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Treasury Chambers, Parliament Street, SW1P 3AG
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13 June 1988

The Rt Hon Lord Young of Graffham
Secretary of State for Trade and Industry
1-19 Victoria Street
London SW1

NBPM
PRCG
14/6

Dear David

REPORT ON THE STOCK MARKET FALL

Thank you for your letter of ~~26~~ May enclosing a report by your officials on the Stock Market Fall. I have also seen the Deputy Governor's letter of 7 June, and agree with all the points he makes.

There is clearly no reason why you should not send a copy of the report to the regulatory bodies, particularly since I understand they have seen the paper in draft already.

But I see no case for publication, either of this paper, or of an abridged version. There is little pressure for publication, and, frankly, the paper adds very little to the conclusions of earlier reports eg. by the Stock Exchange. If published, I fear it will be seen as a somewhat feeble and very belated response to October's events.

That said, it is for you to decide on publication. If you do decide to go ahead I trust it will be made clear that this is a report by your officials and not in any way a joint product with the Treasury.

I am copying this letter to the Prime Minister and the Governor.

Yours
Nigel

NIGEL LAWSON

Econ Pol: Domestic Monetary Policy Pt 8.

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Not to be released before 11.30 a.m. CET on Monday, 13th June 1988

BANK FOR INTERNATIONAL SETTLEMENTS

13th June 1988

PRESS COMMUNIQUÉ

The following are excerpts from the speech delivered by Dr. W.F. Duisenberg, Chairman of the Board of Directors and President of the Bank for International Settlements, to the fifty-eighth Annual General Meeting of the Bank held in Basle on 13th June 1988.

I now turn to economic and monetary developments in 1987 and the first few months of this year. That period has, in certain respects, been a very eventful one. In the industrial countries it has been marked by three main features: continuing economic growth with inflation remaining subdued, but inflationary expectations rather volatile; a reduction, both in real and, to a lesser extent, in nominal terms, of the major payments imbalances; and, owing mainly to the persistence of large nominal imbalances, episodes of major turbulence in the financial markets.

1987 was the fifth year of the economic upswing that had begun towards the end of 1982. The industrial countries' overall growth rate was 3%, slightly higher than in 1986; and growth appears to have continued steadily in the first quarter of this year, although perhaps not quite at the same pace as in the second half of 1987. Two features of the recent growth performance have been particularly encouraging: the resilience of economic activity in the face of the stock market crash, as demonstrated by the marked acceleration of growth in the second half of the year; and the vigorous, domestically oriented expansion of activity in Japan. A less favourable element in the situation is that the growth of real domestic demand in the United States, while lower than in most other large industrial countries, remains rather buoyant in relation both to the need for further external adjustment and to approaching capacity restraints in the economy.

On average, recorded inflation rates rose last year in the industrial world, after having declined in 1986 as the oil price fell. Consumer price inflation went up from 2 3/4% in 1986 to 3 3/4% by the end of 1987, at which level it was slightly lower than just before the oil price decline. Moreover, in the first quarter of this year the rise in prices slowed down a little. Wage trends were not a major problem in most countries last year. In particular, wages rose less than consumer prices in the United States despite the continuing decline in unemployment. In the United Kingdom, on the other hand, where the decline in unemployment was greater, wage increases accelerated somewhat from levels that were already higher than in most other major countries. While inflation itself remained subdued, inflationary expectations fluctuated markedly over the past year. After having been dampened by the stock market crash, they have recently resurfaced, particularly in the United States in connection with the combined strength of domestic and export demand. Given the imminence of bottlenecks both in the labour market and in industry, resources need to be set free if further progress is to be made in reducing the US external deficit.

Turning to the major payments imbalances, the most encouraging evidence of the workings of the adjustment process during the past year has been the strength of US exports. By the fourth quarter of 1987 their volume was over 18% above the level of a year earlier. Export gains have been broad-based both by commodities and by markets, and they point to a major and welcome recovery of competitiveness by US industry. On the import side, the evidence has been less clear. Excluding oil, US imports rose by almost 8% between the fourth quarters of 1986 and 1987.

In Japan there was evidence last year of adjustment on both sides of the trade balance. Between the fourth quarters of 1986 and 1987 the volume of non-oil imports went up by nearly 14% while that of exports was unchanged. In Germany, too, real non-oil imports increased over that period quite strongly, by 8 1/2%; in contrast to Japan, however, exports rose by 7 1/2%.

