Recent speeches by the Governor of the Bank of England

An address, given in the Governor's absence by the Deputy Governor, to the 10th International Savings Bank Congress in London on 25th April 1972

I am very pleased to be able to open the business sessions of this International Congress with some remarks about monetary stability, a subject which is clearly of fundamental importance to a professional central banker, as indeed it is to bankers and to savers of all kinds throughout the world. This meeting is the first international savings banks' congress of the 1970s and, although every decade brings its problems, the present one seems likely to be a particularly challenging time for the international savings movement. As an illustration of this point, may I suggest that, if I had delivered a speech to the first international savings banks' congress of the 1960s, its theme would have been simpler, its tone more optimistic. The value of personal savings in the short and long term, to both the individual and society, seemed so clear then (and was so widely accepted) as to need little discussion. As for the monetary problems we then faced, the remedies for many of them appeared to be at hand, given sufficient resolution and international goodwill.

However, events since that time suggest that many of these problems are either more complex than was then thought or that they have subsequently become so. Although one major and immediate threat to international stability has receded in the last few months, with the international agreement on currency realignment reached in December, many problems remain. Of these, the most important for the long term, and probably the most intractable, is that of inflation. It is difficult to think of any greater challenge to economic and social stability than that offered by persistent and rapid inflation.

Inflation is, of course, hardly a new problem. Examples of extreme inflationary pressures which have toppled governments and brought widespread economic and social disruption can be found throughout most of recorded history. Indeed, by such standards the period since 1945 has been relatively untroubled for the more developed countries, apart from immediate post-war experience in Europe.

Certainly, the topic of inflation would have received little more than a passing mention and a few words of caution if this speech had been addressed to your congress in 1960. It did not then appear a severe problem; during the second half of the 1950s consumer prices rose by only about $2\frac{1}{2}$% a year in the United Kingdom and by a little over 2% a year in the United States and in West Germany; Italy and Japan fared even better; of the major economies only France was then suffering rapid inflation. To many observers, a 'moderate' degree of inflation of this order was welcome. A body of opinion held – and still does hold – that inflation on a modest scale is on balance beneficial to real economic growth.

A decade ago, there was also fairly general agreement on the main cause of the inflation which was being experienced – namely 'excess demand'. This is the economic phenomenon aptly if crudely described in the standard phrase 'too much money chasing too few goods'. In the period immediately after the Second World War, excess demand was particularly evident, arising both from industry trying to make good war damage to its capital stock and from the release of pent-up consumer demand. Throughout the 1950s, the general explanation of inflation in terms of excess demand seemed the most relevant of the theories put forward.

Given this view of the main cause of inflation, the role of fiscal policy and, to a lesser extent, monetary policy, in countries such as the United Kingdom, seemed clear. Reducing total demand would reduce inflationary pressures; remedies for inflation were there if governments chose to use them. Moreover, tax increases could be kept to a minimum, or even avoided altogether, if personal savings could be encouraged and channelled into public sector debt, thus reducing the pressure of aggregate demand. In such circumstances, it was quite clear that personal savings were both a public and a private virtue; and one which might appropriately be fostered by government action, for example, in the field of tax incentives. In addition, the interest rates then ruling enabled most forms of saving at least to maintain intact their purchasing power in real terms; in this respect U.K. experience was probably typical. Although a modest degree of inflation had persisted for some years, individuals' expectations of future price changes appear to have adapted only slowly to changing circumstances. No doubt experience since 1945 was also partly offset by memories of the uncertainties and falling prices which had characterised much of the 1930s. It is interesting to note that, according to official estimates, personal savings in the United Kingdom, as a percentage of personal income after tax, rose from $4\frac{1}{4}$% in 1958 to $8\frac{3}{4}$% in 1961, unaided by any major improvement in the incentives offered to saving. This was clearly a significant contribution to easing the demand management problems of the day.

During the 1960s, price inflation became increasingly prevalent in the great majority of countries. By the end of the decade, a problem of world-wide proportions had developed; one which, although more acute in some countries than in others, threatened all. Through the interdependence of the major trading nations, and their links in turn with the developing world, threats to the prosperity of even one major economy have world-wide implications; and the problem of inflation has not been confined to one major economy. Consumer prices rose faster in the second half of the decade than in the first in most of the developed countries; in many cases the acceleration was marked. Consumer prices in the United Kingdom rose by an average of 3·2% a year between 1960 and 1965, but by an average of 4·6% a year in the following five-year period. Comparable figures for the United States – 1·2% and 4·2% a year – show an even more marked deterioration. Most of the members of the European Economic Community also suffered in varying degree.

