Recent speeches by the Governor of the Bank of England

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I am very glad to have the opportunity of making the opening address at this seminar on "The City and Europe". As many of you will know, my personal conviction has long been that it is right for the United Kingdom to join the European Economic Community. I was therefore delighted at the substantial Parliamentary majority in favour and I believe it is now virtually certain that we shall enter. I need hardly tell this audience how great will be the opportunities offered by our entry in the provision of the financial services of many different kinds which are the business of the City. It is not, however, a prospect to be viewed with complacency. The challenge of grasping those opportunities will need to be taken up by the City with alacrity and intelligence. Later speakers will enlarge upon different aspects of the challenge. I have for my text the broader subject of "Sterling and Europe".

Some may wonder whether that is a subject on which there is much to be said. Is it not envisaged that the national currencies of the countries of the Community should progressively lose their distinguishing characteristics until they become, in substance if not in form, a common currency? Has not the road for sterling to follow been clearly set out and signposted? If the answer were as simple as that, then perhaps I should not be able to find all that much to say. But the situation is a good deal more complex. All that has been agreed upon is the final destination of the journey. No one knows for sure how long it will take to get there, nor the precise route that will be followed. But we do know that there is some extremely difficult country to be crossed before economic and monetary union becomes fact rather than ambition.

Dr. Witteveen will be discussing this question in detail this afternoon. I trust he will forgive me if I trespass briefly on his territory to offer a few comments, which I hope will not contradict anything he has to say. What has to be achieved is the progressive convergence of economic performance by countries in the Community, at the same time as the instruments of economic management are harmonised. This process is unlikely to be quick or easy, given the differences of economic and institutional structure from which the member countries start. Quite apart from the obviously difficult questions of political control there is a certain amount of intellectual dispute about the best technical method of proceeding. One school of thought – the so-called 'economist' school – argues that the first priority on the road to integration is to agree upon and achieve common economic objectives; success in so doing is a necessary prelude to institutional reforms, common management of external reserves and other steps towards the irrevocable tying together of currencies. Otherwise, they say, the Community would be subject to intolerable strains, which could manifest themselves in a number of ways; for example, countries whose economic performance is weaker than others might

find themselves – lacking any effective means of adjustment – becoming chronic depressed areas. The 'monetarist' school is impatient with the length of time that might be required, on that basis, to arrive at monetary union. They argue that the necessary economic adaptation will come about only if it is, to some extent, forced on the member countries, and that rapid progress in creating the institutional structure of a monetary union is a sensible and desirable way to exert such pressure.

The Six envisage proceeding on a basis of 'parallel action'. The Werner Report – whose agreed conclusions the E.E.C. Council of Ministers subsequently affirmed – suggested action simultaneously to harmonise the targets for economic performance and the instruments of economic policy that are used to achieve them. But this will still be a process requiring a long, and presently indeterminate, amount of time. It also seems to me that it will need to be accompanied, if it is to be acceptable to all member countries, by a much more fully articulated Community policy for the development of depressed regions. Monetary union must produce no casualties.

My remarks so far have been addressed to what one might call the 'domestic characteristics' of the currencies of the enlarged Community. I do not see their distinguishing features disappearing all that rapidly. But the same is not necessarily true of the external characteristics. Many of you will recall a phrase in Mr. Rippon's statement last June on the discussions he had had with the Six on sterling. After our entry into the Communities, and in the context of progress towards economic and monetary union in the enlarged Community, we should be ready, he said, "to discuss what measures might be appropriate to achieve a progressive alignment of the external characteristics of . . . sterling with those of other currencies in the Community". I propose to devote most of the rest of my time today to discussing two of the 'external characteristics' of sterling – its role as a reserve currency and its role as a trading currency.

In discussing the reserve role of sterling, one has inevitably to begin by looking at the whole background of world monetary and trading relations. These are presently in a state of considerable disarray, following the United States' actions of 15th August. I do not need to elaborate on the potential dangers, for the whole world and perhaps more acutely for the developing countries than the developed ones, if the immediate problems are not speedily settled. All that has been accomplished in the past twenty-five years – and it has been a great deal – could be very soon lost. Once the forward progress towards liberal regimes for international trade and payments is decisively reversed, it will be a long struggle to revive it.

