Credit and economic policy

In a speech at the Institute of Credit Management National Conference,[1] *the* ***Deputy Governor*** *considered the influence of policy on the lending process. He mentioned two particular influences: the institutional and legal framework, which serves to underpin the business of lending; and the macroeconomic climate in which decisions are made. Referring to the 1980s, he pointed to the value of financial liberalisation, which had led to more flexibility, diversity and competition. However, he stressed the link between the monetary laxity in 1986–88 and the inflation and recession that followed. That experience underlines the need for monetary restraint, to create the conditions for sustainable economic growth. In such a climate, lenders could lend with greater certainty, concentrating on the merits of each individual proposition without fear that it will be overridden by further 'boom and bust'.*

Given the title of your conference, I thought I would use this opportunity to make a connection between two types of credit. One is the lending that individual institutions do. The other is the amount of lending that goes on in an economy as a result of what a central bank does. The links between the two take many forms, but the message that shouts out from history is that those links should never be ignored—not by individual lenders, and not by central banks either.

I begin with the first type—the lending done by all kinds of financial institutions. Lending is part of their job; for a lot of them, it is the main reason why they are in business. It is also a main cause of why they sometimes lose money. That I applaud—not out of some sadistic instinct that allegedly lurks in every central banker's pin-striped breast, but because losses reflect risk, just as surely as success does, and lenders should not try to avoid all risk. It is risk that turns the economic wheels. Any lender that wants to avoid risk will lend only to governments, in return for Treasury bills. In my job, I cannot belittle the many virtues of Treasury bills, but they are not the driving force of a successful economy.

So lending should involve risk, and risk will involve losses. But the interesting thing about losses is what causes them. No doubt behind each loss there is a story, and its details vary. Some losses are huge in scale: on sovereign credits, on big projects, on loans to large companies that go spectacularly wrong. At the other extreme, some losses are tiny—the small firm that went astray, or the individual who could not reduce his overdraft. All along that scale, other details will apparently vary: different firms, different industries, different types of lending.

Beneath this variety, though, it is striking how often the essence is the same. It is faulty credit judgments—judgments about who should borrow, how much and for what—that lie at the heart of so many loans that go bad. Certainly, bankers can misjudge the value of the collateral for their loans. Certainly, investors can get caught out by sudden movements in stock-markets, or interest rates, or exchange rates. But these misjudgments are often overshadowed by the simplest of errors in gauging whether a debtor can service a debt and eventually repay it.

These errors are, no doubt, the things that exercise a lot of lenders a lot of the time. They rightly put a great deal of money and ingenuity into devising ways to reduce them. They look more closely at each request for a loan. They build up masses of data on the credit records of firms and individuals. They have credit committees with clearly defined limits. I hope too that lenders have their instincts, the almost chemical feel for whether a borrower is or is not a good person to do business with. This instinct is often the thing that ensures that lenders do take risks. If they never backed a hunch about a new borrower with little or no track record, it would be hard or impossible for small companies to get started at all.

No doubt all these internal systems help: they reduce the number of bad loans and increase the (far greater) number of those that go on quite happily. The combination of data, sifting and judgment is what defines lending institutions. In theory, they learn from experience. In reality, the lessons are never that simple. The circumstances of particular loans seldom quite match anything that has gone before. Customers want different types of finance. Lenders are anyway always thinking up new ways of lending. So it would be wrong to suppose that errors can ever be eliminated, like a stain gradually being cleaned out of a carpet.

At this point, we should let policy break into the private world of lenders and borrowers. It can do so in various ways, but I want to concentrate this morning on just two of them. One is the institutional and legal framework for the business of lending—who can do what, how, and how much.

(1) Delivered on 9 March.

The other is the part that macroeconomic policy plays in setting the background for lending and borrowing.

In Britain, the legal framework has changed enormously over the past 15 years. The abolition of exchange control, the ending of hire-purchase restrictions, the disappearance of mortgage queues—each of these involved a big shift in policy and was followed by a big shift in behaviour.

But that was not all, not by a long way. In the mid-1980s, Big Bang transformed the securities business in the City of London, by getting rid of many restrictive practices. In this, it simply paralleled what was happening in other parts of the economy. In my previous job, as a journalist, who does what was changed out of all recognition in the 1980s, by a mixture of new technology and new labour laws. The same was true of finance.

By rewriting the rule book, parliament and the various City bodies changed the whole business of lending and borrowing. It has become more flexible, more diverse—and much more competitive. The new world has offered many more opportunities for lenders and borrowers, including opportunities to make mistakes. Alas, many of those were taken up eagerly, which is no doubt why some people look back at financial liberalisation and regret that it ever happened.

