Speech by the Governor of the Bank of England

Given in the Governor's absence by the Deputy Governor at the Lord Mayor's dinner to the bankers and merchants of the City of London on 19th October 1972

It is more attractive on an occasion such as this to look to the future rather than to the past. Visionary expectations or even prophecies of doom usually excite most interest after dinner; they have the important advantage that one cannot be proved wrong, at the very least until the next morning.

Certainly there are plenty of opportunities and dangers to discuss. At the present moment our foremost concern rests upon the outcome of the efforts of yourself, Mr. Chancellor, and of the Prime Minister, to achieve a general consensus of view on how to deal with inflation. I welcome wholeheartedly your initiative to search for such a consensus; and so, I hope, does everyone in this hall tonight.

Now that you have embarked upon this course, you take with you much more than just our best wishes. The dangers of failing to contain the rising tide of inflation, the dangers even of social anarchy, are too grave to contemplate, and to miss the bountiful opportunities provided by success in this endeavour would be heartbreaking.

Both the opportunities and the dangers which we face are enhanced by the immediate prospect of our entry into Europe. In less than eleven weeks we shall be members of the enlarged European Community. If our own economy is under firm command, it will provide a springboard to take advantage of all the new opportunities offered by this historic move.

Turning to yet wider horizons, we have begun the process of reshaping the whole of the world's monetary and trading system. In your speech at the Bank/Fund meeting last year, you, Mr. Chancellor, gave this process an excellent start. Perhaps we in the Bank may take credit this year for making a material contribution to the furtherance of this work by providing Jeremy Morse to serve as Chairman of the Deputies of the Committee of Twenty. I am sure he has the confidence and good wishes of us all in his vitally important task. After the recent Bank/Fund meeting, I am now more hopeful about the prospects for international accord on monetary reform. The U.S. proposals offered a good starting point for the coming negotiations, and I am sure that others will follow in the same constructive vein.

However, if you will bear with me my Lord Mayor, I want this evening to devote most of my remarks to the more ungrateful task of looking backward. It seems appropriate to do this because it is just over twelve months since we inaugurated our new system of competition and credit control. I should like to take stock of our position, to see what successes we have achieved, what mistakes we have made, what lessons we can learn.

Last year we sought, by reforming the structure of the banking system and the official restraints under which it operated, to strike off the shackles that had been frustrating initiative and innovation in the provision of financial services. We believed that the forces of competition, working in an environment unencumbered by cartels and restrictions, would instil renewed energy to develop better and more efficient financial services.

A year's experience strongly suggests to me that we were right. Developments within the banking system during the past twelve months confirm not only the strength of competition but also the latent talent for new initiatives. It has been a period during which many changes have occurred and others have been foreshadowed. The banks have been re-arranging and improving the services they offer; they have provided a wider range of both lending and deposit facilities.

This provision of better financial services should materially contribute to the greater efficiency of British industry. But it is not the only new contribution that the City can make in this field. There are many more; and I am particularly interested in one of them, namely, in improving the means whereby institutional investors can collaborate with industrial managements to secure increased efficiency. On the initiative of the Bank, this matter is being carefully examined in a City Working Party set up for the purpose, with the support of the Confederation of British Industry, and I very much hope that we shall see a positive conclusion and see it quite soon.

Naturally, in an exploration of this kind one must expect differences of view about the right way of solving a problem which, I am glad to note, almost all concerned agree requires some solution. From the start I have been well aware of the very real difficulties that have to be overcome; and also that for some the dangers of innovation overshadow the advantages that I – and others – believe are there to be won. Hesitations perhaps flow mainly from a fear that some powerful new organisation will emerge which, once set up, will run away with its creators. An answer to this can surely be found in incorporating firm safeguards, which should put control of the organisation indisputably in the hands of the institutional investors involved. While recognising the need for such safeguards, I remain wholly convinced that a manifestly positive forward move is required – a foot, not just a cautious inch. Here, as in so many fields, change is in the air. Unless the institutional investors successfully develop and enlarge their role in this direction, I fear they will in the course of time find that they have abdicated it. I am sure this is not what they want.

To all these efforts to improve the efficiency of the system, our critics tend to say: certainly we are getting the competition in the provision of financial services, but where is the credit control? And they point to the increase in the money supply over the past twelve months. This establishes a powerful prima facie criticism which we must take seriously.

It is, however, worth noting that the major structural changes introduced last year were bound to bring about considerable changes in the business of the banks, in the composition both of their assets and of their liabilities. If you encourage the banks to become more competitive, you must expect them to take a larger share of the available business, and this kind of expansion carries no connotation of excessive monetary ease.