Perhaps the most encouraging feature of recent months has been the widespread recognition of these dangers. Countries have done their best to avoid taking any action, in the new situation, which would increase those dangers or obstruct an early settlement. On one point we are agreed, and that is that the future of the world economy and of international trade depends greatly on the re-establishment of stable relations between currencies. The stability that is

sought is that of an exchange parity system. The preference for adjustable parities over floating exchange rates, which I have expressed many times, appears to be widely shared by the international financial community.

I am hopeful that a solution to our present problem, incorporating a return to exchange parities in a new and realistic alignment, will not be long delayed. But that would be only the beginning of what is needed to create the conditions for the orderly and liberal expansion of world trade in the future. Also needed is a reform of the international monetary system itself. The aspect of the system that is of immediate relevance to my theme today is the position of reserve currencies.

National currencies now account for over one half of the total of international monetary reserves. Sterling accounts for only about 6% of the total – it is overwhelmingly the U.S. dollar which provides the currency component of reserves, and which has been the principal source of additions in recent years. There are two main unsatisfactory features in this state of affairs. First, it is extremely difficult for the total amount of reserves to be controlled by collective international decision. Control over aggregate reserves is needed if we are to provide for them to grow at the right pace. Growth must be sufficient to enable the expansion of world trade not to be inhibited by widespread balance of payments problems in individual countries, but reserves must not be excessive to the point where they induce widespread inflation. The principle that control over reserve creation should be exercised by collective international decision was enshrined in the decision in 1969 to set up and activate the scheme for Special Drawing Rights in the International Monetary Fund. But the principle is undermined by the fact that large and erratic movements in international reserves can come about as a result of deficits in the balance of payments of reserve centres.

The second unsatisfactory feature is that the ability of a country in a dominant position to finance a deficit by building up reserve liabilities in its own currency distorts the operation of the international adjustment process. It does not remove from reserve currency countries, as we well know, all need to adjust. But it can mean that large, and perhaps growing, deficits are financed without difficulty until a situation arises in which confidence in the currency disappears. Then the adjustment that the reserve centre needs to make may be so great as to threaten the entire monetary system. Even though sterling has only a modest reserve role, the disturbance to the monetary system that preceded and followed its devaluation in 1967 was a cause of considerable international concern. Now that it is the U.S. dollar that is in difficulties the problem is greater and it afflicts us all.

It now looks increasingly likely that the major countries of the world will insist that, in future, no national currency should be permitted a central role in the international monetary system. The Chancellor of the Exchequer, in his speech to this year's Annual Meeting of the I.M.F., went some way in spelling out how the system might be adapted so as to have for its basis an internationally controlled reserve asset – something like, and probably developed from, the S.D.R. As part of the process of exercising international control over

the rate of creation of reserves, national currencies would be added to reserves only to the extent that they were needed as working balances, and there would be provision for existing holdings of reserve currencies to be converted into the new international asset.

In this country we came to the conclusion some time ago that it was right that we should not seek to perpetuate the use of sterling as a reserve currency. We accept the general case for regarding an international monetary system based on the use of national currencies as inherently unsatisfactory. Sterling has not, in fact, been an active contributor to the growth of reserves in the post-war period: official reserves held in sterling were, at the end of 1970, at much the same level as they had been ten years and twenty years previously. So we have not been enjoying the privilege which some impute to a reserve centre of immunity from pressures to adjust. On the contrary, we have been aware that the operation of a reserve currency involved the assumption of responsibilities that it was even more difficult for a country like ours to sustain than it was for an economic giant like the United States. We came to the conclusion that it was not in our own interests to resist a decline in the reserve role of sterling.

I should like at this point to make clear my views on one proposition that is occasionally made – that, with our entry into the E.E.C., sterling might become 'the reserve currency of Europe'. I put the expression in quotation marks because it is not always obvious what is meant by it. A moment's reflection will reveal that sterling could not become the asset in which the Community as a whole held its external reserves, if the United Kingdom were itself a member of the Community. All that could happen is that the other member countries of the Community might choose to hold sterling, so that some or all of the external reserves of the Community would become concentrated or centralised in the custody of the United Kingdom. On that proposition I offer three comments. The first is that there is nothing, in their public statements or private conversation, which leads me to suppose that those responsible for monetary affairs in the Six would wish to adopt such an arrangement – rather the reverse. The second is that the present pattern of reserve holdings within the Six offers no hint that their practices are moving in that direction – sterling forms only about one tenth of one per cent of their total reserves. But, finally, I think it most unlikely that we would wish it to happen. The same reasons would still apply that led us to the conclusion that it was not in our interests to promote the use of sterling as a reserve currency.