I am sure that regret is misplaced. Burnt fingers are painful, and visible. But they should not obscure the numerous instances of where the old restrictions had stopped things from happening. Credit denied to potentially good borrowers is capable of doing more harm to an economy than credit advanced to bad ones. For a long time, restrictive practices hampered the British economy, as surely in finance as in printing. The new freedoms do not guarantee benefits, but they certainly give them a chance of happening where none had existed before.

But the financial liberalisation of the 1980s went even deeper than that. It was a supply-side reform, one of many; but it was distinguished by having effects on the demand side as well. Borrowers and lenders could do more business, and they set to it with a will—under the indulgent eye of the monetary authorities. This is the second point where private transactions meet public policy, and it is here that the greatest lessons from the 1980s need to be learnt. We should not regret the financial liberalisation, but we should—and do—bitterly regret the monetary laxity that went with it.

In common with the position in many other countries, Britain's financial conditions in 1986–88 were far too loose. They produced the inflationary surge of 1989–90, which in turn had to be stopped by policies that caused the recession of 1990–92. It was as simple and as brutal as that.

As a result of that sequence, lenders lost money and many borrowers suffered enormously. I talked earlier about the difficulties that lenders face with credit assessment and credit control, but I know that those difficulties are magnified if the macroeconomic climate is itself unstable. The swings of 1986–92 guaranteed that too much would be lent and borrowed and then much would be lost. Lenders and their customers were responding to the swings. They were not causing them. The cause, as ever, lay in monetary policy.

The changes of the past 15 years have deprived the Bank of England of some levers of monetary control. But most of those levers worked by the monetary equivalent of ration books, which in the rest of the economy had disappeared many years before. It may have been convenient for the Bank and the Treasury to limit certain types of credit by law or by the Governor's eyebrows, but it was also arbitrary and inefficient. Nobody should have any desire to return to those bad old days.

A more serious consequence of financial liberalisation was that it broke down the familiar relationships between money and the economy. It *was* harder to interpret what was happening, so it was harder to get policy right. Hence all the shifts in the methods of monetary policy during the 1980s. We tried different types of money-supply targets, each of which proved unreliable. This was not government being fickle, switching from one target to another as the mood took it. The aim was admirably robust: to set out clear guidelines for policy, and to stick to them. But it would have been perverse to stick to a particular monetary target when it was providing confusion rather than certainty, and there is no doubt that the confusion arose largely because of the structural changes that were made to the financial system. But that is an explanation for the failures of monetary control, not an excuse.

Today, we have fewer instruments of monetary control than we did; but we have enough. We have no simple and direct pointer to how prices will change; but we have enough useful indicators, provided we watch them closely. We may still be feeling queasy from the big-dipper ride of 1986–92; but we have our eyes on the future. Our task is to keep demand growing moderately and steadily, so that the private sector can plan ahead with some confidence. The result would be sustainable economic growth. By the standards of the 1986–88 boom, that sounds dull—and it is: blessedly, wonderfully dull.

In the dull new world of macroeconomic management, it is the private sector that provides all the excitement. That is another way of saying that the conditions for growth—for investment, jobs, saving, training, developing new products and new services—are greatly enhanced. Of course, the statistics month by month will not always be ideal: blips happen, but it takes a lot of them to change a trend. The trend today is pretty clear. The economy will soon enter its third year of recovery, and the pace of that recovery is enough to have started reducing unemployment. Meanwhile, inflation is low and the government's target is for it to go lower still.

That point is worth dwelling on, because too many people seem to misunderstand what anti-inflationary restraint actually means. It is tempting to feel that, after all the pain of the past few years, Britain has won the war against inflation, so we can now afford to relax. That is a delusion, and a dangerous one too. We have got inflation down in order to establish the conditions for resuming economic growth; now we have to keep inflation down in order to sustain growth. Monetary restraint is not a hair-shirt, but it has to be a habit. After all the unforced errors of the past, it will take many years to prove that we have acquired it.

As far as the credit business is concerned, this combination of steady growth and low inflation will allow lenders to lend with greater certainty. Their customers can think more about the long term. Lenders can concentrate on the intrinsic merits of each business proposition, with less danger that it will be overridden by another boom or bust. So if lenders have bad debts, you will find it much harder to blame recession. One of the features of macroeconomic stability is the disappearance of scapegoats: no stars, dear Brutus, just ourselves. As your conference title puts it, you are there on the front line.

At the Bank of England, we are merely part of the supply lines. As such, we have the ability to mess things up—and our record shows that we have often used it. In the 1990s, we can do better than that, much better.