Policy after the ERM; supervision after Bingham

The **Governor** *reviews*[1] *the state of the economy and the challenges facing economic policy-makers following sterling's suspension from the ERM. The major challenge, he argues, is to pursue a more balanced domestic policy (now no longer dictated by the consequences of German unification) without undermining the medium-term commitment to stable prices. Uncertainties about the current conjuncture and, in particular, about the strength of debt deflationary pressures require the authorities to be alert to changes in the economic situation. But the* **Governor** *warns against a short-run stimulus to activity; this would be costly later as there is no long-run trade-off between inflation and output. He also stresses the importance of greater openness in explaining the basis of monetary policy and welcomes the Chancellor's recent initiative, including his invitation to the Bank to publish a quarterly report on inflation. Turning to banking supervision, the* **Governor** *describes the changes the Bank has introduced in response to the lessons of the BCCI affair and the conclusions of the Bingham report. These changes, which do not represent a shift in the Bank's overall approach to supervision (which Bingham recognises has served the community well), involve a major strengthening of the Bank's supervisory capacity with a particular focus on ensuring that supervision is more alert to signs of possible criminality.*

It is always an honour to speak on this great occasion. And it is a pleasure—and an encouragement—to hear one's health proposed in such generous terms. David Coleridge has reviewed recent developments and reforms at Lloyd's of London. It has not, of course, been an easy time, and I should pay tribute to David and his team who deserve great credit for steadfastness and determination. They have seen through some important and perhaps painful reviews, and have shown courage in introducing the necessary reforms. I have no doubt that this puts this great market of ours in a strong position to return to profit and success, building on the support evidenced by the strong vote of confidence at the extraordinary general meeting last summer.

Economic and monetary situation

Much water has flowed under the bridge since we met here last year. And the rebuilding of the credibility of our counterinflationary policy is still under way. The suspension of membership of the Exchange Rate Mechanism was clearly a major disturbance. It was a shock; it was a shock to confidence; and it was a shock to a framework for monetary policy which had become highly visible and easily understood. It was not something which we had sought.

But towards the end our membership of the ERM had forced us to adopt an unbalanced mix between monetary and fiscal policy, a mix dictated by the consequences of German unification and one unsuited to the rest of Europe, and, some are now saying, to Germany itself. The challenge facing the United Kingdom now—and I stress the word challenge—is to pursue a more balanced domestic policy stance without undermining the medium-term commitment to stable prices.

We must not be misled into thinking that being outside the ERM gives us easy choices. It does not. There is genuine uncertainty about the state of the world economy and of our domestic economy. On the one hand, there have in this country been sharp reductions in business and consumer confidence, further declines in house prices, and large falls in manufacturing employment. On the other hand, retail sales have picked up over the past three months, and the effects of the recent easing of monetary policy—the falls in both interest rates and the exchange rate—are still to be seen.

In some respects an accurate *qualitative* description of the process affecting the UK economy is debt deflation—with the burden of debt leading to disposals of assets, and the resulting fall in asset prices leading to even higher capital gearing ratios. But the *quantitative* significance of this is hard to assess—we have no experience of similar circumstances in the post-war period.

The risk of a further world downturn resulting from debt deflation is real. But we should not forget that total domestic demand in real terms has, in fact, risen over the past year. A certain humility is, therefore, in order in reaching judgments about current policy. And commentators have not been slow to offer us their favoured solutions. But intellectual honesty compels us all—the authorities and critics alike—to recognise the genuine uncertainty that now prevails.

The acceptability of any further overall easing in policy rests critically on how alert we will be to new information about the state of the economy, and how willing to tighten

(1) In a speech at the Lord Mayor's dinner for the bankers and merchants of the City of London, on 29 October.

monetary policy as soon as there is evidence that demand is rising sufficiently rapidly to endanger our long-run goal of price stability.

At this juncture it is imperative that the authorities are not perceived as taking their eye off their counterinflationary duty. For that would be a signal to businesses or unions that they could count on higher inflation in the future. And an exaggerated short-run stimulus to activity would have a longer-run cost—the cost of reducing inflation the next time around. As I said on this occasion a year ago, it is precisely because there is no long-run trade-off between inflation and output that we must retain a firm counterinflationary policy. The idea that growth could be bought at the expense of some rekindling of inflation represents an absolutely false choice in anything other than the short term. That is why I greatly welcome not only the Chancellor's renewed commitment to price stability, but also his willingness to quantify the long-run inflation rate which can be considered as consistent with price stability.