Even for a country whose currency has not customarily been used as a reserve asset, it may be no easy thing to avoid assuming a reserve role. In the past year, official holdings of a number of continental currencies have risen substantially. In 1970, for example, deutschemarks to the value of over $\$1\frac{1}{2}$ billion were added to national reserves, and we estimate that total reserve holdings of all E.E.C. currencies are not far short of 20% of official sterling balances. One could almost say that E.E.C. currencies have moved towards alignment with sterling in this respect. But this development has been absolutely contrary to the expressed wishes of their governments, and despite the adoption of policies

designed to prevent it. My point is simply that it is easier to decide that you would rather not operate a reserve currency than it is to achieve that objective.

For a country whose currency has an established reserve role, as sterling has, it is even more difficult to withdraw from it by unilateral action. It is not realistic to think of paying off the balances over a short period of time out of the proceeds of balance of payments surpluses. Even for the United Kingdom, the size of the surplus required would be so large that, first, it would inevitably put us into conflict with other countries also trying to earn surpluses, and create problems in international balance of payments adjustment, and secondly it would make demands on our domestic resources even more harmful in their consequences for economic welfare than the constraints on economic management we were seeking to escape. There is the more general problem that any reduction in reserve currency balances implies that total international reserves will very probably be lower than they would otherwise have been, which might not be appropriate.

These considerations were reflected in the statement by Mr. Rippon to which I referred earlier. He said that we were prepared "to envisage an orderly and gradual reduction of official sterling balances" after our accession to the E.E.C. But it has also been made clear that any process by which the balances are reduced has to satisfy certain conditions; it must protect the interests of the holders of the balances; it must not put unacceptable burdens on our balance of payments; and it must serve to promote the healthy development of the international monetary system.

The reform of the international monetary system that is now in prospect might well include, as I suggested earlier, some arrangements for the conversion of existing reserve balances into the new S.D.R. That seems to offer the most promising way of meeting the conditions that have been specified for the run-down of official sterling balances. A theoretical alternative is a purely European arrangement, in which the conversion of sterling balances would be into the future European common currency – let us call it the Europa – issued by an E.E.C. Federal Reserve Bank. At this point in time neither of the two alternatives can be said to have got off the drawing-board. But S.D.R. conversion, if it comes, is likely to be a practical proposition rather sooner than any Europa scheme could be. To that reason for preferring the former may be added a second, that the phasing out of reserve currencies is truly an international rather than a regional matter; and a third, that conversion into Europas would mean that the enlarged E.E.C. became, in its turn, the operator of a reserve currency, which is something which the existing Six are, as I have already said, determined to avoid if they possibly can.

So those are my views on how in one particular 'external characteristic' – its reserve role – sterling might become aligned with other European currencies. The immediate question that it prompts is whether a decline in the use of sterling as a reserve currency would have serious implications for the City and its institutions. To that my answer is an unhesitating "no" – a view which I am happy to see, from his recent Dallas lecture in Glasgow, is shared by Sir Kenneth

Keith and, I believe, by most others in the City. My reasons are the same as those given by Sir Kenneth. A distinction must be made between the reserve role of sterling and its trading role, and a decline in the former does not necessarily lead to a decline in the latter. Even more important, the past decade has shown that the City can flourish and expand internationally even when sterling is weak, and the international use of sterling is being curtailed.

