The markets, the City and the economy

Speaking in the immediate aftermath of the worldwide upheavals in stock markets in October, the ***Governor*** *reviewed*[1] *the successful implementation of the major changes in The Stock Exchange and the progress towards establishing the new structure of City regulation. He went on to examine prospects for the UK economy in the light of the stock market fall, arguing that the strength of activity and the improvement in productivity left the United Kingdom relatively well placed to weather the storm.*

. . . In the past, this dinner has been held in the middle of October, and I very much applauded your decision, my Lord Mayor, to hold it this year rather nearer the end of your term of office. But I cannot help speculating upon what my speech might have contained had it been given at the customary time. No doubt it would have been very different, even though one of my themes tonight is that, with appropriate policies, our views on the prospect for the real economy need not undergo too drastic a revision. I understood your original suggestion, my Lord Mayor, to be that your year should end with a bang! I hasten to add that I do not hold you personally responsible for the upheavals in the world's markets since the middle of October, although these have, of course, been the intense preoccupation of the financial community. But although the markets have remained uncertain over the past day or two, it is still appropriate, as in former years, to offer what has become the traditional annual stocktaking.

One of the most important influences of recent days has been the resolution of the BP sale, and the City is I think to be commended for the readiness of so many of those expecting to be adversely affected to see the share offer carried through. In this connection I would like to take this opportunity to congratulate the Chancellor on the wise and effective choice that he made last week, to resolve the unprecedented dilemma of having launched the largest-ever internationally-underwritten equity issue and then being faced with markets more dramatically disturbed than at any time in the present century.

I would agree with the widespread comment that part of the fall in equity prices constitutes a correction. This carries the implicit criticism that a more rational market might have avoided both the earlier overvaluation and the recent disturbance. In part, however, what happened was the markets' reaction to unresolved tensions in world payments balances, and particularly in the public finances of the United States.

While market conditions on the first anniversary of Big Bang were scarcely comfortable, we should not allow that to detract from the achievements of the past twelve months. The efficiency and liquidity of both domestic and international capital markets in London have improved, and the presence of British houses in the world securities industry has been strengthened. Although much still needs to be done with respect to settlement systems, the technology that backs the very visible quotation system of The Stock Exchange has operated to a very high standard indeed. The new dealing arrangements which this permits involve much quicker reactions than before. These may sometimes sharpen, rather than reduce, price movements in the very short term, but in most cases the more rapid assimilation of information enhances market efficiency. Even so, one of the features in the markets has been the disparity between stock price movements in the major centres, and in particular the fact that the UK market has shown a much steeper fall than might be suggested by the strength of our economy in relation to others.

The past year has also seen rapid development in City regulation, and it has been a formidable achievement to put the new structure into place. But within that structure, the main emphasis so far has been on drawing up detailed and fully-articulated regulations, and in this phase the practitioners' contribution has been overshadowed. I hope that we are now moving into a phase of application and refinement in which the practitioners can be allowed a greater part. This should contribute to a more sensitive balance between the protection of small investors and promoting efficient professional markets.

The main focus of attention during the changes in the City has inevitably been on market intermediaries. At the same time, the CBI task force, under Sir David Nickson, has examined many aspects of the complex relationship between the main users of the market—investors and industry. I was glad to hear that its report was so well received by the conference in Glasgow yesterday. It is of course essential for investors and the market to be sensitive and sympathetic to the problems of industry. It is therefore encouraging to know that emphasis is being placed on improving relations and communication in both directions, for this will stand all parties in good stead whatever lies ahead.

(1) In a speech at the Lord Mayor's dinner for the bankers and merchants of the City of London, on 4 November.

The health of this relationship is important for the real economy, which has recently been expanding at a robust 4%, with manufacturing expanding at an even faster pace. Unemployment, after peaking in the summer of 1986, has recently been falling at a rate of about 40,000 a month. In the last three years we have seen the pace of growth falter and then surge ahead; this has had an effect on productivity and unit labour costs which has run the risk of feeding alternately false fears and misplaced euphoria about our prospects. Our view is that the underlying trend growth of productivity has now reverted to something like the levels of the 1960s—which is more than can be said of most of our competitors.