The necessity to be alert to changes in the economic situation is matched by the need for a further ingredient in our monetary policy—that of openness. As the Chancellor stated in his letter to the chairman of the Treasury Select Committee—'It will be important to explain clearly to Parliament and the markets how we assess the progress being made towards the Government's inflation objectives'. I greatly welcome this initiative which the Chancellor has amplified this evening, including his invitation to the Bank to publish a quarterly report on inflation. This will assess the progress made in achieving the inflation objective the Chancellor has set and the prospects for inflation in the future. This assessment will, of course, be the basis for our advice on monetary policy. Outside commentators will then be able to make their own assessment, including an assessment of our view, and we for our part will be publicly accountable for the quality of our analysis.

I have spoken tonight about three important qualities of a successful monetary policy—alertness, firmness, and openness. These attributes are no less relevant to our other principal responsibility—supervisory policy. Perhaps you will feel that this subject has had enough exposure in recent days, but equally the present audience is at least entitled to hear at first hand what I think.

Banking supervision in the light of the BCCI affair

Alertness, in particular, is something which the Bank has had cause to address following the Bingham Report on the BCCI affair. The criticisms of lack of vigour in pursuing signals of possible fraud have been well publicised, as I trust has our response involving establishing a Special Investigations Unit and a Legal Unit under seasoned experts recruited from the professions; strengthening our capacity for on-site examination; enhancing the training of our supervisors; increasing the use we make of the Board of Banking Supervision; and participating in the new machinery which the Chancellor has set up to co-ordinate responses to fraud amongst supervisors, and other prosecuting authorities.

These measures are designed not to change our overall approach to supervision, which Bingham recognises to have served the community well. They are designed to ensure that we are more sensitive to any suggestion of malpractice, when there will be a sharp change of mode.

In general, though, our supervisors have been very successful in maintaining financial stability and in addressing problems when depositors' interests are threatened. In fact, from a community of over 500 institutions there have been just eight liquidations and six administrations since 1986, which compares favourably with anywhere else in the world.

This reflects success in spotting and remedying problems *before* they come to a head. Over the past six years, in some 35 cases, banks have, at the Bank of England's instigation, successfully implemented remedial programmes, involving changes to the business, to the management or to the shareholders, and continued in business to the benefit of depositors and indeed of shareholders too. This was precisely the approach taken by the Bank to BCCI when major problems emerged at the beginning of 1990: a remedial programme, implemented by controlling shareholders, involving recapitalisation, reorganisation, major changes in senior management, and a radical restructuring to make the group amenable to more effective supervision. On the information available to the Bank, that strategy held out every prospect of success. It was blown out of the water by the revelations of pervasive fraud in the Section 41 report. But that does not mean the chosen strategy was wrong. Bingham does not say it was wrong. If we had closed the bank during 1990 when, on the information available to us, there seemed every prospect of a successful remedy, I am in absolutely no doubt that we would have been pilloried from every corner for causing unnecessary loss to depositors.

It is said that we are timid in the use of our powers. I do not accept that. Since 1986, apart from the 35 cases of successful remedial action to which I have referred, there have been 17 occasions on which we have used our revocation powers, and 28 acts of restriction. Those are not acts of a timid supervisor. And they are the acts of the same supervisors who are criticised over the BCCI affair.

And I totally reject the offensive and wholly unfounded allegations, made here and abroad, that the Bank was somehow party to a cover-up, or colluded with BCCI, or even that our officials took bribes.

But we do have lessons to learn and learn them we will; there is a *major* strengthening of our team and our structures; we will be more alert to signs of possible criminality. My supervisory team at the Bank is among the best in the world; and with the measures we have announced, they will have additional support to help them continue to serve the community with the determination, dedication and mutual confidence which have always characterised the Bank's approach. And I am determined to see that that happens.

My Lord Mayor, it is my privilege to propose tonight the health of yourself and the Lady Mayoress, and I do that now with pleasure. Your energy and hard work have been manifest throughout this year on our behalf in this country and overseas. You have made a signal contribution to promoting the City of London, and I have been immensely heartened by the active co-operation between the Corporation and the Bank achieved during your period of office. And typical of this is our latest joint venture—the establishment of the Financial Law Panel, which we have announced today with Lord Donaldson as its first Chairman. But this is only one element of a year characterised by energy, generosity and vision. We all wish to thank you both and I propose that we do so by drinking your health here tonight.