When one comes to consider the trading role of sterling, it is not difficult to detect that its alignment with that of other European currencies is already taking place, and rapidly too. If one takes as a crude yardstick the size of the banking and money market liabilities in domestic currency to private non-residents, the latest statistics suggest that the total for E.E.C. currencies may not be far short of one and a half times the figure for sterling, whereas five years ago the position was the reverse. The recent figures are, of course, somewhat inflated as a result of the prevailing currency uncertainties, and include balances that are held for investment as well as trading purposes: but it must be borne in mind that a number of E.E.C. countries have had in force for some time measures designed to prevent the accumulation of non-resident balances, whereas our own similar measures are much more recent. We have made in the Bank some very tentative estimates of the trading role proper – that is to say the invoicing in a particular currency of goods traded internationally. Our conclusion – which, I repeat, is very tentative – is that the proportions of world trade settled in sterling and in the existing E.E.C. currencies are now broadly the same. Five years ago the sterling proportion was perhaps half as large again as that for E.E.C. currencies. In relation to the respective shares in world trade of the United Kingdom and the E.E.C., sterling is still used a good deal more extensively than E.E.C. currencies, but the convergence is unmistakable. I would guess that this trend will continue in the future.

Nowhere is this process likely to apply more strongly than in the patterns of investment. Sir Martin Wilkinson will no doubt have a good deal to say on this subject, but let me briefly mention two of our present obligations under the E.E.C. Directives on capital movements. We have undertaken to liberalise the financing of direct investment to E.E.C. countries by the end of the first two years after our entry, and portfolio investment by the end of the five-year transitional period. Thus, it is to be expected that the pattern of U.K. investment will be changing in the direction of greater investment in Europe. But I would expect a comparable contribution to the convergence of investment patterns to come from changes in the direction of the investment of the existing countries of the E.E.C., and in that process the City might have a considerable part to play. There is likely, it seems to me, to be a notable increase in investment by other E.E.C. countries in those parts of the world that have traditionally looked to London as their source of finance, principally the countries of the Commonwealth and of the sterling area. In mobilising the resources for that investment, there will be ample opportunities for the financial institutions of the City to make use of their established connections.

Beyond that, the skills and sophistication of the London capital market will be available for all the needs of Europe. European capital may well be mobilised here for investment within the Community as well as outside it. But we should not assume that our capital market is in some absolute sense superior to other European capital markets. Different in history and character it may be, but in terms of the actual volume of funds raised by new capital issues, there is no ground whatsoever for complacency. In proportion to national income, the amounts raised on new capital issues by domestic borrowers (excluding government issues) has been lower in the United Kingdom than in the E.E.C. on the average of the last five years: considerably lower, not much more than half the level. Of course, this result can be attributed in part to the differences I have already mentioned in the structure of markets, which make it difficult to make a satisfactory like-with-like comparison, and also in part to the economic conditions prevailing during the period. The latter factor accounts for the almost total eclipse of non-resident sterling issues in London – the comparable function being taken over to some extent by Germany. But, by any reckoning, we cannot rest on our laurels.

Let me now sum up the conclusions I have offered. We are embarked on a journey which will ultimately lead to the emergence of a single currency system for the members of the European Community. We do not know quite how long that journey will take, and it is essentially the harmonisation of the domestic characteristics that will determine the answer. Meanwhile, we have agreed to discuss after our entry what steps might be appropriate, in the context of progress towards economic and monetary union, to achieve a progressive alignment of the external characteristics of sterling with those of other currencies in the Community.

My discussion of the reserve role of sterling led me to conclude that official sterling could be handled in such a way as to enable us to take our full part in the progress towards economic and monetary union. Meanwhile developments in the trading role of sterling and other European currencies are already well advanced on a path of convergence, and patterns of investment can be expected to move naturally in that direction also. In other words, in the coming years sterling will continue to have its own character but will become less distinctive and more like other major currencies in the E.E.C. These developments need have no adverse effect on the future prospects for the City as a thriving financial centre, for which the opportunities abound, but those opportunities will have to be energetically pursued.

Given at the annual dinner of the Finance Houses Association in London on 11th January 1972

. . . Since this time last year, in the domestic field, something little less than a revolution has taken place so far as the control of the granting of credit is concerned. Perhaps 'revolution' is not the best word, since the authorities initiated

the change. Nevertheless it was without doubt the most thorough-going reform for many years.

In January 1971 the lending of individual finance houses was subject to ceiling restrictions. Official controls over the terms of hire purchase contracts were fairly severe. The Bank's proposals, now familiar to all under the title of "Competition and credit control" had not yet been fully formulated. And finally the Crowther Report on Consumer Credit, though it had certainly been completed a year ago, had not yet been released for public scrutiny. All these things have changed during the past year – a year which will have profound effects on the conditions in which your members will conduct their business in the future.

