in domestic demand and creating the need for an urgent improvement in their current accounts. The counterpart is a sharp decline in net external demand in the industrial countries, which, if it is not offset by action to stimulate domestic demand in those countries, could lead to weakening global activity and price deflation.

In fact to varying degrees – reflecting differing assessments of how far their particular currency area is expected to be affected by the slowdown in external demand, and different starting points in their assessment of trends in domestic demand, and of how close they were initially to full capacity, in their respective overall economies – both the UK and the euro-zone, as well as the US, have acted fairly aggressively to reduce interest rates since the autumn; and Japan has moved to more active fiscal stimulus. And if the global economic prospect, and net external demand in the industrial countries, were to deteriorate further, then it would be right to contemplate further moves in the same direction – consistently with our aim of effective price stability. What we are trying to do, as I said earlier, is to keep aggregate demand in line with the supply capacity of our economies. We have no interest in the creation of unnecessary spare capacity in our economies as a whole or in a fall in the underlying general price level.

But what this will inevitably mean is a worsening of the balance of payments on current accounts of the industrial countries, individually and collectively, reflecting the imbalance between external and domestic demand growth in our economies. That imbalance clearly will need to be reversed at some point as the flow of international capital is restored to a more sustainable level. The pressures can in the meantime be mitigated by official international financing, but private flows may take a while to settle down. For the time being, though, the directly and indirectly internationally exposed sectors, not just of the UK economy but throughout the industrial world, will continue to operate in a highly competitive environment.

All in all this is an uncertain and difficult prospect. It will be an exceptionally challenging period for both international and domestic monetary policy management in both the UK and the euro-zone as well as in the rest of the industrial world. And it will, I know, be a challenging period for many of you – even though the excessive strength of the exchange rate has now started to ease. But our economy as a whole starts from a position of relative strength compared with the past, and our own financial underpinnings, including both corporate and personal sector balance sheets, are relatively robust. We are currently seeing an overall slowdown – as we needed to do. That slowdown could go further. But I would frankly be surprised if it developed into a steep or protracted recession – that certainly is not the most probable outcome; it is not a necessary outcome; and it is one which the MPC will certainly seek to avoid – always consistently with achieving our inflation target.

Mr President, I can promise you that the next two years will be eventful. The only other certainty is that we will be confronted by the millennium. But I would hope that by the time we meet at this Dinner again the situation will be both clearer and calmer.

In the meantime, I thank you once again for your excellent hospitality and I ask you all to rise and to join me in a toast to the health and prosperity of the CIB in Scotland.

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