Extract from a speech by

THE GOVERNOR OF THE BANK OF ENGLAND

at a dinner given by the Lord Mayor to the bankers and merchants of the City of London on 20th October 1966

... When my distinguished predecessor, Lord Cromer, first spoke to the merchants and bankers here assembled five years ago, he could justly claim that he had been thrown in at the deep end—Bank rate up to 7% within three weeks of assuming office and a massive credit squeeze within four. I take no pride in outdoing that baptism of fire. None of us can derive any satisfaction from the fact that we have been similarly assailed now three times in little more than a decade. *Stop-Go* has long been a term of abuse and we all want to find some more creative and enduring way of getting rid of our recurrent balance of payments crises. Central bankers are sometimes thought to love credit restraint and deflation for their own sake. How far from the truth this is. What could be more satisfying than to expand our way out of trouble, selling both at home and abroad more and more goods at competitive prices? In effect we have been trying that alternative for the past three years. Does any unprejudiced observer think that during that period we have made the best use of our resources, fully employed, on the face of it, though they are supposed to have been? Some say we are now headed for stagnation, but have we not been enduring nearly that and worse for far too long? As has been said many times already, we have paid ourselves much more money for little more production, set our ambitions in a pretty wide field of policies sometimes too high, sometimes on too short a time scale, and consequently have sucked in other countries' production by way of imports at an alarming rate. It seems to me that the prices and incomes policy, despite its dangers and imperfections, is a courageous attempt to bring us all to our senses. I see signs already that it may succeed better than its detractors will admit. However, even if it does succeed to a notable extent, I believe, after our experience since 1955, that we shall have to maintain continuously some margin of spare resources until we find out how to keep the economy on an even keel without it. This involves human problems which will certainly have to be taken care of, but I deny that in any economic sense it means waste as serious as that flowing from an excessive level of internal demand, such as we are now bringing under control. The fierce *Stop* that has been necessary to achieve this could have been avoided, and should be in the future, by not allowing the margin to disappear. It is on this point that the criticism of *Stop-Go* should properly be concentrated. And the whole process can and should be made less painful by the redeployment, retraining, and help for the development areas on which H.M. Government are working.

It is true that the measures that have been taken may result in some reduction in fixed investment. Indeed this is already occurring, and it is regrettable. But investment which is carried out only in response to inflationary demand is very apt to be wasteful investment; we can do without this. What we need more of is inventive, technologically-advanced, labour-saving investment. But there can be no virtue in letting home demand off the leash again, and re-creating inflationary conditions, as a way of advancing such investment. If investment is to be encouraged—as, in the long run, it clearly must be—it will have to be done by other means than this. Moreover, vital though a high level of investment is to this country, it does not provide the only—or even the most important—key to greater prosperity. The benefits of higher investment can be dwarfed by the effects of widespread basic changes in attitudes towards getting things done; these changes require thought and energy rather than money.

After the long drawn-out erosion of confidence overseas from which we have suffered we simply cannot afford to let the outside world think that even now we shrink from actually swallowing the medicine we are taking. Obviously we must guard against taking an overdose. But only if we persevere can we achieve the healthy balance of payments position in 1967 which, I agree with the Chancellor, we now have good reason for expecting. If I may say so, my Lord Mayor, I was delighted that the Chancellor in his impressive speech at the Labour Party Conference so firmly dismissed the idea that what we are doing and have to do is in any way connected with a " bankers' ramp ". It is time that that hoary old bit of folklore was laid to rest, and who better to do it. So far as my central bank colleagues overseas are concerned, they could not have been more understanding, helpful and patient. When I say that we owe them a great deal, I hope I shall not be misunderstood.

It needs to be more fully and widely realised that in almost every respect we live in a shrinking world. Nowhere is this more so than in the field of economic and financial policy. Some may decry what they call " the annual jamboree " of the Fund and Bank meetings, from the latest of which the Chancellor and I have just returned. But in what other context does the whole free world meet and consult annually? The interdependence of national economies is now accepted without question and the authority of the Fund as guardian of the international monetary system grows all the time. Multilateral surveillance, which means collective examination of each country's economic performance and problems, has come to stay and will become more searching. It is no use trying to shrug off other nations' legitimate concern in our actions which affect them as " interference by the world's bankers ".

Another favourite taunt in some circles is that we are sacrificing the people to save the pound. On the contrary, the pound is being protected for the sake of the people. It cannot be treated as a sort of fascinating toy for bright boys to play with. I do not believe in the future of any economy where nothing ever gives way except the exchange rate. The Government's firm stand on this subject is most heartening. After two years I think it is about time they were given more credit for this both abroad and nearer home.

There is, of course, a variant of the " pound first " complaint. All our troubles are due, it is said, to the burden of the pound being a reserve currency—or, as I prefer to say, an international currency. But it is simply not good enough to go blaming sterling for our external difficulties. The facts speak for themselves. So far this decade, we have had only two years when we were in surplus on current account and, according to the figures, the capital account has looked adverse too. Two years ago our total deficit was shown as four fifths of our reserves. Nothing need be at fault if a country moves in and out of balance in different years. But persistent deficit, or deficit on a scale that stuns belief, discloses everything at fault. It was impossible to continue like this. The balance of payments has to be put right and kept right; and in whatever way we do this it means transferring resources abroad—letting the foreigner have more of our output and having less at home. It is nonsense in this situation to say that the domestic economy is being sacrificed to the balance of payments. The only conflict involved is the familiar one that most people's desires conflict with their income.