Many governments have found it necessary to take measures aimed directly or indirectly at containing price inflation. These have included formal controls on prices and incomes, budgetary actions to reduce aggregate demand, tight monetary policies and so on. For the United Kingdom – because of the great importance of international trade to our economy and the international use of sterling as a trading and reserve currency – the problem has been particularly acute. The slow growth of productivity in this country has provided little margin of protection against inflationary pressures; in other countries, where productivity has grown more rapidly, firms have had greater scope for absorbing cost increases than have their U.K. competitors.

Besides the particular domestic problems of individual countries, the international implications of rapid inflation have also become more obvious – and progressively more troublesome – as variations in the rates of inflation experienced by the major trading nations have put increasing strain upon the structure of exchange rates. This strain was only temporarily alleviated by the devaluation of sterling in 1967 and the subsequent changes in the French and West German parities. Hopefully, the recent 'package' of currency realignments which I mentioned earlier may lead the way towards a more lasting solution. Unless the problem of inflation is tackled equally resolutely by all concerned, however, no package of currency realignments can be expected to prevent the recurrence, sooner or later, of international imbalances.

I suggest, however, that the most disturbing feature of all, in the development of the inflation problem, has been the emergence of a form of inflation markedly different from that of the immediate post-war period. Excess demand appears no longer to be the root cause. This has become particularly apparent in the United Kingdom and the United States, where the pressure of demand on productive resources has been manifestly low for some time; but it would seem to hold true for other economies also. We have the unwelcome and unusual sight of rising unemployment and declining capital utilisation coupled with rising prices – circumstances which call into question the possibility of controlling inflation through measures of orthodox demand management. If, then, doubt arises about the appropriateness and efficacy of the weapons formerly relied upon to counter inflation, does it arise also in respect of the target at which we should aim? Does it continue to matter, in the circumstances of the 1970s, whether or not we curb inflation? I propose to devote much of the time I have available today to the examination of this crucial question, for if we are *not* convinced that tackling inflation really matters, we are accepting that monetary stability may be sacrificed in order to achieve other policy objectives, with all that that implies. If, on the other hand, we have no doubt that curbing inflation should have a very high priority indeed, the search must continue for appropriate and up-to-date methods of doing the job. It is not my purpose today to discuss the relative advantages and disadvantages of specific anti-inflationary policies and programmes. No one policy seems likely to have completely general validity; different institutions and circumstances require that each country should seek its own best remedies. It would also be foolish to suggest that there are any easy or painless remedies; breaking down general expectations of inflation is bound to be a difficult, uncomfortable and sometimes painful process. The question is, are we convinced that these difficulties, and costs, really must be faced?

In examining the need to curb inflation, I would begin by emphasising a point which I have touched on already – just how much everyone is affected by the stability of prices in any economy which has passed beyond the stage of subsistence farming and barter; that is, where money plays a major role. Money, of course, serves a number of functions; it is a unit of account, a store of value, and above all a medium of exchange. One can safely say that the less certain is the future stability of money, the less well does money fulfil these functions. Going beyond this, there would be general agreement with the view that in an inflation which gets out of control, money is prevented from performing these functions adequately.

In the context of somewhat less alarming rates of inflation, however, some economic theorists have suggested that in a world in which it was perfectly anticipated, inflation would have no effect; the allocation of resources and the distribution of income would be the same as when the price level was known to be stable. But in the real world, inflation can never be correctly anticipated by everybody; and the prices of goods, labour and capital are not accurately adjusted for the changing value of money. Thus inflation is not, in practice, a stable state. Differences in expectations set up tensions, and adjustments, which may further affect expectations in a spiralling fashion – a fundamentally destabilising process, and an all-pervasive one. Inflation, once begun, is not likely to die down of its own accord; indeed, its repercussions may readily become wider and wider.

