David Clementi: The Bank of England's roles in monetary and financial stability

Speech by Mr David Clementi, Deputy Governor of the Bank of England, at the Association of Private Client Investment Managers and Stockbrokers (APCIMS) Annual Conference, London, 19 October 2001.

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Introduction

Thank you for the kind invitation to address your conference today. APCIMS performs an important function, representing and informing the views of a wide range of private client investment managers, brokers and banks. Its voice is increasingly heard in a number of public debates. At one time, back in 1984, I worked very closely with a number of private client firms as we sought to sell shares to the retail market in British Telecom, the first of the large privatisation issues. It's good to see that a number of the firms involved then are represented here today.

When Angela Knight asked me to speak, she said she wanted something which would allow us all, in the midst of our day-to-day preoccupations, to lift our eyes to the horizon. That reminded me of Harold Wilson's description of John F Kennedy: "he had his eyes on the horizon, but his feet on the ground." "Keep your eyes on the horizon and your feet on the ground" certainly ought to be written into every modern central banker's contract of employment. Looking to the future, assessing risks to our economic and financial systems, and - where necessary - acting on these assessments is absolutely core to what we do. So I am very grateful for the opportunity to expand on our role here today.

I want to cover three main themes. First, I want to explain the Bank's approach to the exercise of monetary policy, and then, second, give you some assessment of the current state of the British economy. And, third, I want to discuss the Bank's other key role - that of maintaining financial stability in the system as a whole. That role is, I think, less well understood than our monetary policy responsibilities. But financial stability is every bit as crucial to our national welfare. So I'd like to spend a few minutes setting out our objectives, and picking up on one or two themes of current concern.

Maintaining monetary stability

I turn first, though, to the Bank's better known role, that of maintaining monetary stability. Our target for monetary policy is extremely clear. We aim for 2½% inflation in retail prices (excluding mortgage payments) at all times. That target is set by the Chancellor. 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 May 1997, when the current arrangements were put in place, RPIX inflation has averaged 2.3%. If inflation is more than one percentage point either side of the target, we are required to write to the Chancellor explaining the reasons for the miss and the steps we are taking to bring inflation back to target. There was a flurry of excitement earlier this year when inflation reached 1.8%, and many commentators thought that we might soon have to polish up our letter writing skills. But so far we have not had to put pen to paper. Of course, a number of factors have contributed to the stability in inflation. Monetary policy takes time to affect inflation, so inflation in the early part of this period reflects decisions taken before the MPC was formed. And in the short term at least prices can reflect factors other than monetary policy. But, judged against previous policy regimes in this country, inflation targeting has been successful. Of course, you might expect me to say that. But the growing credibility of the arrangements is also reflected in measures of expected inflation in coming years, most of which remain close to the 2½% target.

People often ask if this 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 the recent UK data, it is hard to see any trade-off even in the short run. Output has now risen for 36 consecutive quarters, the longest continuous expansion since post-war records began. And unemployment is close to its lowest level for a quarter of a century. In my opinion, that has not happened by chance, but is the result of a range of policies. 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 take no interest in 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 guess 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.

So far, I have spoken as if monetary policy is carried out by faceless bureaucrats hidden deep within the vaults of Threadneedle Street. Of course, as any of you who read the Diary columns regularly will know, nothing could be further from the truth! 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.

The first stage occurs on the Friday before the policy meeting, with a briefing by Bank staff on all of the data that have been released over the previous month. The following Wednesday afternoon, the MPC meets by itself to have a detailed discussion of all of the key issues raised by the data, plus any tactical considerations. Then, on Thursday morning, each member indicates the factors he or she considers relevant, and gives his or her vote. The decision is announced to the public at 12 noon, with the minutes of the meeting following two weeks later.

The regularity and the rigour of this process are absolutely key to the continued success of the UK regime. We do not respond in an unreflective way to individual pieces of data. We do not choose the timing of meetings to suit the headlines or some special interest group. And we seek to avoid rush judgements. Wherever possible, we try to take decisions in the round, on the basis of as broad a data set as possible, and after detailed discussion of the alternative economic interpretations. Of course, the Bank of England Act provides for flexibility where it is needed. Highly unusual events - such as the terrible terrorist attacks - may demand a special meeting, such as the one we held on 18 September, outside the normal timetable. But it is this regular, comprehensive, systematic analysis which is the backbone of the process.

