BANK OF ENGLAND

Speech

Speech by the Governor at the Queen Elizabeth Conference Centre, London

Speech given by

Edward George, Governor of the Bank of England

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Thank you, Mr Chairman, for that kind introduction. I'm honoured to have been invited to open this 3rd Euromoney International Bond Congress. I remember with great pleasure launching your initial Congress in October 1994 in the Barbican. It is an even greater pleasure now to launch the QEII! That first Congress was an ambitious and imaginative venture. But it immediately established itself as a major event in the international financial calendar. I congratulate Euromoney on that achievement, and, to judge from the program, on organising an even bigger and better Congress on this third occasion. I am delighted to welcome you all here.

I remember our debate at that first Congress particularly well, Mr Chairman. I remember it because I looked up my notes over the weekend! The context then was one in which yields had fallen very sharply, to unusually low levels, almost everywhere during 1993 only to back up just as sharply during 1994. We concluded, I think, that none of us really understood either the earlier strength of the market or its subsequent weakness! But we had a very enjoyable two days of discussion.

One concern at the time was that we were facing a global capital shortage, with increasing demand from the emerging, transitioning and developing countries at a time of strengthening economic activity and large government deficits across the industrial world. Referring generally in my remarks this morning to 10 year maturities, real yields - measured by our own indexed gilts had indeed risen in 1994 - by ¾% or more to close to 4%. But nominal yields had risen by substantially more - by something like 2% in the major markets - reflecting increased uncertainty no doubt, but clearly also worsening inflationary expectations.

In my remarks on that occasion, I ventured to suggest that bond markets might just be exaggerating at least the inflationary risks, by underestimating three factors in particular:

- First, the commitment of governments and central banks all around the world to disciplined macro-economic polices.
- Secondly, the restraining effect of both the level of real yields and of structural unemployment particularly in Europe.
- And thirdly, the counter-inflationary effect of global competition and technological innovation.

Now I seem to recollect that this suggestion was met with a degree of scepticism. That was not at all surprising. You had all heard that sort of optimism from the authorities before!

But the fact is that since around the time of that first Euromoney Congress bond yields have nevertheless trended fairly consistently lower, and are now in many cases close to or even below the low point they had reached around the end of 1993. Real yields, again measured by our own indexed gilts have fallen back to a little more than 3¼%; and the first US indexed bond issue yields much the same. And nominal yields have fallen by 200 basis points or more in continental Europe and Japan - though rather less in the United States and the UK. There has been more excitement in the foreign exchange market, with the dollar in particular first weakening against the Yen and the major continental currencies until the Spring of 1995 and then progressively recovering.

These developments were certainly influenced by the factors which I mentioned a moment ago. In particular they have been influenced by the continuing broadly-based consensus - in countries all around the world, and across a large part of the political spectrum within countries - on the importance of macro- economic policy discipline.

Macro-economic policy is no longer seen as an instrument for short-term demand management, which can be used to trade-off the conflicting demands of growth and stability in the short run. It is now much more widely understood and accepted that the rate of growth that can be sustained, or the level of employment that can be achieved and maintained in anything other than the short run, depend fundamentally on the structural, supply-side, characteristics of the economy, and not just on the level of demand. So today's orthodoxy ascribes to macro-economic policy the job of keeping demand in line with the capacity of the economy to meet that demand in the medium and longer term.

Within this overall framework, monetary policy is allocated the specific task of achieving and maintaining effective price stability. This is not, as some commentators still seem to suggest, simply some doctrinaire end in itself. Inflation is seen rather as a symptom of imbalance between demand and supply in the economy. So what we are essentially aiming to do through monetary policy is to anticipate the emergence of that imbalance and head it off before it becomes entrenched. If we are successful in that, inflation will be lower, there will be less need for violent interest rate movements than in the past, and the economy will grow at a steadier, and more sustainable and predictable, rate. That, in turn, will encourage more rational, longer-term, economic decision-making and investment, which will help indirectly to improve underlying, supply-side, performance.

Similarly today's macro-economic orthodoxy requires fiscal policy to be directed to restricting government borrowing to levels that can be sustained into the medium and longer term, without either forcing up real yields or implying the prospective need for progressively rising tax rates - which could otherwise damage the development of private sector economic activity.

Now in some respects we have made considerable progress over the past two years and more. Inflation in many countries - including virtually all the industrial countries but not confined to them - is now consistently lower than it has been for ages. That in itself has contributed to lower interest rates and to the lower nominal bond yields that I have described. But, in addition to that, fiscal consolidation, which has lowered the combined government deficits of the G7 countries from around $600 bn in 1994 to around $540 bn last year, has helped to reduce real yields, notwithstanding the continuing demand for capital from the developing world. And the really good news is that this macro-economic discipline has been accompanied by sustained economic expansion, with world gdp as a whole growing at an annual rate of some 3½ - 4%.