One result, the impact upon exchange rates, has already been noted. Perhaps it should be added that the introduction of floating exchange rates would not necessarily enable us to ignore this aspect of inflation. By removing the discipline of a fixed parity, floating exchange rates could serve merely to encourage an acceleration in the rate of inflation. For example, exporters would have less incentive to resist pressures for inflationary cost increases if they could be sure that the exchange rate would be allowed to float downwards whenever their prices became uncompetitive; while increases in the domestic prices of imported goods arising from the exchange rate movement would automatically add – both directly and indirectly – to such pressures; and so on. A second result – the impact upon the domestic allocation of resources – is also on balance likely to be adverse. Here we come to the crux of the matter, for this point would be contested by those who favour some degree of inflation as an aid to growth. The arguments of such 'inflationists' seem to me to rest on two main propositions, both of which relate to the rate of investment, and both of which need careful examination.

The first proposition is that, if nominal rates of interest are slow to respond to an increase in the rate of inflation, as has often happened, investment will be encouraged by the resulting lowering of 'real' rates of interest. In the United Kingdom, however, a high rate of inflation in recent years has meant that real interest rates have been low, and sometimes negative; yet this has failed to stimulate the economy. Any incentive to borrow money to finance increased investment which has been given to industry and commerce by a low real rate of interest appears to have been more than offset by the allied uncertainties over the future course of the economy. What real basis is there for borrowing to finance investment, when inflation makes it almost impossible to assess the likely path of prices over the period in which such borrowing must be serviced and repaid?

The second proposition is that inflation redistributes income from the poor to the rich and that in turn this increases the share of national income devoted to investment, because the rich will tend to save a higher proportion of their income than the poor. In other words growth in investment occurs directly at the expense of consumption by the poor – a fact which hardly commends it on social grounds. However, experience in the United Kingdom seems to conflict with this proposition also; it does not seem to have been the case in recent years that inflation has benefited the rich at the expense of the poor. Social pressures have of course ensured that attempts have been made to bring social security benefits, pensions, etc. into line with changes in the price level – albeit with some considerable lags. Meanwhile, many groups of workers have been able to bring pressure to bear to safeguard their own interests against inflation – and to such an extent that profitability has been squeezed. Company profits (before tax) fell sharply as a percentage of national income during the 1960s, a trend noticeable in other economies over the same period.

Any change in the balance between wages and profits has both economic and social implications. Although wage and salary earners have improved their relative position in this country in recent years, the gains have not been evenly distributed. As one might perhaps have expected, the strongly organised groups of workers (those who tend often to be among the better paid in any case) appear to have gained at the expense of their less well paid colleagues. Attempts by various groups to protect themselves against inflation, both experienced and expected, have led to industrial strife on a scale not seen in this country since the 1920s. Partly as a result, companies have been forced to reduce investment plans, to lay off workers and to press for higher prices in order to improve liquidity and restore profit margins. Again, this pattern of events has not been confined to the United Kingdom.

Similarly, the balance between creditors and debtors is inevitably disturbed by inflation. As I have already noted, interest rates often respond only slowly to changes in rates of inflation and, although there has been a world-wide rise in interest rates since the mid 1960s, prices have tended to rise faster over much of the period. While the benefits for investment have been somewhat elusive, the rise in interest rates has imposed an often severe capital loss upon holders of fixed interest stocks and the fall in the value of money has provided an entirely gratuitous gain for the issuers of such stock. Governments have of course been affected. On the one hand the burden of outstanding public sector debt has fallen in real terms, but on the other many governments have been forced to raise long-term money at nominal rates of interest which are, by past standards, very high. Savings movements too have found themselves forced to raise interest rates in order to remain competitive in seeking deposits. For institutions such as those which provide finance for housing, such an upheaval in rates must pose grave problems of adjustment and equity.

I conclude, therefore, from experience during the last few years that the supposed benefits of inflation are illusory, while the disadvantages of the uncertainty, instability and inequity associated with the inflationary process are very plain to see. In my view it does matter whether we curb inflation – it matters very much indeed.

