Extract from a speech by the Governor of the Bank of England

Given at the Lord Mayor's dinner to the bankers and merchants of the City of London on 15th October 1970

. . . We are gathered here again for this annual dinner, for which we are so much indebted to the Lord Mayor, after yet another eventful year. In the recent past this adjective has been a euphemism for disastrous but at last this is not so. Our balance of payments has improved dramatically, a large slice of our foreign exchange debts has been repaid, and the international exchange system at present causes less anxiety than it has done for many years.

After the prolonged and grievous troubles through which we have passed, it is good to be able to record this improvement. Would that it offered us the sure prospect of a better future. I am afraid there is great danger that it may not do so. Still worse troubles will surely overtake us if we do not grapple firmly and successfully with the problem of inflation. This is a world-wide problem. At the recent meeting in Copenhagen many speakers deplored the damage done by inflation to industrialised and developing countries alike. But, as the Chancellor has said, we must each of us put our own house in order.

My Lord Mayor, the present rate of increase of wages and prices in this country is very serious indeed. Of course, rising prices are not a novelty for us. Prices in the United Kingdom have gone up in every year since the war and the average annual increase over the past twenty-five years has been about $3\frac{1}{2}\%$. For much of that time our prices rose more than those of the other important industrialised countries. It is probably true that the majority of people in this country are prepared to accept a small rate of inflation as a slightly irritating by-product of a fully employed, relatively well-off society. I believe that even this acceptance, though understandable, is shortsighted, because it does not reckon with the costs of adjusting to the balance of payments consequences.

However, slowly creeping inflation is not what we have been experiencing over the past year or so. Devaluation followed by the weakening of incomes and related policies gave a fillip to price and wage increases which now, nearly three years after the initial stimulus and despite the absence of any noticeable overheating in the economy, have developed into a self-perpetuating spiral. Percentage increases in wages of well into double figures are now a commonplace and we are frequently seeing more than one increase within a twelve-month period. Unions are making larger and larger demands, while firms are raising their prices more and more peremptorily to try to recoup past cost increases. Everybody is now involved; and I believe everybody is now alarmed. Inflation has ceased to be – if it ever was – simply a bankers' bogey or a problem for the balance of payments. It is something which for the sake of us all – trade unionists, industrialists and housewives every bit as much as bankers – we have got to conquer.

Unfortunately it is one thing for everybody to recognise how unsatisfactory, not to say dangerous, the present situation is, and how futile each attempt to raise money incomes is likely to prove; it is another thing to cure the disease.

There are some counsellors of despair so overcome by the difficulties that they give up and say we must simply learn to live with inflation. But living with inflation at anything near current rates would have profound consequences in terms of unfairness, social tensions, damage to thrift and investment and in many other incalculable ways. It would of course mean a steadily sinking exchange rate and steadily rising import prices. The whole process would also become increasingly difficult to stop.

One has only to look at those countries where inflation has become endemic to see how it feeds on itself. There is, moreover, a deeper lesson to be learnt from the experiences of other countries and other times. I know of no instance where a continued high rate of inflation has not been accompanied by serious political instability. However, one effect of the present situation is perhaps that it is becoming less necessary to argue the case against 'living with inflation'. This was a popular idea in some quarters when the rate of increase was only 2% or 3%, but less of it is heard today.

I know that some feel I should limit my public pronouncements to reporting on the movements in the money supply and our efforts to influence it. It is my belief, however, that for a lasting solution to the problem of inflation we must look much wider than the bounds of conventional monetary and fiscal policy. I do not see how we can expect to maintain a fully employed, fully informed and increasingly well-off democracy, in which the development of wages and prices is left entirely to the operation of market forces. The bodies on both sides of the bargaining tables, the unions and employers in both the public and private sectors, are too big and too powerful for such a process to yield us the result most likely to contribute to our general welfare and prosperity. If we try to rely on the market place and on the strict operation of fiscal and monetary policies, we shall find, I think, that we can achieve price stability only at the cost of unemployment that might be on a very large scale indeed. Throughout the world more and more responsible people are coming to take this view. It is notable, for example, that the annual reports this year of both the International Monetary Fund and the Bank for International Settlements have emphasised the importance of developing some form of incomes policy.

