BANK OF ENGLAND

Speech

Henry Ford II Lecture

Speech given by

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Mr Chairman, Ladies and Gentlemen.

It is a real pleasure to be back here at Cranfield to deliver this Henry Ford II Lecture. The Lecture - as you have just heard - commemorates an award made by the Ford Motor Company, in celebration of Henry Ford II's 60th birthday, to Cranfield School of Management. It was one of just two such awards to European business schools. And we have just seen evidence - in the presentation of the Henry Ford Award - of the continuing close relationship between the Ford Motor Company and the School of Management. The University has every reason to take pride in the fact that the achievements of the School are recognised by a great multinational company in these ways - as I take pride in my own links with Cranfield.

Given the nature of the occasion, Mr Chairman, I thought it might be appropriate if I were to look beyond the narrow perspective of the monetary and economic situation in this country - though I will say something about that towards the end of my remarks - and focus on some wider aspects of the international economy. I will begin with a broad overview of the current international approach to overall economic management, then say something about the present disturbances in Asia, and finally about their implications for the prospects for the rest of the world.

Let me begin with just a few words about the process of international economic and monetary management. I have just returned as it happens from the annual Spring Meeting of the IMF in Washington, where the Finance Ministers and Central Bank Governors from all around the world gather to discuss current international developments. We all meet again every autumn. Last week, we debated much the same agenda in a variety of meetings - in the Group of 7 major industrial countries; in the Group of 10 - actually eleven - a somewhat wider range of industrial countries; in the Interim Committee in which all IMF member countries are represented, in constituencies; and this time in a new ad hoc Group of 22 or 23 countries including a broad cross-section of industrial, emerging and transition countries. Invariably the journalists, who also gather in Washington, quite reasonably ask, "What exactly did you decide in all those meetings?" And almost invariably, we have to respond that "We did not actually decide on anything - we agreed we should do some further work and meet again for further discussions!" You could be forgiven for thinking that the whole process of reaching international agreement on anything moves at a snail's pace!

But even a snail can make remarkable progress if it keeps going. I am told that the quick species - I suppose they are the Model T snails - travel at a speed of three inches a minute - say 5 yards an hour. In that case a quick snail could have travelled quite easily from Cranfield to the borders of Scotland since the collapse of the Berlin Wall! And if you look back over a decade rather than at the outcome of just the latest meetings, then there really has been remarkable progress - within the developing, emerging and transitional economies as well as the industrial world - towards a broad international consensus on approaches to economic management. That consensus can perhaps be summed up essentially as macro-economic stability and supply-side flexibility - but that needs some elaboration.

On the macro-economic side we have learned - and it has taken some countries longer than others - that you cannot achieve what we are all trying to achieve - sustained growth, high levels of employment and rising living standards - simply by pumping up demand in our economies through expansionary monetary and fiscal policies without regard to the underlying supply-side capacity of our economies to meet that demand. Short-term demand management through monetary policy too often led just to accelerating inflation, which had then eventually to be brought under control through recession - an absolute recipe for short-termism in both financial and business behaviour. Equally, excessive public expenditure - which had ultimately to be financed through higher taxation - imposed burdens on the private sector which weakened its capacity to generate employment and income and wealth.

So the emphasis now, more or less everywhere, is on effective price stability as the immediate objective of monetary policy - not simply as an end in itself but as a measure of the balance between aggregate demand and underlying supply in the economy as a whole, in order to moderate rather than aggravate the economic cycle, and so to provide the basis for sustainable growth at around the underlying rate of growth of productive, supply-side, potential. And the emphasis now - again more or less everywhere - in relation to fiscal policy is to limit public sector borrowing, and the outstanding level of public sector debt, to levels that can be sustained into the future, without the need for increasing tax burdens or rising real interest rates on the private sector.