Of course, some things can be done to *alleviate* the problems of inflation through government action. Equally, companies and their employees will find ways, over time, of adjusting themselves to inflation; firms will include escalation clauses in contracts; workers will seek to tie wages to the cost of living. None of these reactions offer more than a temporary palliative; moreover, some experiments of this kind have shown very clearly that short-term alleviation may well lead to long-term aggravation of the problem. The destabilising character of the inflationary process remains, as do the economic and social costs of failure to deal with it at the roots. The choice then lies between accepting these costs, and the risks of intensifying already bitter struggles by sectional interests to maintain their standards of living, and accepting the challenging task of restoring monetary stability. I have no simple panacea to offer; I need not stress again, in this international gathering, the variety of the circumstances in which inflation has to be faced, or remind you of the immediate practical problems which any determined anti-inflationary policy must overcome. But we should be a great deal nearer practical solutions if we could achieve unanimity of view about the fundamental importance of the inflation problem; it is certainly fundamental to the particular challenges facing the international savings movement.

Having dealt so far with long-term aims and problems, I would now like to turn to a more immediate question, namely, the implications for savings of present economic conditions, which in a number of countries – and not least in the United Kingdom – indicate an urgent need for a rapid increase in demand. What role does this leave for personal savings? Of course, the main raison d'être of personal savings – the need of individuals to save money for old age, to meet unexpected needs, to provide for a family – is basically unaffected. In so far as a savings movement will inevitably reflect and respond to such needs, its role is equally unambiguous. The social and political value of encouraging personal savings is also clear for, by giving a tangible stake in the future of the economy, they provide security and stability. Nor is the long-term economic value of saving seriously in question. All investment must be financed from saving by individuals, companies or government and there can be few economies where the level of investment is so high that more would not be welcome. Moreover, the increasing claims of investment expenditure which is not directly productive – for example, expenditure on environmental conservation – increase the need for more saving. In this country the problem is particularly obvious because it has long been recognised that investment is far too small to provide growth at a rate comparable with that achieved elsewhere. It is no coincidence that personal saving in the United Kingdom appears to have been a markedly lower proportion of income than in most other developed economies for many years. (Such international comparisons are fraught with statistical and definitional problems, but the gap in relative performance is so considerable that I cannot believe that these problems and differing institutional structures can provide a complete explanation.)

Accepting, then, that more saving is in general desirable, what are the likely prospects for savings in the sort of conditions which we have been experiencing? Certainly, they have not led as yet to the development of a general 'flight from money'. Indeed, savings have generally remained quite high in recent years despite the increasingly apparent fact that the purchasing power of many forms of savings was by no means fully protected against inflation. One might have expected this disincentive to saving to be reinforced by the fact that, if they expect the rate of inflation to increase still further, consumers have every incentive to bring forward their purchases. Perhaps the overall level of personal savings has not suffered on account of fears of inflation because the combination of inflation and unemployment has greatly increased uncertainty about the future; hence, the desire to save to meet the unexpected has increased overall, even though this may not have been uniformly evident throughout all sections of the community.

One can offer only intuitive explanations of the path of personal savings at any given time because, of course, little is known about what actually determines the volume of such savings. A number of factors that are probably significant can easily be listed but it is difficult to assess their relative importance. In my own view, one very important factor is the variety of choice offered to individual savers. If it is true that uncertainty has helped to maintain savings in recent years, I think it can reasonably be argued that increasingly sophisticated channels, which have opened for personal savings in many countries, have also been important. This is particularly evident in the United Kingdom, where over the last ten years there has been a significant switch of new savings into areas offering greater protection against inflation. The trend is well illustrated by the growth over the period of life assurance offering participation in profits or specifically equity-linked. But it has also been noticeable that those who prefer forms of saving where the nominal value of their capital is certain have shown increasing concern to maximise the yield on their savings, while new and higher-yielding forms of contractual saving have been introduced with this in mind. It seems very likely that the overall level of personal savings would have been much lower in this country if all these media had not been so well developed and widely available.

In various ways, then, the development of personal saving in many countries in recent years is reassuring. It suggests that the inflation experienced so far has not severely weakened the habit of saving. It would indeed have been a tragedy if it had done so. However, we should not be complacent. The fact that a short period of relatively severe inflation has not greatly disturbed the habit of personal saving does not mean that a flight from savings in financial form to the holding of goods might not occur if the inflationary pressure continued for long enough. This is another reason, in addition to those which I advanced earlier, for resolutely tackling the problem of inflation, and one which commands particular attention in a gathering of this kind.

