Stability and economic policy

*Reviewing the conditions necessary for durable economic growth in the 1990s, the **Governor** stresses[1] the vital importance of stability of prices and stability of policy. This, he argues, can only be achieved by building up the constituency for a consistent counterinflationary policy and a credible medium-term framework. The **Governor** goes on to underline the equal importance of a strong and stable banking system, and warns against a relaxation of the Basle capital adequacy standard. Finally, he comments on the benefits that liberalisation has brought, and points out that, although recent financial scandals around the world may have been encouraged by the new competitive climate, liberalisation has also been accompanied by increasing vigilance on the part of regulators and by stricter standards of conduct.*

We in the City of London are often accused of taking an unnecessarily short-term view of industry and its prospects. So let me tonight step back from the current conjuncture and look at the longer-term opportunities and challenges which face the British economy in the 1990s.

Those millions of people who enjoy taking part in 'spot the ball' contests almost seem nowadays to be matched by others who prefer playing 'spot the turning point'. From a single economic statistic they construct a complete picture of where the economy is heading. But we need to look at the underlying trends. As I said in a speech in Birmingham recently, these suggest that the picture is improving. So, I shall not try to forecast where the economy will be a year from now. But I do want to say this—and it was by far the most significant part of what I said in Birmingham. Our approach must be to ensure that the recovery is sustainable. The most important task facing us in the 1990s is to ensure that we do not swing between recession and unsustainable expansion. There will always be events and disturbances which cannot be foreseen—after all, we live in an unpredictable world, and it would be foolish to pretend that we could eliminate the business cycle. But—and this is the critical thing—the knowledge that we shall be consistent in the application of our counterinflationary policies will help to minimise the impact of unexpected shocks.

What is the basis of steady growth? My answer in a word is 'stability'. Stability of prices and stability of policy. With price stability, monetary values provide clear and unambiguous signals; no-one can be misled by the changing value of money. But I stress price stability not because it is an end in itself; plainly our basic economic objectives are fundamental things like higher living standards and the prevention of poverty. But in recent decades the pursuit of these other goals has been thrown off-course because of the great damage done to our society by inflation, and the consequent need to take action to bring it down. And the cumulative past failures to control inflation make the necessary corrective action painful for us all—whether as *families* facing higher mortgage payments and, for some, even worse the repossession of their homes and the loss of their jobs; as *businesses* facing the prospect of lower profits and even of liquidation; and as *bankers* experiencing losses and having to tighten lending criteria. It is hardly surprising that it is those now experiencing the pain who insist that never again shall we take risks with inflation.

Stability of policy—especially monetary and fiscal policy—is also vital, and is, perhaps, the most important contribution that government can make to providing an environment favourable to investment and prosperity. There has too often been a temptation to manage policy in order to raise output and reduce unemployment in the short run. This discretionary fine-tuning of policy has invariably led to inflation. And the truth of the matter is that companies, unions, and households are not fooled—at least not for long. They come to expect this policy reaction, and to anticipate higher inflation. Higher expected inflation exacerbates the short-run trade-off between inflation and output growth the next time around. And since there is no *long-run* trade-off, unstable policy simply leads to higher inflation without lower unemployment: in other words, quite the opposite of what was intended. We have to learn from this.

The commitment of the authorities to maintaining the value of the currency is an essential ingredient of a stable policy. And this makes it vital that we have a credible medium-term nominal framework. The way in which this nominal framework is expressed in terms of intermediate targets will vary with circumstances. In times of substantial innovation in financial markets monetary aggregates may not provide a clear picture; and it may then be more helpful to express our policy objective in terms of some other variable, such as nominal GDP or the exchange rate. But, in any event, of much greater importance is the credibility of the policy stance itself—the belief that the authorities will not take gambles with inflation. Inflationary expectations—and inflation itself—should then converge on the ultimate goal of price stability.

(1) In a speech at the Lord Mayor's dinner for the bankers and merchants of the City of London, on 31 October.

An important element in our recent strategy has been membership of the ERM. In the past twelve months we have seen inflation steadily reduced, and interest rates with it, but sterling has remained relatively stable, underlining the credibility of our policies. Membership of the ERM will remain a key part of our strategy; its strength depending too on the commitment of our partners to the objective of price stability. And indeed it is that shared commitment to counterinflationary policies both here and in the rest of Europe which will be essential to the success of the closer co-operation and integration envisaged in the monetary sphere.

Perhaps the most important lesson of the past—and one which has had to be learned again and again—is that 'the quick fix' does not work. It is the consistent application of a medium-term policy that provides the foundations for stable non-inflationary growth. Price stability is the foundation upon which genuinely sustainable growth and prosperity rest; without it we shall not match the best among our peers. So our aim now should be for a steady recovery, rather than a rapid expansion which requires correction later on. I shall judge policy to be successful when price stability has become part of the accepted economic background against which businessmen and bankers go about their business; and when monetary policy is sufficiently uncontentious—indeed uneventful—that only central bankers worry about it.

Stability is no less critical in the financial system. The Basle capital standard, much commented on recently, is an integral part of this. It has two basic objectives: to strengthen the world banking system and to achieve greater competitive equality in banking markets. Sound progress is being made in both respects. I acknowledge that it is perhaps unfortunate that for some countries the introduction of the Basle standard has coincided with an economic downturn and associated problems with asset quality. But that coincidence is no reason to weaken the standards or to delay their implementation, and I am sure it is in the longer-term interests of the banking community worldwide that there should be no relaxation on this front. A well-capitalised banking system may, on the face of it, be a rather less adventurous one; but it is one in which banks, their depositors and their customers can work with greater confidence, and where banks are therefore able to provide a better service to the economy.

That capital adequacy standards remain strong is also all the more important now that we are, happily, far removed from the era of quantitative credit controls and other restrictions on competition in banking. Liberalisation has brought many benefits: the range of financial products has increased dramatically for individuals and businesses, and price competition is much greater, promising a better overall allocation of resources in the industry.

But while the benefits of liberalisation and competition are clear, I am conscious that there have been suggestions that it has been accompanied by a lowering of standards of conduct. There has obviously been a disturbing number of financial scandals recently, in many financial centres around the world. But it is important to keep this in perspective. Problems in the financial world tend to be very evident, whereas the way in which the large part of the financial community steadily conforms with high standards does not attract remotely comparable attention or comment.

Those scandals which have been seen might, I agree, have something to do with the new competitive climate. But it is a mistake to lay the blame on liberalisation. Liberalisation has actually brought with it increasing vigilance on the part of regulators and market authorities. And there is now a greater degree of codification of standards of conduct, of heightening awareness of what is permitted and of making breaches of the rules more clear-cut than before.

Furthermore, the standards now required—most obviously, but by no means exclusively, in such complex areas as insider trading and market manipulation where the scope for exploiting the inexperienced grows as markets become more sophisticated—these standards, I say, are also stricter than in the past. This is as it should be. For just as the credibility and consistency of monetary policy are integral to its success, so the credibility and fidelity of financial markets are crucial to their wellbeing. High standards are expected of financial markets. They should be.

My Lord Mayor, I have stressed tonight the need for stability in our economies and in our financial markets. In the economic sphere, we cannot ever afford to treat inflation as yesterday's problem; rather we must reinforce our commitment to seeing that that is exactly what it becomes. For this, we must build up the constituency for stability; a constituency including every family and every business which has experienced at first hand the disappointments and hardships resulting from those reversals of policy forced upon us in the past; a constituency which demands stability of prices and stability of policy. The duty for all of us involved in economic policy in the coming years is to do our utmost to satisfy this constituency.