If we call the sterling balances a burden, some countries are inclined to view them as a privilege which we enjoy at their expense. Putting it another way, running an international currency provides special opportunities for enlightened policies but it also imposes special penalties for mistakes. Anyone who runs a business on a capital largely supplemented by credit will be embarrassed if he becomes less creditworthy or if particular creditors demand payment because they themselves are in need. But that does not stop businessmen in general feeling that without credit everyone's activities, profit and prosperity would be much curtailed. That is precisely our position as a country.

Recent talk about a possible funding of sterling balances has, I regret to say, given rise to fears abroad that they may in some way be blocked. Such fears are entirely without foundation. These balances represent the liquid foreign exchange assets of overseas governments or their nationals. In my view, no arrangement, even supposing one were possible or desirable, is conceivable which would impair their essential character.

My Lord Mayor, finally I would like to speak of a feature of the international scene that has a very direct connection with the type of economic policy pursued in individual countries. What I have in mind is the tightness of credit and the high level of interest rates seen in so many countries and in the euro-currency markets. It is a situation that has two lessons for us. It is another reminder that neither we nor any other country can pursue a policy towards interest rates in isolation. It should also make us think whether there has been anything unbalanced within our own country—where indeed we have no love for high interest rates.

Official policies have reinforced the general influences making for high rates. In many countries a relatively rapid growth of governmental spending has added notably to the demands for funds. Taxation arrangements have increasingly favoured fixed interest borrowing rather than the issue of equity and have prompted a great increase in that form of borrowing. As the margin of unused resources became reduced, the authorities in a number of countries have acted to resist the rising inflationary pressures. This was necessary and right. But for various reasons the burden of restriction in most countries has been thrown unduly upon monetary policy.

Tight and dear money can have dramatic effects on international flows of funds and these may make competitive increases in interest rates difficult to avoid. Mr. Pierre-Paul Schweitzer, in his speech a fortnight ago at the International Monetary Fund meeting in Washington, had reason to conclude: " In short, interest rate developments in the industrial countries have not contributed significantly to a lessening of the disequilibrium in international payments." But I do not wish to suggest that the risk of competitive interest rate movements is a cause for alarm at present. The major central banks have shown themselves alive to the situation. There are, too, some recent signs that in several markets the escalation of rates has ceased.

What does need to be stressed is that while the present growth of world economic activity continues, a substantial reduction in interest levels needs a significant shift in emphasis from monetary to fiscal policies. In some countries it seems as if the emphasis may have begun to shift. The question is whether we ourselves have the balance right. Confidence in the out-turn of policy has rightly strengthened. The levels of capital development proposed by industry, business and perhaps by private persons have begun to fall. These, among other influences, are very understandably playing a part in the downward turn our medium and long-term interest rates have lately taken. On our fiscal side, no one can say that measures have recently been lacking. We have advanced boldly in the field of prices and incomes policy. Yet, as I see it, there is grave risk that at bottom the structural problem may remain.

If government spending rises steadily and inflexibly faster than private expenditure, weight will have to remain thrown on taxation and on monetary and credit policy.

I have pointed to the dangers of relying on the latter. Taxation may be regarded as something outside my field. As a technical subject it certainly is. Nevertheless I venture to think that its level in this country is already dangerously high. I have much sympathy with the points made by the Chairman of the Stock Exchange. I wonder how much thought is given in the appropriate quarters not merely to raising taxes but to shaping the tax structure so as to increase the incentives to us all to work and produce efficiently. I believe that this would help to bring about the change of attitudes we so badly need and in so doing increase the taxable capacity of the economy at tolerable levels. Without such a change I do not see—I certainly would not want to see—taxation taking the strain any more than credit policy.

While the set-back to capital developments in industry can be accepted for a time, during the reappraisal of plans, it can be no object of policy to see it endure. Yet if the level of such outlays is restored, room must be found by trimming other demands—or back we will be, straining at our productive capacity and staggering along with an external deficit.

All this, it seems to me, leads inexorably to the conclusion that for this country now " fiscal policy " must mean further reduction in the growth of governmental spending, including with special emphasis that of the local authorities. I know the Chancellor has done much already to regulate the pace and I have some appreciation of the difficulties. But the need for a further appraisal of the scale and flexibility of governmental plans is, in my view, essential. The objectives of such expenditure are for the most part admirable, indispensable or overdue. I would not presume to criticise them. But I am convinced that restraint of public expenditure designed to help to secure a healthy and balanced economy will hasten the realisation of those objectives, not impede them. The need to look after the goose that lays the golden eggs is a simple old saying but it speaks a fundamental truth. It is often said nowadays that the vast mass of government expenditure is a powerful and useful weapon permitting government to stimulate or restrain the economy as circumstances demand. This is indeed so but only so long as the weapon can be used effectively in either direction. We have yet to see that this is possible.

My Lord Mayor, my predecessors in my Office have for many years said, in effect, what I have now been saying about the claims our governments make upon our real resources. I firmly follow their tradition. But if this is to be set aside as no more than a traditional theme of central bank governors, I fear the consequences will be bad for us all. It would be a remarkable waste of a fine opportunity if we went through our present cure only to relapse when it was over. For our cure is beginning to work; what I have just been speaking of is a medium-term problem—though needing action now for all that. If we persevere we can achieve the healthy balance of payments position which, as I have already said, I agree with the Chancellor that we now have good reason for expecting. From this more healthy position we shall, I believe, be able to look the world in the face, recover confidence in ourselves and achieve with ease things which now seem scarcely within our capacity.

We all know of the plans elsewhere to establish a *Great Society*. We here have long had the elements of such a society ourselves, with a splendid cultural heritage, mature political institutions and attitudes, and the longest industrial experience of any country in the world. With these ingredients it would take so little in new and forward-looking attitudes to enable us again to lead the world.