Government policy can of course do much to affect both the volume and the distribution of personal saving. Its most obvious channel of influence is through the tax system, where both the total raised in taxes from the personal sector and the distribution of the tax burden will be highly significant. In the long term, as I have already noted, the arguments for a government using its influence over personal savings in a constructive way are too strong to brook dispute. In the short term, however, the position may be less simple for at any time a government has a number of policy targets to be achieved, one of the most important naturally being the maintenance of a reasonable level of employment in the economy. When the level is not adequate, as in both the United Kingdom and the United States at present, moves to raise employment are very likely to include direct stimuli to personal consumption. Thus, in the short term, governments may need to encourage a lower ratio of personal savings to income, although the impact of such reflationary measures upon the overall volume of saving may be partly offset by the fact that – if the measures taken succeed in stimulating the economy – there should ultimately be a higher level of income from which to save.

The intensity of government encouragement for personal saving must therefore be expected to fluctuate somewhat with short-term variations in economic activity. For the longer term, however, the aim of good government must be to seek the set of conditions most suitable for steady and sustained economic growth, the best atmosphere to foster the growth of savings. For the reasons which I mentioned earlier, it seems to me that a pre-requisite for the encouragement of steady growth is that conditions of monetary stability should be restored and maintained.

Looking back over the last year, I see some encouraging indications – both internationally and nationally – that we are moving towards re-establishing monetary stability and that its importance is increasingly widely recognised. Some measure of success has been achieved with the anti-inflationary policies which have been so widely adopted. In this country we have had some successes, as well as some failures, and I hope that such setbacks as have been experienced will stimulate us to still greater efforts. Some progress has been made, but much more is needed. I believe that a gathering of this kind must be particularly sympathetic to the pursuit of policies aimed at restoring monetary stability; and I think we can all contribute towards their success, not only by the practical support which we can give through our day-to-day activities, but by consistently seeking to bring home to a much wider audience the real benefits which we believe can be derived from monetary stability.

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Few central bankers, I think, would dispute that high on the list of "Central banking issues – national and international" stands the topic on which I have chosen to speak today – the problem of control of capital movements. After the experience of the past three years, it is impossible to deny that international movements of liquid funds pose problems. They have the potential to be internationally disruptive, dominating foreign exchange markets and threatening unwanted and perhaps unjustified changes in exchange parities. They have the potential to be domestically disruptive, undermining attempts to overcome inflation by the pursuit of restrictive policies in which monetary control, and in particular interest rate policy, are assigned an active part.

There is no mystery over the reasons why international capital flows have recently grown so fast, substantially outstripping the growth of world trade, which has itself expanded at rates without historical precedent. First, the means of movement have been greatly developed. The financial markets of the world are much more closely linked together than they were twenty, or even ten years ago. Partly this has resulted from technical advance or commercial enterprise, the growth of international banking and multinational business corporations, with their associated communications networks and the much greater opportunity for the leading and lagging of current payments. But partly it has resulted from deliberate official encouragement, based on the belief that the greatest possible freedom of capital movement is the most likely way to serve that purpose of the I.M.F. ". . . to contribute . . . to the promotion and maintenance of high levels of employment and real income and to . . . develop . . . productive resources . . ." That philosophy is embodied in the Code of Liberalisation of Capital Movements adopted by most member countries of the O.E.C.D., and has been reflected in the adoption by the developed countries of market convertibility for balances of their currencies held by non-residents.

Secondly, the incentives, as well as the means, for international flows, have become greater. This is in some respects a product of inflation. It has been necessary in most industrial countries in recent years for nominal rates of interest to rise to levels that were by historical standards very high, if they were to represent a real rate of interest that could contribute to controlling the economy. Scope was therefore created for correspondingly large differentials to open up between nominal interest rates in one country and another, especially, for example, if they were at contrasting phases of the economic cycle. Interest arbitrage takes place if the differential in nominal interest rates exceeds the possible exchange rate loss at the time of repayment, or the cost of forward exchange cover which is related to it. Changes in parity rates apart, the extent of possible exchange rate loss has been limited by the width of the margins of fluctuation permitted by the I.M.F. Articles, until recently 1% either side of parity. This has proved rather ineffective as a deterrent in face of the interest differentials which were established.

Some international flow of liquid capital is a normal and constructive feature of cyclical adjustment. A country that is for cyclical reasons in deficit is enabled thereby to obtain the external finance it needs, and a country that is correspondingly in surplus is enabled to employ that surplus usefully. But interest induced flows considerably overdid what was necessary to produce payments balance in 1969, when a U.S. basic deficit of just under $3 billion was turned into a surplus on the official settlements basis of about the same amount. Something was clearly wrong with the classical balancing mechanism of interest arbitrage.