There is no doubt about the difficulties of doing so. It is easy to point to the failures and shortcomings of the various forms of incomes policy so far tried in this country and elsewhere. But the fact that the problem has not yet been solved, despite all the efforts applied to it, is simply an indication of its complexity. Ultimately, in our society, a successful incomes policy must be based upon the general consent of those to whom it is applied – which means all of us. At present, the prospect of obtaining some general consensus of opinion about the course of incomes is unpromising. In these circumstances it may be that the Government has little option but to pursue its present policy of being prepared to stand up to strikes if necessary, rather than concede wage increases even greater than have at present been offered in various parts of the public sector. There has to be a period of coming to our senses, which may, I am afraid, prove rather painful.

A policy of industrial confrontation is probably, therefore, a temporary necessity. But I hope that neither the Government nor anyone else is expecting any more than temporary or tactical advantage from it. A prolonged period of trench warfare between employer and employee would produce no victors and many casualties. Over the longer term, I believe that the Government will have to set about devising a fair and workable incomes policy and developing the understanding and acceptance of it throughout society. This will be easier if we have the right framework of industrial relations: and although I would not presume to comment on specific proposals, I am sure that much needs to be done in this field.

But that is for the longer term; and it does not in any case mean that there is no role for the fiscal and monetary authorities to play. To say that achieving a particular rate of increase in the money supply, for example, will not automatically or acceptably solve the problems of wages and prices is not to say that sensible monetary policies cannot contribute to our well-being, or that bad policies cannot make our problems worse.

But what constitutes sensible policies at this time? Many voices are heard urging the authorities to relax, to encourage some expansion of demand. In this way it is said that industry will be able to spread its fixed costs over a larger output and so reduce its unit costs. It is also hoped that the resulting increases in earnings will moderate the demand for higher wage rates. I must say I find this a very risky and doubtful prescription. It is true we have some slack in the economy now and that production has not risen quite as fast as was expected last spring; and of course we want the economy to expand as fast as the economy's productive potential allows. But there are signs of increasing expenditure. Retail sales are well up and so are sales of motor cars. Let us hope we will see some further much-needed expansion of exports too in the coming months. If production has so far remained obstinately stagnant, this can unfortunately be largely explained both by the heavy incidence of strikes and by the fact that an increased proportion of home spending is being met by imports. These are both very disturbing facts about our economy. Neither of them is in the least likely to be conjured away by going for unsustainable expansion.

Looking back we can see occasions since the war when the authorities have stepped on the accelerator to stimulate home demand at a time when in fact the economy was beginning to expand on its own. Time and again the result was, after a little time lag, an overheating of the economy, the development of demand inflation and a balance of payments crisis. I hope we shall not risk another similar episode.

On the contrary, it seems to me that monetary policy is more likely to have to exercise a restraining rather than an expansionary influence in the months ahead. Since the spring, money supply and domestic credit have been expanding at a much faster rate than was indicated as appropriate for the financial year as a whole in the Budget speech of the then Chancellor. There were a number of special factors here: conditions in the capital market during the summer doubtless added to the pressure of demand for bank advances and we have had a large redemption to cope with in the gilt-edged market. For these and other reasons, it would be quite wrong simply to extrapolate the increases we have seen so far in domestic credit for the rest of the financial year. I do not accept either that the monetary authorities can exercise a precise control over the rate of increase in the supply of money from month to month, or that in regulating the course of the economy overwhelming priority should be given to trying to influence movements in this particular magnitude. Real life is too complex and the objectives of policy too many and various for us to be able to rely on any simple rule.

But when all this is said, there is no question in my mind that developments in the money supply and domestic credit are important: and it is clear that whatever the special factors may have been, the rate of increase in the spring and summer was higher than one would wish to see continue.

As you are all aware, the new Government has over the past few months been engaged in intensive examination of measures necessary to cut public expenditure. I know the Chancellor is going to announce a whole range of measures when the House of Commons assembles. Only those who are not called upon to take the decisions think it is easy to cut public spending: but it is necessary if we are to lessen the burden of taxation and I am sure we must all welcome and applaud the efforts being made by the Chancellor personally and by the Government as a whole. So far as monetary policy is concerned, all I will say now is that I believe that the experience of the past few years has taught us the necessity of supporting a sound fiscal policy with an appropriate monetary policy. I do not intend to ignore that lesson.