Of course, agreement on process need not imply agreement on substance. Members of the MPC do not always agree precisely on the appropriate stance of policy, as those of you who read our minutes will know. 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

Let me turn now to an assessment of the economy. The recent debate has, of course, been dominated by discussion of the implications of the terrorist attack on the United States, and the political and military response. The loss of life was grievous. Few of us will forget the sights we saw on our TV sets that day. And for those most closely involved the feelings must still be of the utmost intensity. Standing back, from an economic perspective I would say that the most serious impact has been on sentiment, particularly in the United States. Consumer confidence there has fallen quite sharply. Equity prices dipped in the immediate aftermath of the attack, the sterling price of oil has fallen by some 18% since the start of September, and credit spreads have risen. Of course, equities have since rallied strongly, with the FTSE100 for example now back above its pre-September 11th levels. But substantial uncertainties remain. At the very least, firms and households are likely to delay major expenditure decisions until things become clearer. And this may act as a drag on the recovery in activity. The rise in the cost of security and insurance will also probably have a more long-lasting effect on activity.

Discussion of the attacks has somewhat obscured the fact that the world economy seemed to be slowing more rapidly than expected even before 11 September. Overall activity in the US had been weak, despite continued strength in some sectors, notably retail. And the euro area grew by just 0.1% in the second quarter, as net trade slowed sharply. The monetary policy reaction has of course been rapid. In the United States, in particular, interest rates have already been reduced by four percentage points since the start of the year. And fiscal policy has been expanded. These actions should clearly stimulate demand. But, as is always the case, the size and timing of these effects is extremely hard to judge.

So far this year, the UK economy has fared rather better than its main trading partners. GDP growth has slowed from the peaks it reached during 2000. But the economy still grew by 0.6% in the first quarter of this year, and 0.4% in the second. Much of that strength, of course, reflects domestic demand growth, and particularly household consumption, which rose a further 1.3% in Q2. In many ways, this should not be a surprise. Average earnings have been growing at around 4.5% per year, house prices have been rising by between 10-15%, and total consumer borrowing is the highest in real terms since 1988. But, even given these factors, consumption growth has been strikingly strong.

There are, of course, downside risks to the outlook for consumption in the UK. Consumer confidence fell in September, even before the terrorist attacks. Despite the recent rally, equity prices are still much lower than their peaks eighteen months or so ago, and that will have reduced consumers' financial wealth. And there may be the first sign of easing in the labour market which, if it persists, will reduce disposable incomes. Despite this, however, there is little sign yet of any sharp reduction in consumer spending. Retail sales volumes grew by 5.9% in the year to September. That picture of continued strength is corroborated by the CBI Distributive Trades Survey measure for September (gathered largely after the 11 September attack), which was the highest since October 1996. And the higher frequency British Retail Consortium survey suggested that sales volumes by the end of September had returned to pre-attack levels.

I focus on the continuing strength of consumption because it - together with its partial correlate on the output side, the retail service sector - is absolutely key to understanding why UK interest rates have fallen less far than in other countries. But, of course, elsewhere in the economy, things have been looking less bright for some time. In particular, the manufacturing sector has been struggling under the effects of sterling's ongoing strength and the weakening in the world economy which I have already discussed. Manufacturing output today is little higher than it was in March 1998, and employment in the sector has fallen considerably over that period. The difficulties faced by the traded sector are reflected in the UK's relatively weak net trade position, which has reduced GDP growth in 14 of the last 17 quarters. Surprisingly, but encouragingly, manufacturing output rose by 1.4% in August - the largest monthly rise for two years. Whether this pickup will persist is, of course, unclear at the moment.

In assessing whether some of these short-term movements are likely to last, the MPC is particularly reliant on intelligence from firms. Like others, we pay close attention to the major industrial surveys. But we are also able to call on our network of regional Agents, who talk each month to a wide variety of companies, including, I know, some of you. It is clear from the Agents' reports that the confidence of many of those they speak to has been hit in the aftermath of the terrorist attacks. Labour hiring and discretionary spending decisions may be deferred for a while, whilst the situation becomes clearer. And investment could be reduced if businesses look for a higher return to cover any increased risk.

What does all of this mean for inflation? So-called 'upstream' prices - including raw material costs and factory gate prices - remain very subdued. Some business costs, such as insurance, will rise, but that should be at least partially offset by the sharp fall in oil prices. RPIX inflation rose briefly above target in August, but fell back to 2.3% in September. We are just starting to put our next formal inflation forecast together, and you will be able to see the results of that exercise in the November Inflation Report.