A period of change and innovation is never restful; and this has certainly been a very busy and exacting time for you, Mr. Chairman, when you have been called upon both to co-ordinate your industry's response to the complex issues raised by the Crowther Report and to negotiate with the Bank about the new arrangements for credit control. I believe your members have been most fortunate in having such a forceful and penetrating advocate. We at the Bank have come to admire your enthusiasm and energy and to respect and be grateful for your understanding of the needs of the authorities as well as those of your members.

I am glad, and without doubt you are too, that circumstances have at last allowed us to remove ceiling controls. We have been fully aware of the inhibiting effect of these controls on innovation and competition and were becoming increasingly concerned that what was intended to be a temporary measure was lasting for so long.

Cynical voices may perhaps say that the authorities' conversion to the new philosophy is only skin-deep and that at the first whiff of crisis we shall be back to 1965 all over again. That is not how I see it. I believe that we have now devised a system which will enable the authorities to exercise appropriate influence over monetary conditions at all times, without stifling competition.

You, Mr. Chairman, have consistently represented to us the importance of allowing finance houses the opportunity to compete on equal terms with each other and with other financial institutions. On this I agree with you. Direct restriction of lending undoubtedly impeded the development of improved services for the customers of banks and finance houses. This was one of the most important reasons why we felt the regime had to end. With the lifting of the old controls we have been greatly encouraged by the eagerness with which banking and other financial institutions are already seeking to take advantage of the freer atmosphere.

This is not the occasion for me to embark on a full review of the new credit arrangements. Both the technical details and the thinking behind them have been fully described in successive issues of our *Bulletin*; and, if I may at this point insert a 'commercial', the six relevant articles have just been reissued as a separate booklet for ready reference.[1]

1 This booklet *Competition and credit control* contains the following articles: "Competition and credit control", and "Key issues in monetary and credit policy", June 1971 *Bulletin*, pages 189 and 195; "Competition and credit control: the discount market" September 1971 *Bulletin*, page 314; "Reserve ratios and special deposits", supplement to the September 1971 *Bulletin*; "Competition and credit control: extract from a lecture by the Chief Cashier of the Bank of England", and "Reserve ratios: further definitions", December 1971 *Bulletin*, pages 477 and 482.

It would be of more interest if I could report to you our conclusions on how well the system is working in practice. But I would be foolish to attempt this so soon after it has been inaugurated and before it has been at all fully tested. What I can do is to say a little about the reasons why we have found it necessary to ask some finance houses to observe reserve ratio and Special Deposit requirements.

We had two main considerations in mind. First it was clear that the control should be applied only to deposits and not to funds obtained on the long-term capital markets or borrowed from banks which would themselves be subject to the new arrangements. The activities of the larger deposit-taking finance houses are very similar to those of banks. Both banks and finance houses take short-term deposits from the public and compete in making loans to consumers and to industry. In fact some institutions now called 'finance houses' should soon be in a position to describe themselves as 'banks'; but more of that later. We felt therefore that the effectiveness of the proposed arrangements, including their acceptability to the banks themselves, would be seriously impaired unless at least the principal deposit-taking finance houses were brought within the frontier. Recent developments have emphasised that in the new environment the banks will be increasingly offering a challenge to the finance houses in their own territory; and the finance houses will be girding themselves to meet that challenge. This seems to me to confirm that it would have been neither efficient nor equitable for us to draw the frontier round the banks and leave all the finance houses outside.

Secondly, as a practical matter, the Bank could not readily undertake to control all deposit-taking finance houses, however small. We therefore agreed in the end to exclude institutions with deposits of less than £5 million, so long as their deposits remain below that limit. The figure itself is arbitrary but it seemed appropriate because it allowed many small houses, whose impact on the economy is slight, to be exempted, while still enabling the Bank to influence some four fifths of all finance house business. The £5 million limit applies, of course, to all instalment credit finance houses whether or not they are members of your Association. We believe that the boundary we have set will satisfy the requirements of policy without creating any serious inequities.