These objectives of macro-economic policy - monetary and fiscal policy - will be familiar to you in recent years in this country; they are at the heart of the policies being pursued in Continental Europe by those countries that, in just under a fortnight from now, will agree to move ahead to Monetary Union; and they are the policies endorsed, too, by all the members of the IMF in the Madrid Declaration adopted at the IMF Annual Meeting in 1994 and expanded and updated eighteen months ago. Of course on occasion the flesh proves to be weaker than the spirit - and achieving these macro-economic objectives is not easy in practise even as a technical matter. But the intention - the international commitment to macro-economic stability - is clear and this in itself ought over time to mean a radical change - for the better - in the environment for private sector business activity across the world.

Acceptance of the aim of macro-economic stability has brought into sharper focus the structural, supply side, of the economy - that is the whole raft of influences that can affect the underlying growth rate of capacity and thus the growth rate of aggregate demand that can be sustained.

In this context there is a strengthening international presumption in favour of open markets and free competition - both domestically and internationally - with a continuing strong presumption against predatory trade or exchange rate manipulation. The argument is that undistorted competition contributes to potential macro-economic growth through increased efficiency and the more effective allocation of productive resources.

This in itself is somewhat remarkable, given that, at the micro-economic level, competition invariably constitutes a threat to established producers - and their employees - who may be tempted to make, often highly vocal, pleas for protection in one form or another to their national governments. Consumers, who benefit from competition, tend to make less noise. The threat of protectionism is never, therefore, far away. But in fact the presumption in favour of competition has proved encouragingly robust. And that is not just in relation to international trade. Domestic deregulation is increasingly in vogue in many countries; and there is much greater openness around the world to inward investment and foreign ownership. I see the same presumption in favour of competition, for example, in the global trend to privatisation, through which governments have increasingly returned commercial activities, in which they have no necessary comparative advantage, to the market sector. At the same time, against the background of financial globalisation, attention has in the past few years increasingly focused on removing restrictions on the free flow of capital - again domestically and internationally - essentially on the grounds that this can further improve the effective allocation of productive resources, increasing the benefits to be derived from competition in markets for goods and services. The IMF is in fact currently working on an amendment to its Articles of Agreement to give it a greater role in promoting the liberalisation of external capital movements.

Of course, it remains true that market competition, and the supply capacity of the economy more generally, are inevitably influenced by virtually every other aspect of public policy, and will be affected to varying degrees by the particular social and economic judgements made by national politicians. This is true whether one is talking about direct public sector provision - of education and training, for example, or incentives to saving and investment, or current or prospective welfare provision, or the structure of taxation. And it is true equally of government intervention in the form of regulation and social protection. But my strong impression is that there is a growing awareness in many countries that policies in all these areas need to take account of potential supply side effects, with an increasing bias towards structural reforms, in labour, product and capital markets, with a view to increasing employment and reducing distortions that impede efficient resource allocation.

Now I do not pretend to you, Mr Chairman, that the international policy consensus that I describe - particularly on the supply side - is fully articulated; nor do I claim that it is subscribed to in its detail equally in every IMF member country. But it does represent a substantial evolution in our collective thinking over the past decade or so towards a much more common approach to economic management, which serves as a valuable framework within which countries' performance can be assessed. The snail may have moved slowly but it has in fact travelled a considerable distance!

It has nonetheless still a long way to go. Its progress has been impeded in the past few years by the eruption of a number of financial disturbances - most recently in Asia - which have drawn attention to continuing deficiencies in our approach to economic management; and we spent much of the time last week in Washington discussing what lessons we might learn from those events.

The storm last year in Asia struck essentially the ASEAN four - Thailand, the Philippines, Malaysia and Indonesia - spreading subsequently to South Korea and intermittently battering Hong Kong and elsewhere.

It is still not wholly clear - to me at least - quite why the storm struck suddenly when it did. Most crises of this sort have their origins in some evident macro-economic policy failure. At least in hindsight there are usually fairly clear tell-tale signs of expanding fiscal deficits and/or lax monetary policies, classically accompanied by evidence of imbalance in the form of accelerating inflation or a rapidly deteriorating balance of payments. There were such signs, perhaps most notably in Thailand; but they were not for the most part particularly pronounced in Asia. In fact through the first half of the 1990's, and in some cases for much longer, the countries in question had been remarkably successful. They attracted, by their very success, huge inflows of capital from the rest of the world, where yields had fallen, in the hope of sustaining higher returns.