This provides a relatively firm base from which to confront the uncertainties engendered by the movements in world stock markets. They are bound to lead to some downward shading of projected growth of world demand—particularly in the United States where demand is relatively more sensitive to changes in wealth. This deflationary tendency alters the context of discussion of the US budget. There is no diminution of the need for measures to reduce the structural deficit, but we should recognise that, for any given policy mix, a slowdown in activity in the US economy must inevitably affect the deficit.

It takes time to adopt and implement appropriate fiscal measures; but the initial responses of the authorities in *most* countries encourage the view that damage can and will be contained. I am sure that these responses, which have involved deliberate increases in the supply of liquidity to the system, were correct, even though at an earlier stage liquidity growth had been seen as a potential source of renewed inflation.

The direct effects of the stock market fall on the growth of consumption in this country seem unlikely to be all that great. Potentially more vulnerable is the recovery of industrial investment which is currently under way, and which is central to sustaining non-inflationary growth.

The rise in the cost of equity capital will be only partly offset by lower interest rates, but company profits should remain strong. Industrial companies have not in fact been financing their fixed investment by borrowing either from banks or from the capital markets, and their balance sheets have not been weakened. I see little reason to shade down much our expectations for next year, and our own forecast for the growth of the non-oil economy is very close to the 3% published yesterday by the Treasury. The perception that a market storm has devastated the ability of companies to conduct their business or to invest seems to me misplaced.

Finally, let me turn to some longer-term aspects of our trade performance. The contribution of oil to our current account reached a peak two years ago. But over half of the decline since then has been made up by growth of invisible earnings; this owes much to the way investors responded to the opportunity presented by the abolition of exchange controls. Moreover, much of the reduction in oil's contribution is due to the fall in its price since 1985. This gave us an opportunity to make industry more competitive without generating inflation. Of course the rise in the oil price from its low point has reduced the scope for doing so, but it has by no means eliminated it.

In a turbulent environment we have endeavoured to give industry the advantage of a more stable exchange rate. This meant reducing interest rates earlier in the year by perhaps more than was justified by purely domestic considerations; so that, when pressures on the exchanges permitted, it seemed right to raise them a little in August. Since then we have seen reductions, including one today, in recognition of developments in financial markets both here and abroad, when the strength of worldwide demand is beginning to be questioned. I have no doubt that our approach to monetary policy should remain flexible and pragmatic; but I can equally assure you that we will not lose sight of our primary long-term objective of stable prices.

Early in the New Year, the ***Governor*** *reverted*[1] *to the theme of the prospects for the UK economy in the changed circumstances following the fall in equity prices. He argued that the growth of domestic demand immediately before the crash was unsustainably rapid: and noted that, while there had been some weakening in expectations, there was no evidence, in the final months of 1987, of any diminution of growth. He concluded that the indicators of continued buoyancy in the economy and the need to prevent a resurgence of domestic inflationary pressure argued for continued caution in economic policies.*

The New Year is a time for taking stock of our economic performance and prospects; but on this occasion it has been peculiarly difficult even to judge what the starting point is—to get a clear picture of where we are now. The stream of bullish economic indicators, most of them still relating to the economy before 'Black Monday', is telling one story; post-crash sentiment, often rather grandly described as 'anecdotal evidence', sometimes appears to tell another; while the forecasts, with uncharacteristic and slightly worrying unanimity, tell yet another.

Of course, you cannot judge where you are just by looking at your wake. But the national indicators do tell us that the growth of domestic demand immediately before the stock market crash was significantly stronger than many had thought—indeed, unsustainably rapid. So far, the

(1) In a speech at the Dundee and Tayside Chamber of Commerce and Industry, on 7 January.

indicators for the period since October suggest no diminution in this rapid growth. With retail sales still rising at an annual rate of 6%, we have yet to see any real impact of diminished financial wealth on consumer spending, and there is no sign of any weakening in investment outlays—while at the same time there are some reports of skilled labour shortages and capacity utilisation is at its highest level since 1979.