In addition to these signs of real external adjustment, the nominal current-account surpluses in both Japan and Germany declined in the second half of last year. In the United States, however, it was only in the early part of 1988 that the first clear signs of a reduction in the nominal current-account deficit appeared and it was the persistence until then of very large nominal trade deficits that was in all likelihood the most important cause of last year's financial turbulence.

Three features of that turbulence were notable. Firstly, its magnitude. That was most evident in the scale of last October's stock market crash. But in addition the volume of central bank exchange market intervention since the Louvre Accord of February 1987 has been exceptionally large, despite which the dollar had by early this month fallen by a further 18% against the yen and by 6% against the Deutsche Mark. Moreover, the yields on long-term US and Japanese government securities varied by as much as one-third and one-half respectively in the course of 1987, despite only modest changes in these countries' observed inflation rates.

The second notable feature of the past year's financial turbulence was the confirmation it provided of the extent to which financial markets are now interconnected. Thus, in the spring of last year lack of confidence in the dollar affected not only the exchange markets, but also the bond markets, where rates rose in the US market and fell in those of the strong currencies. Moreover, the stock market crash was remarkable for the fact that, except in Japan, the decline of equity prices was rather uniform across countries, regardless of the extent of their earlier rise or of differences between countries' economic fundamentals. Subsequently, during most of the first quarter of 1988 we saw a phase of relative stability in all financial markets.

Despite the interconnections between different markets, however, there was no point last year at which all markets were in trouble at the same time. In particular, the stock market crash, while it led to further exchange market turbulence, triggered a strong recovery of prices in the bond market and did not create any systemic problems in the financial system. No doubt that reflected in part the actions taken by central banks to provide ample liquidity to their markets in the wake of the crash.

The third feature of last year's turbulence was that it was limited to the financial markets. There appears to have been no significant impact on economic activity. In that very important respect events since October 1987 have contrasted sharply with those that followed the 1929 stock market crash. To my mind, a more appropriate comparison is with the large, although much less rapid, fall of share prices on many stock markets in 1962. That fall occurred at a time of even more buoyant economic activity and it also was not followed by any weakening of real growth.

As regards the course of events in the developing countries, the first feature I should like to mention is the further increase that occurred last year, to over $30 billion, in the combined current-account surpluses of certain newly industrialised countries in Asia. These combined surpluses, of which Taiwan alone accounted for over $18 billion last year, are now the largest counterparts, outside Japan and Germany, to the current-account deficit of the United States, and by the end of 1987 Taiwan's foreign exchange reserves were the largest of any country in the world. This group of countries, and Taiwan in particular, can make a significant contribution to the reduction of the present global payments imbalances, mainly by the adoption of appropriate trade liberalisation and exchange rate policies.

As far as the international debt situation is concerned, the middle-income problem debtor countries reduced their aggregate current-account deficit last year, partly through increased export earnings. Together with lower interest rates, this contributed to a sharp decline in the share of their export earnings that was devoted to debt service. Moreover, various new initiatives were taken with a view to giving added flexibility to the handling of debt problems. Some of these were aimed at speeding up rescheduling and new money negotiations between the debtors and the banks and others at achieving voluntary reductions of outstanding debt. The latter included debt conversion and buy-back schemes based on the secondary market prices for countries' banking debt.

There is as yet, however, no sign that these countries are regaining spontaneous access to market finance. Indeed, last year's substantial debt provisioning by US and other banks and the greater awareness of secondary market discounts on these countries' debts may make it more difficult for banks to put up new money for problem debtors. Nevertheless, it is hard to conceive of a solution to the debt problem without the banks, as the major creditors, contributing to it in one form or another. Debtor countries themselves should, of course, continue to pursue their adjustment efforts. All in all, and despite the progress that has been made since 1982, particularly in reinforcing the capital positions of international banks, the debt situation remains a major problem.

At the centre of the international scene at present, however, are concerns about problems in the industrial world. I should therefore like to conclude by spending a few minutes considering the outlook for conditions in financial markets and for the evolution of the major payments imbalances.