There is no question that this capital inflow made a very big contribution to the economic expansion in Asia; but with the benefit of hindsight, the accelerating scale of the inflow, and particularly the forms that it took, became an important part of the problem. It was not all in the end productively employed. There was over-investment in some sectors; much went into ambitious property development; and much went into financial rather than real assets. The hoped-for higher returns could not be maintained.

Again with the benefit of hindsight, it is possible to identify a number of structural weaknesses in the mechanisms for financial resource allocation in the recipient countries. There was, for example, a general lack of reliable financial information, and a lack of transparency in relation to the financial position, of both public and private sectors. Complex and opaque links between government, financial institutions and non-financial companies made it difficult for outsiders to understand the real nature of their exposures. Financial markets were not well developed, leaving the system heavily dependent upon the banks. There was inadequate regulatory or supervisory oversight. There was widespread, often informal, government influence over financial flows, which importantly also contributed to a perception that much of the borrowing was implicitly under-written by the government. The list could go on.

The problem was compounded by the absence of any real perception of exchange rate risk. Borrowers were evidently confident that governments would maintain their exchange rate pegs against the dollar, even when it began to strengthen, so that unhedged foreign currency debt, much of it at short-term, appeared to be a cheap alternative to domestic currency borrowing. The result was a build-up of short-term foreign currency liabilities, by banks and non-banks, which was not fully appreciated, and which left the Asian economies especially vulnerable to a flight of capital in the event of a change in sentiment. The problem is that national authorities can create their domestic currency, if they choose to do so, even if it leads to inflation, but they cannot simply create foreign currencies in the same way.

So, once the run started, it was violent and contagious. For a time around the end of last year there was a significant possibility of a chain of default emanating from Asia that could have reverberated right through the global financial system. The immediate task was how to contain that risk.

Essentially there are two broad options for dealing with an external financial crisis. One is simply to allow financial markets - exchange markets, interest rates, and stock and bond prices - to take the strain, and to seek to restore confidence, and moderate the impact of market movements, by restrictive macro-economic policy adjustment. The second is to limit the financial market impact and the extent of the associated macro-economic adjustment by providing or arranging alternative external financing. In practice these options are not, of course, mutually exclusive and the real question is the appropriate balance between them.

Where a country has transparently been pursuing an unsustainable macro-economic policy, most people find it easy to accept that that country should bear the burden and adjust, painful though that may be. Many people find this harder to accept where, as in the present case, conventional macro-economic policies had, for the most part, been relatively responsible. There were certainly adjustments to macro-economic policy that needed to be made - a more flexible exchange rate regime in some cases, for example, or a somewhat tighter overall macro-economic stance, with perhaps some adjustment between fiscal and monetary policy. And, once the capital outflow had started, macro-economic adjustment had to be harsher than might otherwise have been necessary, in order to re-establish confidence. But there are real dangers in extreme market movements or in excessively severe macro-economic adjustment to contain them. That could cause a vicious circle of domestic default and systemic financial weakness in the affected country. And that could have seriously adverse implications - in terms of both financial and economic knock-on-effects - for the global economy.

That, essentially, is why it may be in the self-interest of the international community to attempt to mitigate the market and macro-economic adjustment pressures by providing financial support.

It is why the international community responded to the crisis in Asia by promptly offering very large amounts of official assistance - $17 bn in the case of Thailand, $43 bn for Indonesia and $57 bn for South Korea.

But such official financial help cannot be unlimited and it cannot be provided without strings. It, too, has real dangers. If it were too readily forthcoming it could encourage "moral hazard", especially by encouraging commercial lenders - particularly foreign currency creditors - in the belief that they will be bailed out if things go wrong. That would be likely to add to the problem of potentially volatile capital inflows next time around. Not surprisingly, too, there is strong political resistance in many countries, including notably the United States, to the idea that public - taxpayers' - money should be used to bail out private creditors, especially foreign creditors.