But the buoyancy of the indicators is not altogether reflected in expectations for 1988. Ever since the first decline in the stock market, company managements have been avidly cross-questioned about the likely impact on their turnover, profits and investment spending. Hardly surprisingly, given the chequered background of positive economic data but generally depressed financial markets, the responses have been variable. It has of course been encouraging to see the strength of confidence reported in recent CBI and DTI surveys, both suggesting that capital spending will continue to strengthen this year. But equally, there are industrialists who are looking more closely at their spending, re-examining investment plans and curtailing orders so as to prevent any unwanted build-up of stocks.

There is, I think, a point to be made about the anecdotal evidence. We do need to be sure that the right question is being asked. If one asks an industrialist how the fall in the stock market will affect him, he may truthfully and accurately reply 'not much'. But if, on the other hand, one were to ask how far the appreciation of sterling against the dollar was likely to affect his export prospects; or how seriously a slowing of the US economy and of world demand generally would affect his markets and his profitability; then the response might be more revealing.

Both here and abroad,then, it has been difficult to assess the strength of economic activity. While there is little in the statistics to suggest that policy should be anything other than cautious, it is very difficult to judge just how far developments in the financial markets may themselves exercise a deflationary impact.

In the United States, the immediate response to the stock market decline was an easing of monetary conditions. In European centres, too, interest rates have come down, mainly in order to support the dollar. In this country, our three successive cuts in interest rates were in part a response to the stock market—the aim being to ensure calm in the financial markets, and to offset the contractionary effects of the steep decline in share prices. We have also had to be sensitive to the tendency of markets to become fixed on particular totems—the BP sale, the US budget negotiations, the G7 communiqué.

But just because policy is reacting to a new series of problems, it does not mean that the old problems have been solved. The world economic outlook is still dominated by current account imbalances between the United States on the one hand and Japan, the newly-industrialised Asian countries and Germany on the other. In terms of trade volumes, these imbalances have begun to improve, responding to earlier movements in exchange rates, but we still need to see a considerable slowing in the growth of domestic demand in the United States with increased spending in the surplus countries. We have already made some progress in international policy co-ordination, but there is much still to be done if we are to avoid the dangers of unstable currencies and indeed of a further unwelcome and probably unjustified decline of the dollar. But as the market itself has recognised, higher dollar interest rates may have to play a part in this.

In this country, my best judgement at the moment is that the indications of continued buoyancy in the economy, and the need to prevent a resurgence of domestic inflationary pressures, argue for steadiness in our economic policies. Consumer spending this year is unlikely to slow by very much while earnings are running so far ahead of retail price inflation; and whatever may be said about confidence and intentions, companies in general enjoy very strong financial positions at present. Pressures from domestic demand, therefore, are unlikely to abate by very much, and the likelihood that growth of demand abroad will slip further behind growth in demand here provides yet another reason for cautious policies.

In these circumstances industry will, I suggest, need to keep a tight control over wages and costs: I suspect that competitiveness will take on more than usual importance. In this connection, I should perhaps say a word about exchange rate policy. You will know that we have sought for some time now to secure a degree of exchange rate stability, and while there were limits to what we could do in terms of the dollar exchange rate while the dollar was falling so steeply, we have succeeded in keeping sterling reasonably steady against the deutschemark and other currencies. This involved, for much of last year, measures to prevent any excessive appreciation of sterling, and I know that many industrialists welcomed this as a useful framework for long-term planning. But the policy has to be seen as symmetrical. If pressures were to develop the other way, and if we were not to compromise the anti-inflation policy to which so much of our recent success can be attributed, we would have to resist those pressures as well. The commitment to stability involves a readiness to prevent an undue depreciation of sterling, and industrialists should not expect cost increases to be validated by a weaker exchange rate. It is important that this is understood now since the probable slowdown in output and thus in productivity could markedly worsen our relative labour costs.