David Clementi: A bank for all regions: promoting monetary and financial stability in the United Kingdom

Speech by Mr David Clementi, Deputy Governor of the Bank of England, to the Ulster Society of Chartered Accountants, Belfast, 14 March 2002.

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Introduction

Ladies and gentlemen, thank you very much indeed for your kind invitation to be here with you tonight. Despite its name, the Bank of England is the central bank of the United Kingdom, and as such it is essential for us to get out and about in the country at large, explaining our actions, and listening hard to the views of businesses and the wider public about the way we are doing our job. In the past year, members of the Bank's Monetary Policy Committee have made some 50 visits across the UK. On this trip, apart from attending this dinner, I have held a meeting with the regional council of the CBI, discussed trading conditions with local business people, and explained our mission to some of the Northern Irish press.

I want to cover three main themes in my comments tonight. First, I want briefly to explain the Bank's general approach to monetary policy. Second, I want to give you my current assessment of the outlook for the economy. And, third, I want to explain the Bank's other key role - that of maintaining stability in our financial system.

The accountancy profession is very much under the microscope at the moment, as part of the rash of Enronitis which fills the pages of the press. I want to touch on Enron at the end of my talk here tonight, since it raises a number of issues of relevance to us at the Bank in our broader financial stability role.

Maintaining monetary stability

I turn first though to the Bank's role of maintaining monetary stability. The current institutional arrangements were put in place in May 1997, when the Chancellor established the Monetary Policy Committee. The MPC's target is extremely clear, and - I hope - well known. We aim for 2½% inflation in retail prices (excluding mortgage payments) at all times. That target is set by the Government. And it is symmetric: that is to say, we worry as much about being below the target as we do about being above it. That makes sense because the problems of severe deflation are just as great as the problems of severe inflation.

Since the inception of the MPC, RPIX inflation has been extremely stable by historical standards, and close to target. Some commentators have suggested we have had more than our fair share of luck in achieving this outcome. There may well be some truth in that. But I'm not sure that we should be too surprised. Market and survey evidence shows that people are now clear that the MPC will do what it takes to keep inflation on track. And that expectation is factored into their own behaviour, whether it is negotiating wages, setting prices, or deciding how much to borrow and consume. All of that goes a long way towards ensuring that inflation is well anchored to the target.

Of course, from month to month, inflation will still vary somewhat around 2½%. In recent months, RPIX has been a little below target, and there has even been some interest in whether it might reach 1.5%, the point at which the Governor would have to write a formal letter to the Chancellor explaining what was going on. The pick up of inflation to 2.6% in January has silenced this discussion, at least for the time being. We pore over the reasons for such developments in enormous detail at the Bank. But in the bigger scheme of things these month-to-month movements are quite small, and are I hope likely to play very little - if any - role in the key decisions of your businesses, or those you represent.

People often ask if our relative success at targeting inflation has come at a cost in terms of lost output or employment. It is increasingly accepted, I think, that there is no such trade-off in the long run. And, looking at recent data, it is hard to see a trade-off even in the short run. Unemployment remains close to its lowest level for a quarter of a century - a trend seen in Northern Ireland just as much as in the UK as a whole. And UK GDP has now risen for 38 consecutive quarters (albeit in the case of 2001 Q4, only just!), the longest continuous expansion since post-war records began. Achieving low and stable inflation is the best contribution that monetary policy can make to the wider economic goals of sustainable growth and employment. Having an inflation target certainly does not mean that we ignore real activity. We have discretion over how rapidly we try to bring inflation back to target when and if it diverges from 2½%. And we regularly publish our best estimate about the likely future path of growth up to a two year horizon. But the aim of policy is clear - we do what is necessary to keep inflation on target.

As you know, there are nine of us on the Bank's Monetary Policy Committee, and we meet once a month to make our interest rate decision. This is a rigorous process, and rightly so. But, of course, agreement on process need not, and does not, imply universal agreement on the appropriate stance of policy, as our minutes show. Indeed, an industry has grown up geared to guessing MPC members' personal habits, psychoanalysing our personalities and classifying us into different species of the aviary. But it is important to recognise, I think, that disagreements are evidence of the strength of the system, not its weakness. Economic analysis involves a great deal of peering into the future, so it is not surprising that there should be differences of view. And the opportunity to explore and explain these differences in a rational and open way is an important part of getting to a better answer.