Last year's turbulence in the financial markets was, without doubt, an unpleasant surprise. What are the chances that we could see a repeat performance of those events? I believe that the risks of this happening have substantially diminished. Last year's stock market crash did not lead to any slowdown of economic growth and it was, except in Japan, followed by a stabilisation of stock market prices at much less vulnerable levels than before. In the exchange markets, the further fall of the dollar after the stock market crash should, coming on top of last year's dynamic growth of US exports and the recent clear improvement in the US foreign trade balance, contribute to greater exchange market stability in the future. Lastly, for most of the first quarter of 1988 we did in fact see a phase of relative calm in all financial markets.

More recently, however, there have been reminders from the markets of the uncertainties which still exist. US long-term interest rates have been moving up again because the buoyancy of demand is pushing the economy towards full use of capacity, and rates have risen in Germany and Japan too; and there have been occasional quite sharp falls in equity prices. Moreover, the disappointing US trade figures for February put immediate downward pressure on the dollar, while the much better ones for March triggered a fall in US bond prices. Those episodes showed that markets remain unsettled. Looking beyond recent events, all forecasters seem to be agreed that, barring a US recession, the rest of the world will have to finance sizable US current-account deficits for some time to come. The markets are very conscious of this - hence the close attention they pay to the monthly US trade data.

What, then, can be done to guard against the risk of a recurrence of financial market turbulence of the kind that we saw last year? Obviously, there are lessons to be drawn from the stock market crash and this process is already under way. Those who operate in the securities market need to look carefully, for instance, at the role of new financial techniques such as program trading. Securities market supervisors need to consider the implications of the close connections which exist between stock markets proper and markets in stock futures and options. Last year's turbulence also underlined the importance of financial institutions being adequately capitalised in relation to the risks inherent in today's deregulated and globalised markets. In that connection I welcome the proposals made at the end of last year for a convergence of capital adequacy standards for banks in the Group of Ten countries. Finally, I should like to stress the need to develop co-operation, both domestically and internationally, between banking and securities market supervisors.

In my view, however, given the prospect that nominal current-account imbalances in the United States, Japan and Germany will continue to be substantial for the foreseeable future, the decisive factor for the behaviour of financial markets will be the perceived efforts of governments and central banks to handle the situation by co-ordinated policy actions. What lessons can we draw from the events of the past year for international policy co-ordination efforts? There was certainly no lack of joint action in the exchange market. Indeed, intervention helped to produce, admittedly at considerable cost, substantial results on two occasions - the recovery of the dollar to its pre-Louvre levels in the summer of 1987 and the period of stable exchange rates during the first quarter of this year. But nobody thinks that intervention alone can stabilise the dollar.

Moreover, monetary policy has been used in support of official exchange market intervention, as can be seen from the persistent differentials between short-term rates in the United States, on the one hand, and in Germany and Japan, on the other. However, the policies which produce such interest rate differentials can, beyond a certain point, themselves create new risks: in Germany and Japan the risk that rapid monetary growth may reawaken inflationary expectations; and in the United States the risk that upward adjustments of short-term rates may come on top of, and add to, existing upward pressure on long rates.

What went wrong last year was that policy co-ordination relied too much on exchange market and monetary policies and too little on fiscal adjustment. In saying this, I do not forget last year's fiscal stimulus in Japan. That was a notable contribution to the international adjustment process; it was also a useful reminder that fiscal policy can, in a non-inflationary environment, be an effective tool of demand management policy. Germany's fiscal policy, too, has moved in the right direction for international adjustment, although not as far as some, both in Germany and elsewhere, would like. In the United States last year's reduction of the Federal budget deficit was substantial. However, its effect on total US domestic demand was offset by a further fall in private savings. More adjustment, including additional fiscal restraint, is therefore needed in the US domestic economy.

The goal of correcting, through international policy co-ordination, the payments imbalances that emerged in the first half of the 1980s may seem hard to attain. However, we must not forget the time that elapsed before it was agreed, in late 1985, that the imbalances constituted a problem and the size that they had by then reached. Nor should we overlook what has been achieved so far in dealing with the two main factors that produced them. The misalignment of exchange rates has been corrected, as the recent performance of US exports indicates. In addition, the most recent data show that the earlier difference in the growth of domestic demand between the United States and the two main surplus countries has been reversed. These are not negligible results and they show that we are on the right path. The task now is to build on them by maintaining the momentum of co-ordinated adjustment efforts.