Monetary policy, equity markets and the City's infrastructure

Reviewing the economy's response to date to the tightening of monetary policy, the **Governor** *stresses*[1] *the need for persistence with a firm monetary stance and warns against unrealistic faith in any quick or easy alternative. He goes on to comment on recent events in world equity markets and on some of the questions they have raised; in the UK context he gives a cautious assessment of corporate gearing and high-risk bond finance. Finally, he underlines the importance for London's position as a pre-eminent financial centre of progressive strengthening of the infrastructure of the payment and settlement systems.*

Monetary policy

On this occasion a year ago, I referred back to the natural and financial gales of 1987. It is quite remarkable that over the past week we have again seen the coincidence of a natural disaster, this time in the United States, and a shock to the equity markets. I certainly do not believe that much should be made of the *coincidence*, but it does prompt us to think again about the robustness of our infrastructure. I shall come to that and recent market events later, but first I should say something about the course of monetary policy.

Last year I referred to evidence that tighter monetary conditions were already having an impact on the housing market. At the time, this was most apparent in the South East, but since then a softening of house prices and slowdown in housing activity has spread to most of the rest of the country. And there is a good deal of evidence—of both a quantitative and qualitative kind—that domestic demand both from the household sector, and prospectively from the corporate sector, is being reined back, as it has to be.

The process of adjustment has been a gradual one. Indeed I cautioned a year ago that the policy tightening that had mostly by then already occurred could not be expected to produce a rapid resolution of our concerns, and the subsequent evidence shows that the earlier demand pressures were even more buoyant than had been appreciated. Judged solely by the statistics, the process of adjustment has at times also seemed erratic—statistical series always do contain a good deal of random noise. Not surprisingly therefore at this stage of the process, financial market confidence has been fragile. Sterling began to weaken after the publication of the August trade figures and in the context of developing anticipation of a rise in German interest rates. When that occurred two weeks ago, and was followed immediately by most other European countries (and a little later by Japan), given the market circumstances at the time we had to follow suit.

I have no doubt that tight monetary policy is the right approach to cooling down an economy which has been seriously overheated by excessive private sector borrowing. And I have no doubt either that this further rise in interest rates was necessary to prevent our non-accommodating monetary stance from being undermined by a sharply lower exchange rate. That would have interrupted the adjustment process now in train, making its ultimate effect all the more painful.

I should add that it is quite unrealistic to suppose that there is a series of rabbits waiting to be pulled out of a top hat—whether it belong to the Government Broker or anyone else—which would miraculously make the process easier. There *is* no quick fix solution. This applies as the Chancellor has said to alternative forms of control. It applies also to joining the exchange rate mechanism of the EMS: whatever the arguments for this—and they are powerful—it is illusory to believe, as some comment seems to suggest, that it would bring instant relief of itself or could be a substitute for the policy and the response to it which must come from our own exertions.

What we need now is persistence and patience. There is, as I have said, a great deal of evidence that the policy is already working with an easing in the pressure of demand. This will bring better balance to the economy and a gradual improvement in the balance of payments. Inflation, excluding the element of the RPI directly related to interest rates themselves, has already eased back from the peak of 6% reached in May. Its fall cannot be allowed to be jeopardised by talk of double-digit pay settlements at a time when productivity growth in manufacturing, though still much higher than for long periods in the past, has trended downwards to around 5%. In the face of a continuing firm monetary stance, such high pay settlements would carry ominous implications for employment, particularly in other sectors where productivity grows more slowly. With good sense that too can be avoided.

(1) In a speech at the Lord Mayor's dinner for the bankers and merchants of the City of London, on 19 October.

Markets and gearing

In the last week equity markets throughout the world have experienced a nasty jolt—all the nastier for its echoes of Octobers two and sixty years ago. It is very clear that the experience here owed nothing to the particular problems of the British economy; or to concerns in London's market with the effectiveness of our policy; or to concerns in any market with the state of policy co-operation between the seven major industrial countries. On the contrary, as on the previous occasions,the shock waves had their origin in the United States, with whose markets ours tend to march in step and where a major leveraged buy-out was jeopardised by a failure to secure bank finance. But the fact that we have seen fewer such deals here—and particularly few involving 'junk bonds'—provided no immunity against a shock emanating from that market.