The outlook for the economy

I now want to turn briefly to the current policy debate.

The key focus of the MPC's recent discussions has been the implications of the slowdown in world growth, which became apparent in the US during the first half of last year, but was exacerbated by the tragic events of 11 September. World trade rose by only around 1½% in 2001, less than a quarter of the average growth in the previous three years. That of course has had very serious implications for businesses exposed to international trade, of which I know there are many in Northern Ireland.

Monetary policy has not been idle in the face of this challenge. Interest rates have been cut by 4¾% in the US since the start of last year, by 2% in the UK and by 1½% in the euro area. How far monetary policy by itself would be able to insulate the world economy if the slowdown were to persist is I think hard to say at this stage. Very significant uncertainties remain. But recent news from the US has been encouraging. GDP growth in the fourth quarter of last year has been revised upwards, consumer confidence has rebounded somewhat and the main forward looking surveys of activity in the manufacturing and services sector have been looking substantially more positive since the turn of the year. Consistent with this tentative recovery in optimism, the Consensus survey of professional economists' forecasts for near-term growth in the US has been revised upwards for the first time in quite a period.

So far, the UK has escaped the worst of the squalls raging across the Atlantic. Though GDP growth slowed over the course of last year, output in 2001 was still 2.4% higher than a year earlier, close to trend growth. Underlying this relatively benign aggregate picture, there are of course some quite marked differences: on the expenditure side, between growth in consumption, which has surged ahead, and growth in investment, which has been strikingly depressed; and, on the output side, between the fortunes of firms in manufacturing, which have borne the brunt of the global slowdown, and those of firms in the more sheltered services sector.

These differences are sometimes referred to as 'imbalances', and it is certainly true that we can neither expect (nor wish) for them to persist over the long run. The shake-out in manufacturing has been particularly severe, as you know here only too well. Manufacturing output in Northern Ireland fell by some 4.6% in the year to last autumn, compared with a fall of 3.5% in the UK as a whole. But not all of the sectoral differences that have emerged are necessarily unwelcome. Indeed, for those seeking to ensure stability in the economy as a whole, it is really just as well that consumption growth has remained robust at a time when the net trade position of the economy has worsened so markedly. And, as recent MPC minutes show, that has been our intention. So long as the world economy recovers quickly enough to pick up the slack as consumption slows, it may be that we in the UK will avoid the sharp recessions of previous cycles.

Of course, this is a big 'if', and I do not want to imply that I am excessively confident that this will occur. Rapid consumption growth brings with it considerable risks, not least when it is financed by a large build up in consumer debt. But it is the MPC's central expectation that we will escape a serious slowdown at current interest rates. In the last few weeks, we have seen some tentative signs of an unwinding of some of the more severe sectoral gaps in the economy, with the slowdown in retail sales growth since the start of the year, and an encouraging pickup in a number of surveys of business confidence and investment intentions.

Overall, it seems to me that the risks around the outlook for UK inflation are fairly evenly balanced. On the downside, the speed of the recovery in the world economy may be held back by a number of factors, including the large outstanding debt position of corporate and household sectors; investment in the UK might remain subdued; or the weakness in pricing pressures we have seen over the past year or so may persist. But on the upside, the US might bounce back more rapidly than anticipated; consumption growth might remain robust; or the sterling exchange rate might begin to adjust downwards.

Against this background of risks, it is quite possible we may see rates at current levels for some time until the way ahead is clearer. But, as you know, economic events have a habit of developing quite rapidly, so even short term predictions are never easy. For our part, we will continue to assess the case for interest rate changes on a month-by-month basis.