Thus on the asset side, after so many years of controls and restrictions, it was hardly surprising that there was a large immediate surge in bank lending to those sectors against which the controls had been most severely directed, such as the personal sector. The extent of the shift was perhaps somewhat exaggerated both by the comparative stagnation in the demand from manufacturing industry for bank finance, though this now seems to be reviving, and also by the various measures taken, for example, in the field of taxation and in the abolition of terms control, which had the effect of encouraging personal borrowing still further.

Similarly on the liabilities side, the banks have sought to provide more varied attractions to potential depositors. In particular they have obtained a large volume of funds from large depositors by issuing sterling certificates of deposit at very competitive rates. There has, as a result, been some exaggeration in the pace of expansion of the broader definitions of the money stock, which include time deposits and sterling certificates of deposit. To put our own experience in perspective, M_1, the narrower definition of the money stock, which I regard as less subject to bias, has been rising in the last six months at about the same rate as in France and Western Germany.

But even when all appropriate allowances have been made, I do not regard the record of monetary expansion of the past year with complacency. What lessons can we then draw about improving the operation of the new system? I have stressed on a number of occasions that in a system, free of direct intervention to ration the allocation of credit, the operation of credit control requires the flexible adjustment of interest rates both up and down and, as you will be aware, having with the new arrangements much reduced the importance of the old style Bank rate, we have recently taken an important step to restore flexibility and effectiveness to the rate at which the Bank lend to the money market.

In the last few months there have indeed been periods when prices in financial markets moved very sharply. Naturally this has proved an uncomfortable experience. But the rejection of reliance on direct controls implies the corollary of living with considerably more flexible interest rates. It follows that we must not temper our approach so as to protect whatever soft spots there may be at any particular time, and the emergency help which we extended to banks in the sterling crisis this summer is in no way inconsistent with that approach. This help arose rather from our proper concern to avoid an exceptional event having too disruptive an effect.

This leads me on to the question whether we did in practice last year operate with sufficient flexibility.

My opinion now is that late last year we should have resisted the downward movement in interest rates more strongly than we did; or that failing that, we should have moved earlier this year, perhaps even in February and March, to establish a higher level of interest rates. But when we did begin to shift to a more restrictive policy in June and July, we moved probably about as fast and as far as even hindsight would suggest was desirable.

We should probably have had a significantly higher level of interest rates last winter for several reasons. By then it was apparent that we had under-estimated the strength and persistence of the surge in lending to such groups as persons and financial institutions. Moreover the state of the property and housing market had become unruly with prices moving wildly ahead, unnecessarily far to provide an incentive for new building. Most significant of all, the outcome of the miners' strike dashed previous hopes for a steady deceleration of inflation.

Yet the objections at the time to higher interest rates were very powerful. Unemployment was still rising to new peaks: it did not turn down until April. Output was then barely rising, even after discounting the effect of industrial disruption. Until the settlement of the miners' strike there were some grounds for hoping that inflation would continue to decelerate. For all these reasons it was the Government's expressed policy to encourage by all means the expansion of activity. And perhaps I may be forgiven for recalling that over these months the whole tenor of press comment was that we should get interest rates lower still. If we had done so the necessary subsequent rise would have had to be even sharper than it was.

Certainly the appropriate direction for policy becomes easier to see at a time when real output is moving ahead at a fair speed, but inflationary concern mounts. And this was the state of affairs by the end of the second quarter, by which time the Budget measures were taking effect. The record shows that we did then shift sharply to a considerably more restrictive policy. The upwards movement in interest rates in the two months between the end of May and the end of July was remarkably abrupt by any historical standards. Base rates rose by $2\frac{1}{2}$% and representative money market rates by $3\frac{1}{2}$%.

Monetary developments during the summer months were considerably distorted by the sterling crisis which led to the adoption and subsequent unwinding of abnormal monetary positions. Nevertheless it does seem possible to discern some slowing down in the rate of monetary expansion in recent months after the hectic pace of the second quarter, no doubt partly in response to the sharp upward increases in interest rates in June and July. However I am not confident that we have now done enough to ensure that monetary expansion will moderate to the desired extent in coming months. There are certain features ahead, the sharply rising deficit in the public sector, the revival of borrowing by manufacturing companies, which could lead to a renewed acceleration in monetary expansion. We will need to be vigilant and active to prevent this.

I trust that this re-examination of past events will not have seemed out of place on an occasion so often devoted to invitations to ascend into a hopeful future. I have undertaken this re-examination because, particularly in an era of change, an appreciation of the lessons of the past must form the basis of our future plans. I accept, as most central bankers would, that control of the money supply is one of my principal, if not my most important, concerns and I have no wish to shirk it. But we cannot face two ways at once.

There is no monetary policy which will simultaneously stimulate expansion and moderate inflation. That was never more true than it is today and that is why I pin so much hope on the current initiatives of the Prime Minister and the Chancellor, the successful outcome of which means so much to us all.