Now of course there have been quite marked differences in the performance of individual countries within this overall picture. Some of the transition economies have seen a brutal contraction of output which is only now beginning to stabilise. And there have been marked fluctuations in the growth rates of some of the emerging countries. Growth in parts of Asia, for example, is now moderating, cyclically, to a more sustainable pace; while parts of Latin America continue to recover from the set-back they suffered two years ago.

Among the industrial countries, too, economic developments have diverged over the past two years. In the United States and in this country, for example, inflation has been contained to around 3% with continuing growth and low or falling unemployment. And this pattern looks set to continue. In Japan and on the Continent of Europe, on the other hand, while inflation has been even lower, activity has been disappointingly weak, and unemployment on the Continent at least has risen to quite frightening levels. And while there is now the prospect of a moderate pick-up in activity in these countries, that is not yet assured. Japan, which is in many respects a unique case, faces substantial fiscal consolidation. And in Europe, too, the prospects are clouded by pressure to bring budget deficits down sufficiently to meet the Maastricht convergence criteria this year, notwithstanding the weakness of the domestic economies, and in an environment of longer term structural inflexibility.

These divergent developments go a long way towards explaining recent differences in the behaviour of both bond markets and exchange rates.

In both the United States and the United Kingdom the sustained expansion of domestic demand and of ouput has generated market expectations of an essentially cyclical rise in short-term interest rates. Sluggish economic activity elsewhere, on the other hand, means not only that short-term interest rates are significantly lower in Japan and the core European countries; but it also means that they are thought, by the market, to be less immediately likely to rise. This cyclical difference in the short-term interest rate prospect largely explains the pronounced yield differential between the US and the UK and the other countries at the very short end of the curve. Out to 2 years, for example, whereas yields in the US and UK are within ½% either side of 6%, yields in Germany and France are below 3½%, and they are below ½% in Japan. These differences in the short-term interest rate prospects feed through into yield differentials on longer term bonds, and changes in them also help to explain the recent movements in exchange rates.

But rather more interesting is the relative slopes of the yield curves further ahead, US and UK yields are only about 1% above present short-term yields, at +/-7%; but they are 3% or more above present short term yields in Germany and France, also at +/-7%; and they are 3% higher than short-term yields even in Japan, at 3¾%. The implication is that, if you abstract from immediate cyclical influences, longer term economic performance - and particularly performance with respect to inflation is not expected to be very different between the major countries - though Japan remains an outlier.

It is difficult to know what interpretation to put on this observation. The fact that the yield curves in Germany and France are practically identical is consistent at least with EMU going ahead - at least with a narrow membership. But the steep rise in implied future yields five years ahead suggests that inflation is expected to be higher in the medium term. That could be associated with expectations of softer macro-economic discipline, perhaps more specifically reflecting market uncertainty about EMU in the light of the ongoing debate about prospective membership and about how far the ECB will in practice be free to pursue its statutory task of maintaining price stability. It may, on the other hand, simply reflect some kind of market imperfection.

The same analysis can be applied to Italy and Spain for example to try to assess market expectations about their possible membership of EMU as part of the first wave. It shows that notwithstanding the recent falls in short-term interest rates in those countries - which can largely be explained by their improved economic performance - 5 years forward yields remain significantly higher than those in Germany and France suggesting that early EMU membership is not at all certain in the eyes of the markets.

What can we conclude from all this, Mr Chairman? Well the conclusions that I draw are essentially threefold and hardly very surprising.

I conclude, first, that markets at present are reasonably persuaded that the world economy as a whole will remain relatively stable at least by comparison with much of the post war period. Excluding short-term influences, bond yields in the major countries - apart from the special case of Japan - are converging around a level of around 7% which suggests that relative macro-economic, monetary and fiscal, discipline will be sustained, though it will stop short of effective price stability.

I conclude, secondly, that the markets see current developments in the US and the UK as essentially cyclical; and that they anticipate a pick-up in activity elsewhere somewhat further ahead.

And I conclude, thirdly, that there remains some considerable uncertainty about the prospect for European Monetary Union, in particular about its initial membership but also about the extent of the discipline it will involve.

Now, of course, these conclusions are based on the bond markets as they currently are, which is a bit like forecasting the past! What you really need to know is how the markets will evolve in the future. Happily it is not my task to venture down that path. It is during our next session that the market experts will seek to “forecast the future”. But I do hope they will tell us whether they agree that relative stability will indeed persist, in the medium and longer term, how they see the different national situations evolving in the more immediate future, and what prospects they see for EMU. These seem to me to be the key issues for the future and I look forward to listening to what they have to say.