External financing need not come solely from the public sector. Private finance would, in principle, serve the same purpose, and in many situations market price adjustments may be sufficient to stem the capital outflow. But, given the extent of the loss of confidence in the Asian case, organising private financial support meant in practice persuading existing creditors that their assets would be better protected if they were prepared to leave them in place, especially if other major creditors agreed to do the same and if official support was made available in parallel. But in this case, too, difficult judgements had to be made. There was a danger that, if private creditors had to be in effect coerced into staying put, they would immediately cut their positions elsewhere, while they still could, adding to the international contagion.

In fact, in the critically important case of Korea, the promise of massive official support failed to restore market confidence. And when it became apparent that the official bilateral financing was in practise available only as the very last resort we had to turn to the commercial bank lenders in the major creditor countries and persuade them to extend the maturity of their loans. It was a dangerous moment. But their constructive response went a long way to resolving the immediate crisis and helped to restore greater financial stability to the region as a whole. The creditor banks are also now in negotiation with Indonesia’s commercial debtors.

The discussion in Washington turned to preventative measures for the future.

It would have been understandable in the light of the Asian experience if there had been some turning back from the path towards greater freedom of international capital movements, and there was some suggestion of this. But on the whole the long term benefits of free capital flows were upheld, and the mood was to continue cautiously down that path, but to emphasise the need, not only for sound macro-economic policies which everyone accepts as a sine qua non, but also for steps to accompany capital account liberalisation designed to reduce the risks of volatility.

These related in part to the process of capital account liberalisation, where there was a good deal of stress on ‘sequencing’ **-** that is on liberalising potentially more stable, longer-term, capital inflows initially, rather than short term borrowing.

But they related particularly to three key conditions for living with freedom of capital movements.

The first was "transparency". In a broad sense a need for greater transparency was recognised in relation to public policy, to the relationship between the public and private sectors, to corporate governance and accounting and so on. In a narrower sense there was seen to be a need for greater and more timely disclosure of financial information generally, but especially in relation to countries’ true foreign exchange reserve positions and in relation to their short term external debt. The general point is that we cannot reasonably expect markets to make a proper assessment of the risks of their lending if they do not have adequate information in accessible form. The corollary is that where they do have adequate information they can be expected to accept the penalty if their judgements prove ill-founded.

The second condition for more stable capital flows is stronger financial systems. That includes for example the broadening of capital markets so that the allocation of capital is less concentrated on local banking systems. It includes robust financial infrastructure - for example payments and settlements systems. And it includes more effective financial regulation and supervision. A key feature of future arrangements for me in this area is the encouragement of more active management of short-term foreign currency assets relative to liabilities, by both the public sector and the local banks, taking account of the nature of the exchange rate regime. It was weaknesses in this area, above all, in my view that turned the Asian problem into a panic.

These various steps - which need a great deal of elaboration and refinement - in themselves represent a huge agenda for the future. But however much we try to prevent accidents we need nevertheless to be prepared for them to happen. The third condition for living with greater freedom of capital movements, therefore, is a more consistent view of how, when a crisis does break, the burden might be expected to be shared in future between official and private sector financing.

In this context, one thing seems clear: given the evidence of public resistance, we cannot assume that massive official financing packages will in fact be deliverable in the future to bail out private creditors. Various ideas have been put forward for involving the private lenders in maturity extension - within a formal legal framework or through official persuasion - and they, too, need to be elaborated and refined. But it might help to avoid inflows becoming excessive if private lenders clearly understood from the outset that they would be expected to carry a substantial part of the load.

Mr Chairman, the debate on all of these issues is still at a relatively early stage. But it is an important part of the present international monetary agenda and you can expect that, as the debate crystallises, aspects of it will be gradually added to the policy consensus. Our snail must keep moving forwards.

In the meantime, Mr Chairman, the world too goes on. So let me conclude with a few remarks on the prospects for the global economy, bearing in mind the potential economic aftershock from Asia’s financial disturbances.

