One year on . . . the economy and the City

Reviewing recent economic developments, the ***Governor*** *stresses*[1] *the importance of persisting with restraint until the downward pressure on inflation is clearly re-established; and warns that emerging trends in wage settlements and earnings could extend the current setback to progress on the inflation front and lengthen the period of higher interest rates.*

He goes on to comment on the need for continuing progress in improving the infrastructure of the financial markets, highlighting in particular the need to eliminate the paper-based settlement system in the securities market and the desirability of a centralised book-entry and transfer system for money-market instruments.

Speaking so soon after the anniversary of last autumn's natural and financial gales, it is inevitable that I should ask how the judgements that we made then have stood the test of intervening events. The shocks that we experienced last October provide the themes for my remarks tonight. They fall into two parts: first, our economic concerns; and second, the progress of work on the City's infrastructure, which was severely tested by our hurricane, still incidentally nameless, and by subsequent events in the markets.

I spoke last year of the need for monetary policy to remain flexible and pragmatic without losing sight of our primary long-term objective of stable prices. At the time I judged it likely that the *direct* effects in the United Kingdom of the stock market fall would be small. But I do not regret the part we played in a world-wide monetary response which averted the threat of global recession—albeit, with hindsight, at some cost in sustaining and increasing demand.

I need not dwell on the process by which our fears of recession gave way to a realisation that growth, in particular of domestic demand here, was continuing at an unexpected and unsustainable rate, and that monetary policy should be tightened to head off growing inflationary pressures. The transition was obscured by misleading statistics, which for a while suggested a slowdown in the first quarter, as well as by the strength of sterling at the beginning of this year, which delayed the appropriate rise in interest rates.

The reputations of both economic and weather forecasters are probably lower now than a year or so ago. But we still face uncertainties, and have difficult judgements to make. In particular, while we wait for further evidence of the response of domestic demand to the tightening of policy that has already occurred, the early phases of the autumn pay bargaining season give grounds for concern.

Earnings growth has been buoyed up by a number of factors other than rising settlements. But they too have been edging up, and there is a danger that wage negotiators will be unduly influenced by temporary elements in the retail price index. My fear is that such a reaction would extend the current setback to progress on the inflation front, and that in turn would lengthen the period of higher interest rates to which we have recently reverted.

Some effects of that tightening are already becoming apparent: there is evidence of a slowing of transactions in the housing market—transactions which are the occasion of much other expenditure, and much of that credit-financed; mortgage commitments have fallen off; and if this persists retail sales, which fell back in September, will slow further—as indeed they need to do. I do not pretend that the tightening of policy now in place will produce a rapid resolution of our present concerns, but what is fundamentally important for the longer term is that we should persist in restraint until the downward pressure on inflation is clearly re-established.

The extent and timing of responses to policy moves are always difficult to predict, and some uncertainty is inevitable as we wait for conclusive evidence that adjustment is in train. It is sometimes said that financial markets thrive on uncertainty—always provided, of course, that the actual ride is not as bumpy as last October's! But the capital markets have in fact provided a difficult background for the many firms that have worked so hard over the past few years to build up capacity, to acquire new subsidiaries, and to enter new markets; and which now have to grapple with escalating costs. I do not think that their difficulties can all be attributed to last year's equity market crash; or to the reduction in turnover; or to the earlier stagnation of the Eurobond market; or even, dare I say it, to the requirements of the Financial Services Act. Markets here are at any time highly competitive. A lot of new craft were launched a year or two back, and their experience has been likened, in a recent American report, to 'learning to sail in a hurricane'. Now many firms are looking again at their

(1) In a speech at the Lord Mayor's dinner for the bankers and merchants of the City of London, on 20 October.

objectives in the markets, and at their costs. But there are other needs—not least, an efficient infrastructure and a regulatory regime which is not needlessly intrusive.

Let me speak of the infrastructure first. I think there is much greater awareness now of the risks involved in all those markets where there is a significant delay between transacting a bargain and finally settling it. Maybe we have been too ready to take these back-office matters for granted. But efficient settlement and payments systems are essential to containing risk in the financial markets, and the time may be approaching when we need to look again at the coherence of our arrangements. If progress is to be achieved, the co-operation of all parties will be essential. And in that respect, the story of the past twelve months in London is a mixed one.

The settlement backlog in the Stock Exchange has been dramatically reduced and continues on an improving trend. This has of course been helped by the marked reduction in turnover since the crash. Although the Exchange has adopted close monitoring procedures which will, I hope, prevent a repeat of the difficulties experienced in 1987, the most significant step has yet to be implemented: that is, the elimination of the current paper-based settlement system. The Exchange's plans in this regard are well advanced, and it is important that all those in the City with an interest now share in building on those plans to produce a system which meets the reasonable expectations of all parties. I am pleased, also, that the Stock Exchange is giving thought to proposals to move to a system of rolling settlement in the equity market.

In another field, we have recently seen the intended launch by LondonClear of an initiative to provide a central depository and book-entry transfer of instruments traded in the London money market. This project had to be abandoned because of doubts about its costs, which meant that it could not obtain the critical mass of committed support necessary to ensure its financing. But I do not believe that the termination of this particular project need involve rejecting the concept which underlay it. Indeed, I consider that a centralised transfer system for these instruments would be a desirable addition to the facilities offered by London. And so we and others are examining options for developing an alternative system to that proposed by LondonClear which would meet similar objectives. The City has to modernise and cannot continue to conduct such key parts of its business through methods more appropriate to the era of the coffee house than to that of the computer.

Turning to regulation, I need not rehearse the very welcome steps that are being taken to simplify the SIB rule-book. I hope, though, that those who are looking for progress will understand the complexity of the task facing the new Chairman, and recognise that changes have to be carefully considered and prepared.

With the inexorable approach of 1992, moreover, it is increasingly necessary to view the City's arrangements in a European context. We are engaged in discussions both in London and in Brussels on directives affecting the regulation of the banking and securities industries. We need to ensure that the emerging European framework will be effective, from a regulatory point of view, while at the same time promoting market efficiency. In this context I am particularly anxious, as I know are many here tonight, to see that nothing is done to make our markets less open and welcoming to *non*-European participants.

There are many practical consequences of the single market; and we have through our own enquiries in the City been seeking to ensure that both the opportunities and the risks are properly understood. The agenda is huge, but there are clear benefits to be gained from the series of practical, realistic steps that 1992 encompasses. There is a lesson here, I believe, for those who seek to promote grander and more distant visions of European unity. If they cannot capture the imagination of practical men, or offer tangible and unequivocal benefits, they will remain visions, and their pursuit will have the opposite effect to that intended.

An example of a practical step in the right direction is the ECU Treasury bill programme successfully launched earlier this month. I very much hope that this broadening of the range of instruments will appeal to other issuers. This type of innovation is characteristic of our markets and, as there is little reason to believe that the future will be any less eventful than the past, the resilience of both the markets and institutions here to the upheavals and shocks of recent years give us grounds for confidence that they will flourish as they should.