The markets now appear to have steadied, and this underlines the greater validity of current values than the similar ones of two years ago. The jolt and the questions, scrutiny and analysis it engenders are probably on balance salutary.

In the United States, where LBOs have been taken further and where corporate gearing has been raised more generally by companies buying in their shares, concern has been expressed that the consequent vulnerability of the corporate sector to interest rate increases might inhibit the authorities in the timely conduct of monetary policy. Whether this is so despite the fact that their corporate sector is less highly geared than those of Germany and Japan I hesitate to say. What I can say is that it is not true here. Indeed starting from our traditionally low level of gearing and given the strengthening of corporate balance sheets in recent years, a reduction in corporate liquidity which makes business sensitive, though not vulnerable, to interest rates enhances the effectiveness of monetary policy.

Let me add that I have no difficulty in principle with high risk bonds, provided that those bearing the risks have taken appropriate steps to satisfy themselves that they are to be adequately rewarded. My message in this respect tonight is very similar to that I gave last week concerning property lending.

Thus, my concern as a supervisor of banks is with the prudential implications of such deals for banks which supply bridging or longer-term finance. Such arrangements might bring individual banks up against the rules relating to large exposures—but in practice the loans have been so structured and distributed as to give us no concern on this score. We also continue to watch carefully the exposure of banks as a whole to relatively high risk transactions, especially those vulnerable to a development, such as a general rise in interest rates, which affects many borrowers in the same way. I can say that this exposure too is still at present below the level that might turn on a danger signal.

Regulation and infrastructure

For the best part of five years now the City has devoted a lot of attention to structural and regulatory matters connected with the Big Bang and the Financial Services Act of 1986. I am glad to say that the system provided for by the Act is very largely in place and I hope it can now settle down with less continuous high level attention than it has pre-empted hitherto. There had been a risk that our arrangements would need to be moderately adjusted yet again to meet Community requirements, but happily it now seems that that part of the approach to 1992 may go more smoothly than originally expected.

I am very conscious of the costs that have been, and continue to be, involved in regulation and therefore welcome not only the SIB's simplified rulebook but also the Secretary of State's acknowledgment of these costs and his intention to amend legislation accordingly. We shall need to remain vigilant in striking the balance between the protection of investors and the costs imposed on the activities of financial firms if London's competitiveness is not to be eroded and 'regulatory arbitrage', a terse and sinister phrase, is not to become a criterion in decisions on where to conduct business.

In the meantime, there is a growing recognition of the need to improve the infrastructure of the industry's settlement systems. This is Andrew Hugh Smith's first year as Chairman of the Stock Exchange, and such is the impact he has made that it is surprising to recollect he has been in office for so short a time. As he has just said, he is working with the other interested parties on the equity settlement system, as well as proposing changes in the Exchange's dealing rules and in its structural relationship with the London Traded Options Market. I am convinced that this bold programme for the Exchange points in the right direction. The Chairman calls for co-operation and assistance from all parties involved, and I certainly hope that he gets it.

But the infrastructural improvements in prospect are not limited to the equity market. In particular, I am glad that, building on its experience with the Central Gilts Office, the Bank was in August able to announce its detailed plans for the Central Moneymarkets Office settlement system for the money markets. And earlier in the year, I addressed related themes in my Ernest Sykes' Memorial Lecture, and have been pleased by the debate that has started on the future of the wholesale payment systems and the services they provide to other City markets.

Combined with what I hope will increasingly become—and be seen to be—a strong regulatory system, robust and efficient payment and settlement systems will be essential to maintaining London's position as the pre-eminent financial centre in this time zone. I therefore attach great importance to their progressive strengthening.