Developments in monetary policy and in the City's markets

Reviewing[1] developments over the past year, the **Governor** *notes the problems in pursuing monetary targetry in present conditions, while reiterating the commitment to monetary discipline. He goes on to comment on the major changes in the City represented by the Big Bang and the increase in competition they imply, and emphasises the need for all participants to exercise a degree of restraint in the new environment.*

This is an occasion for looking back with the outgoing Lord Mayor as well as looking forward, as to varying degrees the financial markets always do. As the Big Bang approaches our forward agenda is more than usually full; and I shall turn in a moment to some of the competitive and regulatory issues that we still face. But the past twelve months have been eventful too. I spoke here last year fresh from the Plaza meeting at which the governments and central banks of the Group of Five countries undertook to concert their efforts to bring about a substantial realignment of the dollar. I doubt whether any of us present at that meeting expected to see, over the following twelve months, a further 20% fall in the dollar combined with a simultaneous decline in dollar interest rates: this was, in last year's language, a soft landing indeed. It was made possible by the disinflationary impulse of a halving, in dollar terms, of oil prices.

What the fall in the oil price has not done, contrary to some expectations, is to prompt a sudden burst of non-inflationary growth—the obverse of the stagflation which followed the oil price rises in the 1970s. The fact is that all such shocks are initially deflationary—not only because losers adjust more quickly than gainers, but also as a result of the uncertainties that they breed, not least among financial intermediaries. Nonetheless the oil consumers of the world have benefitted from an increase in real income which will stimulate their demand for other goods, and we are now seeing this in the major industrial economies.

In the United Kingdom, much attention has been focussed on the exchange rate. With lower oil prices we needed the prospect of an improving non-oil trade balance. But thanks to lower oil prices the exchange rate change that has occurred, and which is fully sufficient to effect the necessary current account adjustment, need not add to the risk of renewed inflation. In the past, however, our competitive position has been eroded by failure to contain cost increases, so much depends on wages. Our performance to date on productivity comes nowhere near to warranting the 4%–5% annual growth in real income implied by the recent gap between the growth in overall earnings and retail prices. Room does exist for some rise in living standards, but we should not forget past experience of too rapid a rise in consumption all too easily leading to growing trade deficits. Part of the solution must be a sharp reduction in the general level of pay settlements. Recent indications offer some hope, but settlements averaging $5\frac{1}{2}$% are no lower than in 1983 when inflation was nearly 5%, or twice its present level.

Monetary policy cannot directly reduce the rise in labour costs; nor, more generally, can it bring about the improvements in industrial innovation and efficiency which are needed to take advantage of the opportunities now available to British producers in world markets. The role of monetary policy is progressively to squeeze out inflation, and the major economic distortions to which it gives rise, as an essential precondition for any sustained expansion in activity and employment. That has been our consistent aim over many years, and we have had a considerable measure of success. We are determined to ensure that this monetary discipline is maintained. The difficulties we are encountering in operating in turbulent markets, and at a time of rapid financial change, will not be allowed to jeopardise that fundamental long-term objective.

Our problems in pursuing monetary targetry in present conditions are not new, and, although currently more severe than elsewhere, they are by no means unique to this country. Monetary targets, whether broad or narrow, are being overshot in the United States and even in Germany and Japan. Narrow aggregates tend to be sensitive to nominal interest rates. These have fallen last year, reducing the cost of holding narrow money. Inflation has fallen too, indeed faster in the United Kingdom, so that real interest rates remain higher everywhere than in the 1970s. This is particularly true in the United Kingdom where it contributes to growth in demand for broad money.

In our own case M0, although still within its target band, has shown some recent acceleration and the target aggregate for broader money, £M3, has been growing for much of the last year well above its target range. One factor which has rendered the growth of £M3 more erratic than that of other aggregates is the process of financial change and in particular its sensitivity to the ebb and flow

(1) In a speech at the Lord Mayor's dinner to the bankers and merchants of the City of London, on 16 October.

of the competition between banks and building societies. £M3 is related to bank intermediation. If this expands at the expense of other intermediaries, money may grow without either total liquidity or total credit expanding as much. Even so, liquidity and credit have in fact been growing uncomfortably fast and markets have not failed to perceive this.

Recently there has been heavy speculation against sterling at a time of particular uncertainty about the outcome of meetings relating to interest rates abroad and oil prices. As in January we have refused to be rushed into hasty policy decisions by this period of market turbulence, and have acted to moderate the more erratic movements in both the domestic and foreign exchange markets. But it would be a great mistake to interpret this determination not to be swept off one's feet in the short run as a reluctance to take necessary action at the appropriate moment—as our action on Tuesday showed. Markets deliver important signals; but they also generate a degree of hubbub and it may take time to distinguish the true signal as it emerges from the noise.

My Lord Mayor, great changes in the City are to take place this month: after three years of preparation the reforms known as the Big Bang are about to be implemented. They are the largest changes to have taken place in the City in the lifetimes of anyone present tonight, and represent a triumph of adaptability and vision on the part of the old and the new members of The Stock Exchange who have embraced reform so positively.

These developments in the way in which business is done and in the membership rules of The Stock Exchange were of course quite deliberately intended to open up the market to competition. There is every sign that they have succeeded in releasing a great burst of energy and talent, not only in The Stock Exchange but in many other financial markets. All this is very healthy and welcome, but we need to keep in mind that competition brings risks as well as benefits and can be a destructive as well as a constructive force. Regulation is being modified to accommodate and promote competition, and to ensure that markets are well conducted and investors reasonably protected. Of course, some firms may overreach themselves. There may be losses, and it is possible that some of the participants in these highly competitive markets will eventually withdraw. No one should regard that as a failure of the new system. There are clear limits to the extent to which regulators of any kind can or should influence the conduct of business.

Consequently it will be vital for all market participants to exercise a degree of restraint. Market makers and broker-dealers will naturally strive to secure a market share which will support the capital committed to their business. But if this leads to excessive margin-cutting, they will store up trouble for themselves. Again, if market share is acquired aggressively through predatory pricing, it could work, in the longer run, to undermine the increased competition that we have striven to introduce. Similarly, I should like to see institutional investors recognise their interest in being able to deal with a wide array of soundly-based intermediaries, and I hope that they will exercise restraint on their use of their bargaining power. I hope also that we will continue to avoid levels of gearing in the corporate sector as a whole which, although perhaps acceptable in favourable conditions, could prove to be seriously destabilising when times become harder.