Problems of monetary policy and change in the City

*The **Governor** discusses[1] the problems posed for the conduct of monetary policy this year by the strength of the dollar and the wayward behaviour of the monetary aggregates, and sets out the reasons why the authorities have felt justified in overriding the present £M3 target and placing more emphasis on other indicators, particularly the exchange rate.*

He goes on to comment on change in the City and the role—and limitations—of strengthened regulation and supervision; and notes, too, that the demand for additional physical facilities is likely to require some geographical spread of the City beyond the confines of the 'square mile'.

Monetary policy

It has been an especially difficult year for the conduct of monetary policy. Two factors in particular have complicated what is never an easy task.

First, we had difficulties during the winter with the extraordinary strength of the dollar. Sterling suffered more than most other currencies. It was affected by the accompanying uncertainty over the oil price—itself partly a further manifestation of the dollar's strength. But it was affected too by developing doubts about our own fiscal and monetary resolve. For a brief period the markets became hypnotised by the prospect of sterling parity with the dollar.

The sharp rise in the dollar gave rise to concern about rekindling inflation. And the uncertainty about how long the dollar's strength would last made it difficult to decide how to respond. But then as sterling fell against non-dollar currencies as well, it became clear that a strong corrective response was essential if lasting distortion to the economy was to be avoided.

In the event the inflationary threat from this episode has been contained. Industrial input prices, which in the spring were over 10% higher than a year before, are now absolutely lower than twelve months ago. And retail price inflation, which rose to 7% earlier in the summer, has since fallen to below 6% and looks set to continue falling well into next year. Meanwhile economic activity has continued to expand, employment to increase, and the growth in unemployment to moderate.

The second—purely domestic—factor complicating monetary policy has been the wayward behaviour of the monetary aggregates and particularly of broad money, which has recently tended to increase much faster in relation to nominal income than had been expected, or allowed for, in setting our £M3 target.

This tendency for the velocity of circulation of broad money generally to decline is not new; it has in fact been going on for at least the last four years. I cannot pretend that we fully understand the reasons for it. But two factors seem likely to have been important. First, the fall in inflation and the persistence of positive real interest rates during this period will have made money, particularly interest-bearing money, a relatively more attractive asset to hold than it was in the 1970s. Second, this attraction will have been further increased by the intensifying competition for deposits, which has brought a higher interest return and enhanced liquidity to many forms of deposit. The result has been that relatively high rates of broad money growth in the last few years—because they have been associated with higher demand for broad money balances—have still been consistent with the Government's aims of moderating inflation and nominal income growth.

Identifying these trends, especially in the present environment of rapid change in the financial structure, cannot be at all an exact science—as, for example, the US authorities have also found. And this has obvious implications for the nature of monetary targetry. It means that one cannot simply set targets for a period ahead, regard any departure from them as *ipso facto* decisive evidence that policy is too lax or too tight, and respond in a mechanical way. That never can be the position: real life is far too complex for absolute rules.

The significance of a departure from monetary targets is that it establishes an important presumption of the need for policy action. This presumption is, more often than not, likely to be confirmed by careful examination of all the other available evidence of monetary conditions relative to the Government's final objectives. But it is only a presumption, and, where there is justification to override, it would be perverse and damaging to the economy not to do so. The authorities are compelled to justify any decision to override that presumption, both to themselves and to the financial markets, which typically show a healthy scepticism in these matters. This is an important discipline.

(1) In a speech at the Lord Mayor's dinner to the bankers and merchants of the City of London, on 17 October.

The key question we have now to address is whether the strong acceleration of £M3 growth since the spring signals a dangerous looseness of policy or whether it represents a behavioural change without necessarily adverse implications for the future course of inflation.

There are grounds for believing that £M3 growth should not be taken at its face value in the present circumstances:

- The broader monetary aggregates, which include building society as well as bank liabilities, have not shown any similar recent acceleration. £M3 specifically has been affected by the banks' success in attracting retail deposits since the spring, with building societies having more recourse to the wholesale money markets; and £M3 has been affected also by a switch in building society liquidity out of gilts into bank deposits. These and other factors have tended to increase £M3 relative to other measures of broad money.
- Narrow money, M0 but also M2—a wider measure of retail deposits—is growing relatively slowly.
- The exchange rate is still relatively firm.
- Inflation is currently falling and real interest rates remain high.
- Expectations about the future pace of business activity do not portend undue pressure.