We accepted that compliance with reserve ratio requirements was likely to bear rather more hardly on finance houses than on banks and for that reason agreed that the houses should work to a slightly lower reserve ratio and be given a full twelve months to build up to it. Nevertheless, a number of your members have indicated that they would prefer to accept the full obligations of banks, including a 12½% ratio requirement, provided that they could also enjoy the benefits which follow from official recognition as banks. I have not forgotten, Mr. Chairman, that an opportunity to apply for such recognition was an essential part of the understanding reached between us. Applications have been made by a number of your members to the Department of Trade and Industry for recognition as banks for the purposes of the Protection of Depositors Act. I understand that the Department have just reached decisions on these applications, and

a number of houses have been informed that they will be recognised. I am glad that this outstanding issue has now been resolved. Consideration of the matter has taken some time, but the Department of Trade and Industry have, no doubt, been concerned, and rightly concerned, to ensure that their important responsibilities under the Act are exercised strictly in accordance with the intentions of Parliament.

Together with the demise of ceiling controls, the withdrawal of official controls over the terms of hire purchase contracts will have given the finance houses the best opportunity they have had for a long time to develop their business freely. This does not necessarily mean that business will be easy to come by. On the contrary, once the immediate effects of the removal of terms control have worn off you may find that business has to be won against stiffening competition, both from the banks and among finance houses. There will inevitably be the temptation to compete excessively in terms of reduced initial deposits and longer repayment periods. There are already signs that some institutions – not among your members – are beginning to succumb to that temptation. I am sure that you and your colleagues do not need me to remind you of the dangers to which that could lead. You will not have forgotten the lesson learned in 1958-60, when excessive competition on easy terms led in due course to serious losses. I know that you are resolved not to go the same way a second time. I applaud your resolution and express my own hope that your members will feel able to combine competition in efficiency and service with a reasonable measure of self-restraint, so maintaining the good reputation which the efforts of your Association have done so much to build up in recent years.

While the changes in credit controls which I have so far been discussing have already transformed the conditions in which the finance houses do their business, in the somewhat longer term they may be even more profoundly affected by another document which came out during the past year, the Crowther Report on Consumer Credit. The Bank have not been closely concerned with the many technical questions of law raised by the Report. But we are in general concerned that consumer credit should operate within an efficient legal system providing adequate protection for all parties. We therefore support the broad proposals in the Report to rationalise the existing tangle of laws. The Committee did a very thorough job in examining this complex subject. However, those who have examined the Report in detail are encountering problems in expressing its aims and ideas in concrete legislative form. This seems to have turned out to be an even more complex task than was at first expected and it will inevitably be some time before the process is completed. I know that your Association has played its full part in discussing these problems, in particular at the constructive and well organised conference held at Torquay last October. I hope that the eventual reform of the law will not be delayed too long and that the results of it will prove to have been worth waiting for.

Finally I would like to say a little about the international currency situation and about the prospects for our own economy.

If changes in credit control in the past year amount to a revolution, changes in the international relationships of currencies have been almost as epoch-making. There is nothing unique in a world-wide series of currency adjustments. This took place in 1949 and again to a lesser extent in 1967. But for the major nations of the world to sit down round a table and produce a realignment of all their exchange rates in relation to one another was a unique achievement. It was also a very difficult achievement and only occurred at all I believe because of the way our minds were concentrated by the possibilities we all saw last year of a recrudescence of prewar economic nationalism and trading uncertainties. In achieving a realignment, we have not discovered a magic formula valid for all time. The more fundamental task of reforming the international monetary system must proceed apace. In the meantime, however, I believe that we have provided a background which should be conducive to an early re-establishment of confidence and a strong and continuing expansion of world trade.

As to the present situation of the domestic economy, I will be brief. There are clear signs that a recovery from the current depressed state of industry is on the way. So far expansion has been confined mainly to consumer demand, particularly for cars and other durable goods. You were, of course, among the first to feel the effects of this in your business. Partly because of widespread uncertainty, much of this increased demand has been met out of stocks rather than out of expanding production. However, there is of course a limit to how long this can go on and I believe there are now signs that the expansion is spreading further and wider through the economy. There seems every prospect that the economy will grow strongly this year. As the months go by, I hope and believe that industrialists will become increasingly convinced of the strength and sustainability of the expansion and of the need to put down new capital investment. I am confident that when this stage is reached the companies represented here tonight will be no less deeply involved in meeting the financing needs of industry than in catering for the consumer. . . .