At this point, I know you would wish a crisp conclusion and some indication of where I think rates should move in the future. Some of you may even think you have detected clues in what I have said as to where I think rates should go. If you have, though, that would be an over-interpretation. There are, I think, clear downside risks. The world economy may slow further if adverse confidence effects persist. Spending which is currently delayed may be cancelled. And the labour market may begin turning more decisively in the UK. But for the moment these risks need to be weighed against the continued strength of domestic demand. Of course, if we are to meet our inflation target, a strong domestic economy will be needed to offset the weakening influence of overseas markets. We have cut interest rates by 150 basis points since the start of the year in part to achieve this, and the full effect of these reductions have still to come through. All this will make for an interesting November round where, as I indicated earlier, we will look carefully at all the data, making our decision firmly in the light of the inflation target we have been set.

Maintaining financial stability

Having discussed monetary policy, I now want to turn to the other key role of the Bank of England - that of maintaining stability in the overall financial system. This does not, of course, mean that we supervise individual banks, building societies and investment firms. Since 1997, that role has been carried out by the FSA. The Bank, by contrast, is responsible for providing analysis of potential threats to the system as whole. We are responsible for financial system infrastructure, in particular payments systems. And, in exceptional circumstances, we would be responsible for undertaking official support operations to prevent difficulties in one institution affecting other parts of the financial system.

Of course, we cannot do these jobs in isolation. Co-ordinating our system wide perspective with the FSA's daily supervisory responsibilities and the Treasury's legislative role is essential to the smooth functioning of the arrangements. A Memorandum of Understanding, signed by the Bank, the FSA and the Treasury in October 1997, sets out our respective responsibilities, both in 'normal' times, and in a crisis. And we work hard to foster these relationships, helped by the fact that I am a member of the FSA Board and Howard Davies is a non-executive director of the Bank. The three institutions also get together at least monthly, in what we refer to as the 'tripartite Standing Committee', to exchange information and discuss current threats to financial stability. As you might expect, we have met more frequently in recent weeks.

If the events of 11 September have had an important effect on monetary policy, they had huge potential implication for financial stability as well. In the immediate aftermath, a key priority was to make sure that markets had adequate liquidity to continue and settle their business. In addition to its extensive operations in the US market, the US Federal Reserve entered into swap arrangements with the ECB, the Bank of England and other central banks to ensure a continued supply of dollar liquidity in other key markets. And the main payment systems extended their opening hours in the US, enabling the huge daily volume of dollar payments to be made. I must say that I was particularly impressed by the speed with which most of the big firms affected in New York were able to switch their operations to their contingency sites. Some of those sites were in New Jersey, but others put increased volumes through their London offices. There are of course a number of lessons which firms based in the UK and elsewhere will want to take from the disaster. But, overall, I salute the US firms and the US authorities for their actions, achieved at a time which for many involved was one of acute personal anxiety.

More generally, we - like other central banks - carry out macro-prudential surveillance. The main vehicle for reporting externally on the Bank's work in this area is the Financial Stability Review (FSR), which is published twice a year. The purpose of the FSR is to survey potential risks to financial stability, to analyse ways of responding to these risks, and to encourage an informed debate. This type of forward-looking analysis is absolutely key to avoiding the systemic risks of the future. I hope that many of you have had the opportunity in the past to read it.

Achieving financial stability in the UK not only helps maintain prosperity, it also makes it an attractive place to do business. Earlier this month, the Bank for International Settlements released the results of its 2001 survey of global turnover in foreign exchange and over-the-counter (OTC) derivatives markets. And, yet again, the UK has done extremely well. Firms operating in the UK took over 31% of the foreign exchange market, and over 36% of OTC business - roughly twice the size of the next largest country, the US. Turnover in the global foreign exchange market has shrunk somewhat in recent years, reflecting in part the introduction of the euro. But there have also been important improvements in market efficiency, with for example the increased use of electronic broking. That is reflected in the sharp rise in underlying customer business with firms like yours, which is a welcome development.

Conclusion

Ladies and gentlemen, let me conclude at this point. It is clear that the events of 11 September, and their aftermath, have given rise to considerable uncertainties. There is plenty, particularly overseas, for central bankers to concern themselves with. When I spoke at a conference last week, one newspaper commented that I always looked worried. Well, of course, central bankers are paid to worry. But when reviewing the economic situation we need to achieve a sense of balance. The data do not all point in a single direction. Certainly in the run-up to the November MPC meeting we will need to take a careful look, as I indicated earlier, at all the data. Our feet will be on the ground, but our eyes will scan the horizon! Thank you very much.