In carrying out our task, the MPC relies heavily on having the very best information at our disposal, and in that we are enormously assisted by our network of regional Agencies. Each month, our Agents drive thousands of miles, eat hundreds of rushed sandwich lunches and, on occasion, no doubt push your goodwill to the limit as they seek out the latest news on developments in your businesses. Nigel Falls, our local Agent, is here with me tonight, and for those of you who have not already met him I really do encourage you to do so after the dinner. Agents attend the monthly briefing in Threadneedle Street ahead of each policy meeting, so information from their contacts is fed directly into the heart of the policy process. I know I speak for all of my colleagues on the MPC when I say that we really do find this a crucial barometer of current events, so I hope you will feel that a short while with our Agents once or twice a year is time well spent!

Financial stability and Enron

I now turn to my final subject tonight - that of the Bank's role in ensuring financial stability. Responsibility for the day-to-day supervision of banks passed from the Bank of England to the Financial Services Authority in 1997. But as the central bank we still have a key role in overseeing the stability of the system as a whole. In this guise we meet on a monthly basis with HM Treasury and the FSA in the so-called tripartite Standing Committee, to review the risks facing the UK financial system and take stock of any actions which may be required to address them. Keeping close to the FSA is particularly important. To this end, I sit on the FSA Board, and Howard Davies is a member of the Bank's Court.

Of course, as I have no need to remind you here, with the border of the euro area just a few miles down the road, we cannot look at the UK system in isolation from the wider international financial markets. The world economic slowdown, with the attendant rise in credit risks, the deepening problems in Argentina spreading to its banking system, and the events of 11 September, creating temporary liquidity strains in New York and elsewhere, have all posed serious risks to the stability of the international financial system. So far, the response has been encouraging. The capital position of many of the larger financial players is stronger than in previous cycles. There seems to be a more sophisticated approach to differentiating between sovereign risks in the emerging markets. And the hugely impressive efforts of staff, together with the largely successful operation of contingency plans, and the flexibility of the US monetary authorities, saw us through the worst of the aftermath to last autumn's attacks without a serious crisis emerging.

The latest topic of discussion in financial circles is, of course, the implications of the collapse of Enron. The case raises a host of issues for firms and policy makers. Some of these relate to accounting standards; some relate to the way in which the auditing profession organises itself; and some relate to corporate governance issues more generally. There are also some issues about the scope and operation of the financial regulation net.

There have also been questions raised about the implications of the collapse for health of the financial system as a whole, which is very much of interest to the Bank, given our responsibility for systemic risk. From the current perspective, these implications appear limited, however. Enron had extensive links with banks and other financial firms, mediated in part through the use of relatively new credit risk transfer instruments. Tracing these exposures through to their ultimate owners is not a particularly straightforward business - an issue that we at the Bank have been raising in a macro-prudential context for some time now, most recently in our December *Financial Stability Review*. But on current information, the residual exposures do not appear unmanageable. Indeed, the apparent dispersion of exposures may even turn out to demonstrate the effectiveness of these markets in spreading risk.

The Bank does not have any direct locus on the accounting and corporate governance issues raised by the case. But the way in which firms' financial performance is overseen and presented does have an important bearing on the disciplines applied by financial markets, which are an essential component of maintaining financial stability in the wider sense. Public confidence in financial statements and the role of auditors is critical. One set of issues relates to the appropriateness of accounting rules governing the treatment of special purpose vehicles and those relating to revenue recognition. This is a technical area, and one in which the rules applied in the US and the UK are relevantly different. No doubt the appropriate professional bodies will be looking at these questions.

Another set of issues relates to rules and practice governing the appointment of auditors, and the extent and nature of non-audit work carried out by firms' auditors. Best practice in listed companies has for some time recognised the importance of rotating individual auditors. But the relationship between a major listed company and its auditor goes well beyond the role of the senior day-to-day audit partner. Before coming to the Bank of England, I had been involved with companies where the audit partner had rotated; but the senior partner of the firm, who took a close interest in the relationship, of course had not. If the profession believes that rotation is important to maintain independence, should that rotation not relate to the firm, with whom the relationship is, rather than any individual? There are of course good arguments on the other side, and it will be interesting to see where the review of these and related matters, recently announced by Patricia Hewitt, comes out.

Conclusion

Ladies and gentlemen, it has been a pleasure for me to come to Northern Ireland, to meet with a number of business people during the course of this visit, and to join you this evening. Can I take this opportunity to wish you, and the business communities you serve, all success for the future.