When the interest differentials were reversed, the outflow from the United States was on a correspondingly exaggerated scale. It threatened to destroy the attempts of the countries that by then had the higher interest rates to operate the restrictive policy they desired. Moreover, it was not in the right direction to contribute to equilibrium in international payments. In time, about the end of the first quarter of 1971, its momentum had created a new incentive for funds to move – the expectation that the exchange parities then prevailing would not be maintained. And so the international and the national monetary disturbances already being felt were compounded.

What lessons can be drawn from the past three years for the response that countries should make to the challenge of international capital flows? I will divide the possible approaches into five. Each approach, as will be seen, has limitations or drawbacks.

The first approach is to accept the flows but to seek to undo any undesired consequences. Undesired external consequences – the excessive running down of foreign exchange reserves, for example – can be undone, with the co-operation of other countries, by 're-cycling' the lost reserves back to the country which needed them. The undesired domestic consequences, of expansion or contraction in the money stock, can in principle be undone by offsetting action through instruments of domestic monetary control. The limitation on re-cycling is set by the willingness of other countries to co-operate and the terms on which they will do so. If countries in surplus are not prepared to finance those in deficit for more than a few months, the latter will naturally look to other ways of dealing with the problem. The domestic consequences of allowing the flows to continue may be no more easily undone than the external ones. If one of the principal instruments of domestic control is interest rate policy – directly through changing official discount rates or indirectly through open-market operations aimed at limiting the expansion of the money stock – then its use will serve to aggravate the flows that require it to be used.

That brings me to the second approach, which is to remove the underlying cause of arbitrage flows by not using interest rates as a weapon of domestic control, but relying on other instruments, which would include more direct methods of credit control, fiscal and other policies. The scope for adjusting the 'policy mix' in this way depends on the strength and adaptability of those other instruments. The difficulty of using fiscal policy in a flexible way needs no elaboration. There are also good domestic reasons for avoiding too rigid a form of direct control on credit expansion. We have recently remodelled our system of credit control in Britain in a manner which gives greater prominence to interest rates as a means of inducing adjustment. Other countries rely even more heavily than we do on interest rate policy, and the experience of past initiatives to bring about some measure of international interest rate disarmament is not encouraging. But despite my reservations about the extent to which adjusting the 'policy mix' can be pressed, I am convinced that it has a greater contribution to make to the control of capital movements than it made in the past three years.

The third approach is to impose controls directly on the capital flows. This could be done by administrative controls on the external borrowing or lending of the country's residents – banks and non-banks – or on the acquisition of assets by non-residents; by segregating capital movements into a separate exchange market, where the rate might fluctuate freely but the level of net flows could be under official control; or by placing restrictions on the activities of the intermediaries in international capital movements, principally the international banks. This whole approach raises formidable practical problems, first of constructing a system that is effective, without at the same time involving undesirable interference with trade and other current transactions – as well as a costly and cumbersome administration: secondly, of making the system sufficiently discriminating so that it controls the capital flows that threaten disruption, but allows freedom for other flows to continue. We have sought to preserve that distinction in regulating outflows from the United Kingdom, for which we have an established framework of exchange control. We believe it has worked well, but we acknowledge its limited ability, common to all systems of exchange control, to influence flows that take the form of 'leading and lagging' of current payments – especially at times of intensive speculative activity.

We adapted our control framework last autumn to discourage certain types of *inflow.* It seems to have been effective up to a point, but it was certainly not proof against flows at times when expectations of revaluation were strong: for example a nil interest rate on non-resident bank deposits could not prevent their rising substantially. The measures taken during that period included some that we should be very loath to retain as a permanent feature of the system, because of the interference they brought to normal business transactions – and we were pleased to be rid of them. That problem presents itself in an even more acute way with comprehensive dual market systems. The practical difficulties of constructing such a system for a currency as widely held and used as sterling are daunting.