For these reasons we cannot at present rely upon the broad monetary indicators as much as we would wish. We have therefore felt justified in overriding the present £M3 target, and placing correspondingly more emphasis on other indicators, particularly the exchange rate.

There may be some who are tempted to go further and conclude that the present difficulties of interpreting the behaviour of broad money are such that we should, for the time being at least, ignore it altogether. In my view that would be extremely dangerous.

For one thing, there are some worries in the situation which can be seen, as it were, with the naked eye. Pay settlements and earnings, and, most disturbingly, unit labour costs, are drifting up. If these trends are not contained in the wage round which is now starting, the pressures they represent could threaten the continuation of growth in output and in employment.

These concerns underline the fact that we cannot be indifferent to whatever happens to broad money. Nor can we ignore its credit counterparts, particularly bank lending, whether to the public or private sectors. The build-up of liquidity in the economy remains an important feature of the overall monetary situation. And the faster that build-up, the more cautious we need to be about its interpretation.

In policy terms this means that the faster the growth of broad money generally, taking £M3 alongside the other broad aggregates, the greater the reassurance we need to find in the other available indicators before accepting that monetary conditions remain appropriately firm and that policy is continuing to have its intended counter-inflationary effect.

Change in the City

I turn now to change in the City, where we find a spirit of enterprise and innovation as vigorous as any previously seen. Alongside these new initiatives from the markets there have been new initiatives from the supervisors. For instance, the Securities and Investments Board and the Marketing of Investments Board Organising Committee have already been set up. And I was glad to hear what the Chancellor said about the philosophical approach to regulation, which we can look to see reflected in the forthcoming financial services and banking legislation. Meanwhile, at the Bank of England we are increasing and enhancing the resources devoted to banking supervision.

The supervisors must clearly persist in their efforts but we must not forget that there are limits to what a supervisor can be expected to do. Let me make three points here.

First, no system of supervision, however good, can substitute for management unless the supervision is so intrusive as to risk throttling the business. Good external supervision is necessary, but not sufficient, to assure the prudent and responsible conduct of business in an open and competitive financial service environment. The direction and management of individual businesses themselves are the key factors here.

Second, good supervision and regulation can ensure that financial service companies can transact their business in well-regulated markets, with protection against intermediary and counterparty risk and with disclosure and other provisions to combat manipulation. But this does not of course insulate shareholders in such companies from loss either as a result of fierce competition or from market risk, both of which may even become greater. We need to keep very clearly in mind that the more entrepreneurial environment in the City brings greater risk of loss as well as greater prospect of gain. When the gains come they will be generally welcome; but when the losses come, and they will, they should be construed not as a failure of the new City but rather as evidence of market forces at work in a competitive environment.

Third, like the Chancellor, I want to touch on the subject of fraud. Strengthened regulation and supervision should make fraud less likely, by reducing the possibility of dishonest managers entering the system; but they cannot be counted upon to stop every fraudster. There must also be a determination to investigate and prosecute where fraud is suspected and evidence found, so that those responsible are brought to book. The establishment of the Roskill Committee was a welcome initiative by government, and I hope that the vigour and resources currently being put into both statutory and self-regulation will be seen to be matched by parallel and reinforcing effort in the pursuit of financial fraud.

Change in the City also has a physical dimension. Some of the larger institutions now want different kinds of buildings with tailor-made dealing floors of much bigger areas than we are used to. Accommodation of this kind is in short supply. The City will certainly provide some of it, perhaps with some further development. I think it doubtful, however, whether it can, or indeed would want, to provide it all. I hope for the sake of all of us that a flexible balance can be found by suppliers, by users and by the planning authorities, which satisfies those requirements but also preserves the best of the environment in which we all have to work.

In this situation developers, their clients and the planners are looking at the alternatives. This naturally raises the question of our attitude at the Bank of England. Traditionally we have preferred the banking community to locate within easy reach of each other and ourselves. In practice this has tended to mean clustering within the 'square mile', although several large banks have already moved away. Perhaps the shift in emphasis from personal to electronic communication has altered the balance of the argument somewhat. If we are to achieve our goal of keeping London as one of the three major international markets in financial services, the people who provide them must have the physical facilities they need. For that reason financial institutions should choose for themselves where to locate in the light of commercial considerations. It is not our intention to stand in the way of their judgement.

We hope, however, that the City itself will retain its cohesive character. There is space within reasonable reach of the City to meet an overspill of demand. In short, a combination of imaginative adaptation by the City and complementary development in adjacent parts of London, particularly perhaps those whose traditional livelihood has largely vanished, would seem an appropriate evolution.