In fact those prospects are less bleak overall than you might suppose.

The last few years have seen world growth at around 4%, against a longer term average rate of just under 3 1/2% - with the improvement extending across both the industrial and the developing countries as a whole and with stabilisation now in the transition economies. Meanwhile inflation has declined almost everywhere.

The latest IMF projections suggest world growth of just over 3% this year - more than 1% less than was projected as recently as last October. The slowdown - and downward revisions - are heavily concentrated on the Asian countries themselves, notably Japan, which, because of the massive size of its economy has a large impact on world growth. Elsewhere among the major industrial countries weaker demand from Asia is expected to be offset by relatively strong domestic demand, so that overall output growth is not much affected - indeed it is expected to pick up on the Continent. A troublesome feature of these projected developments - coupled with recent exchange rate movements - is that they imply large external payments imbalances which will need to be carefully managed if they are not to lead to protectionist pressures and exchange market volatility.

Against that background the G7 surveillance discussion focused particularly on Japan, where financial fragility - in the wake of the bubble and subsequent collapse of asset prices - continues, which is itself acting as a drag on the domestic economy and which is compounded by a loss of both consumer and industrial confidence. Both the financial fragility and the domestic economic weakness are now aggravated by the problems elsewhere in Asia. Everyone at the meeting welcomed the Japanese commitment of public funds to strengthen the financial system and the recent announcement of large fiscal stimulus to strengthen domestic demand led growth, which will help to reduce Japan’s external surplus and also to strengthen the Yen.

In relation to the other major industrial countries there was general puzzlement at the persistent strength of equity markets and about the implications if it were to continue - or even if it does not.

Particular points made in relation to Continental Europe were that it is important there, too, that the gathering recovery - hitherto driven largely by external demand - should increasingly be based on sustained growth of domestic demand; and that continuing structural reforms will be necessary to combat persistent high unemployment - especially now in the context of monetary union. In the United States and this country, on the other hand, which both grew strongly last year on the back of domestic demand, the emphasis was on a need for vigilance - as always - to stay on a non-inflationary path so that sustainable growth can be maintained.

The IMF’s analysis of this country’s position, Mr Chairman, is in fact very similar to our own. We both recognise that aggregate demand growth needs to moderate quite sharply if inflation is to be held to the Government’s target over the next two years or so. We are already clearly seeing a weakening of net external demand in response to sterling’s exaggerated appreciation - particularly against other European currencies - since the autumn of 1996 and now in response to the Asian crisis. However undesirable that may be in terms of the balance of the economy - and I am very sensitive to the hammering being taken by the internationally exposed sectors - it does provide a little more time to bring about the necessary moderation of the strength of domestic demand growth, which we expect to occur as a result of both the fiscal and monetary tightening already in place, and in the absence this year of "windfalls" from demutualisations. The critical judgement relates to the precise timing and pace of this moderation of domestic demand growth, and whether it will be sufficient to prevent a pick up in inflation as the dampening effects of the strong exchange rate and weaker external demand wear off.

Now - although there are some encouaging signs - frankly no-one can know the answer to that question with any great confidence - we are not blessed with perfect foresight! As the IMF says in one of its documents prepared for the recent meetings: "Striking the right balance for monetary policy in this environment is a difficult challenge." Well you can say that again! It is hardly surprising against this background that there should be disagreement within the Monetary Policy Committee as to whether or not a marginal further tightening of monetary policy is necessary - in fact I would normally expect there to be disagreement when we are close to where we need to be. But we are all unambiguously clear about where we need to get to in terms of inflation, and it is unrealistic in the circumstances - indeed in any circumstances - to expect us to say what will happen to interest rates in the future.

Mr Chairman, the overall prospect for the world economy - and indeed our own domestic economy - is for continuing growth with low inflation, and we do I think have a clear vision of where we want to go and the policies to take us there. But there are certainly a number of immediately painful blackspots - internationally and here at home - and there are some formidable rocks and potential whitewater further ahead. Navigating through them will not be easy. I only hope that our snail is able to swim.