These difficulties of controlling capital movements at the point when they cross over a national frontier, coupled with the philosophical distaste for direct restriction of capital transactions to which I have already referred, have led some commentators to look for a solution in regulating the activities of the principal intermediaries through which the flows take place. The principal subject for such regulation would be banking in euro-currencies. I have previously expressed my doubts whether this approach could provide a solution to the practical problems, and those doubts have not been removed. As many of us have learned from our experience in domestic regulation, restrictions which bite at all severely on financial intermediaries lead quite quickly to disintermediation or to the rapid growth of new intermediaries not subject to the same strictness of regulation. Furthermore, *international* intermediaries have a freedom of choice of location that is limited only by the practical requirements for communications. They could, therefore, escape relatively easily from any system of regulation that was not virtually world-wide. Finally, it is difficult to see how a system of control could be applied so as to limit those flows that were causing disturbance, but to allow others to continue as before. Would it be necessary, in order to stop an unwelcome inflow into Europe, to stop as well capital flows to countries such as, say, Brazil?

My two remaining approaches to the control of capital flows both concern the conduct of foreign exchange markets. The first involves official intervention in the forward market, designed to limit directly the scope for covered interest arbitrage. It is a theoretically attractive way of countering undesired flows, but those central banks that have tried it have found it less satisfactory in practice. It does not affect uncovered flows, and official forward operations have tended to generate offsetting private speculation in forward markets and so to be somewhat ineffective even against covered flows. Perhaps the technique has been used at times when expectations of parity changes were too strong for its usefulness in countering arbitrage flows to be properly assessed. We must, I think, continue to regard it as one of the weapons in the armoury, but remain cautious in our assessment of what it can contribute to controlling capital movements.

The final approach is to seek to increase the potential foreign exchange costs of the flows by allowing more flexibility in spot exchange rates – either by having larger margins of fluctuation from parity than 1%, or by letting rates float freely. We took the view in Britain some time ago that a 1% margin of fluctuation from parity exchange rates gave inadequate scope for discouraging interest arbitrage flows. The $2\frac{1}{4}$% margins that are now permitted would, I feel sure, have been extremely useful at times in the past three years, though I note that they have not made life easier for developing countries. The effect of greater variability of spot exchange rates on capital flows influenced by expectations of changes in parities is a more difficult question. Despite my reservations about some of the techniques for controlling capital movements that I have been describing, they offer between them an armoury that could be entirely adequate provided there is confidence that the existing pattern of exchange rates will be maintained. But if that confidence is lacking, they could on occasion be found seriously wanting. The problems of capital flows and of confidence in the exchange rate system are inseparable.

I believe that 1971 will be judged, in the light of hindsight, to have given an exaggerated picture of the severity of these problems. It provided one fundamental change. At the beginning of the year, the U.S. dollar was manifestly in a position of being over-valued, by the criteria that would have been applied to any other currency. But there was still doubt that it was proper for the United States to respond as other countries might, by proposing a new par value for the dollar, or that such a proposal would in fact produce a change in the dollar's effective exchange rate. Now it has been established that the exchange value of the dollar can be changed by U.S. action, and we have a pattern of exchange rates from which, for the first time in many years, all major distortions have been removed. But, having arrived in a thoroughly disorderly way at this fresh start – which, because of the size of the adjustments required, will still take some while to consolidate itself – we must now set our hands to avoiding a recurrence of the disorder of 1971.

It is common ground that the exchange rate system should be flexible enough to allow rates to move in accordance with underlying economic trends. I hope our hosts will not mind my saying that it is also essentially common ground among the monetary authorities of the world that a par value system provides the most suitable environment for the development of world trade and prosperity. The question is at what point do the benefits of flexibility outweigh those of fixity, and vice versa.

This question arises in judging the appropriate size for the permitted margins of fluctuation about parity, and in deciding whether or not the system should provide for a period of temporary floating if a country were to feel unable to continue adding to its exchange reserves at a time of intensive capital inflow. But above all it arises in the reform of the par value system so that needed parity changes are made more promptly and by smaller amounts than hitherto.

International monetary reform has already had one session of this Conference devoted to it, and Chairman Burns has introduced it into this session, so I will add only a brief comment. British concern over the reform of the reserve base of the system is well known, following the Chancellor's statement at last year's I.M.F. meeting. Such a reform could eliminate any remaining doubt over whether the United States had the same freedom as other countries to initiate exchange rate changes. It should be regarded as complementary to the desire to operate the par value system flexibly, with prompter and smaller changes.