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 17 October 1974

... My mind goes back, my Lord Mayor, to this occasion last year. That was my first exposure of the kind in my present office: it is already a world away, to say nothing of one Chancellor, two governments and three budgets. The year has transformed not only the world balance of payments but also the place of industrial countries in the world balance of power; it has seen too a sharp acceleration, in this country and most others, of an inflation, which last year was already serious enough, but whose powerful and disruptive effects are now starting to become increasingly evident.

We have, I think, to recognise that events have become less predictable, and less manageable in some fundamental respects. I will mention two. The vast capital flows being generated by the rise in oil prices will profoundly alter the whole manner in which the international monetary system operates, and make it – for us and other countries – increasingly subject to hazard. Secondly, two-figure inflation creates large and arbitrary uncertainties for all who earn, or buy, or sell, or save; and puts our social, economic and financial structures under strains of a sort not previously experienced in this country in our lifetime. These great forces inevitably constrain our policies. They suggest to me a special emphasis on prudence at home, and the need for continuous and intense co-operation abroad. We shall, of course, live through our problems. The question is at what price to our place in the world and our system and standard of life.

These forces will underlie much of what I wish to say tonight.

International banks

The new wealth of the oil-producing countries has greatly increased the role of the international banks, which have already recycled vast flows of capital back to the oil-consuming countries. There is, however, a limit to the contribution the banking system can make; and the flow of oil money is still accelerating. It is expected to grow by as much in the last three months of this year as it did in the first nine[1] – and may go on at a high rate for some years.

We therefore need to supplement private markets by organising a range of alternative mechanisms for handling the capital flows. The Chancellor has advocated the development by the International Monetary Fund of a non-concessionary facility under which deposits could be taken in and on lent in such a way as to ensure that the flows go, not to one or two countries, but more widely, and in some stable manner. It will no doubt be a delicate task to establish terms fair to both lenders and borrowers. But both sides have a common interest in the continued viability of the international system.

None the less, much will still be expected of the euro-currency markets. Despite some gloomy forebodings, their record has been excellent. The well-publicised losses in international banking have arisen from foreign exchange dealing, not euro-currency lending. Nevertheless, these losses disturbed the markets, and led for a while to a very cautious tone – almost an excess of prudence. Recently the market has been regaining its confidence, as a result both of its own self-regulatory efforts and of measures taken by the authorities in many countries.

There has been much talk of the absence of a formal lender of last resort in the euro-markets and of the problems to which this could lead. Some have pressed for new mechanisms, new institutions, new regulations, or special funds. The central bankers of the major countries have, of course, discussed the question very fully in Basle and elsewhere; and we have reached a shared understanding of the problems, and a shared determination – made public last month – to support the markets in any way which may prove necessary. Our approach is essentially to reinforce the strength of what sound commercial practice would dictate. It is therefore working with the grain of natural forces, not imposing regulations hostile to them; and for this reason is more likely to prove right and effective.

I believe that no bank which owns, in part or in whole, another bank operating internationally can wash its hands of the affairs of its subsidiary or consortium bank. What we have done is to clarify and make explicit the responsibility which parent banks of banks operating in London have always implicitly assumed. We have started with the consortium banks because it is on their position that most public discussion has concentrated, but we are now also approaching the subsidiaries. I am glad – but not in the least surprised – to tell you that we have had an overwhelmingly favourable response. The undertakings are coming in fast, and we do not expect any difficulties in obtaining them from all the banks concerned.

Domestic banking supervision

As to more domestic problems, our main concern in this country earlier this year was with the difficulties of the secondary banks. That a wider crisis of confidence was avoided is due, as I think is clear, to the exertions of the control committee, to whose establishment the chairmen of the London and Scottish clearing banks gave swift support, and to whose operation their senior managements have given unstintingly of their time. I want to single out the Deputy Governor for special recommendation in this connection.

Among other central banks I believe I have detected some admiration of what we have been able to do here; and I believe it came the more easily to us because we were not relying on statutory agencies and procedures. For unlike the position in many other countries, the Bank of England's role in the supervision of the banking system has not rested on formal authority, and has depended as much on close and personal contact between the Bank and the banking community as on the periodic examination of accounts.

What we have done is to build on that way of working, with all the opportunities for quick adaptation that it provides. By making a succession of changes, which recent experience convinced us were desirable, we have reinforced our position substantially.

[1] Growth is no longer thought to be so fast – see the section on oil money movements in the financial review.

Our method of approach in this area, in my view, provides a useful pointer to the way we should seek to adapt to change in other areas of the City's work.

Inflation

I turn now to the economy at large.

Inflation – and the complex causes from which it springs – is at the heart of our problems: its disruptive force is, I am sure, greater than, even yet, many realise. You, Mr Chancellor, have emphasised the role of the social contract. It has its evident frailties, but it is in all our interests that it works as effectively as possible.

An essential ingredient is that wages and salaries should advance no more rapidly than the rise of prices. That would not promise any early end to the spiral, but it would gradually slow it down. In a field where expectations tend to be self-validating, it is clearly very important that this, at least, be achieved – that inflation should decelerate, and be clearly seen to do so.

Position of companies

But in our efforts to make the social contract work, we must not induce side effects as serious as the disease we seek to cure. This brings me to the present position of companies, who are being severely affected. This matters. Companies are not the enemy of the people, entrenched on the other side of some no-man's-land. Companies are bodies who organise employment and output and turn savings into productive investment. For this, companies – including those in the public sector – need profits.

Everyone, I think, agrees, Mr Chancellor, that companies have been having a lean time. I would not think it right to enter into the question of remedies, especially in this pre-Budget period. But – situated as I am at the point where the financial needs of Government and industry impinge on the banking system – I may usefully attempt to analyse the problem. To me the main elements seem clear. Both profitability and liquidity are involved, and these, of course, are interacting.

The share of profits in the national income has been declining for many years and (excluding stock appreciation) is probably now as low as in the Great Depression of the early thirties. Industry has had to borrow heavily; and since the capital market has not been available this has had to come from the banks. I hardly need say there is no question of the banks having failed industry in this respect, nor of their being unable or unwilling to continue lending on a substantial scale.

The position is, however, now being reached where many managements feel that, with the present outlook, they cannot prudently add further to their debt. Instead companies are being forced to save money in any way they can, including notably the postponement of investments essential to their future, and the future of all of us.

The gravity of this development has been emphasised by some of the most efficient firms in the country – and would be even better understood if some form of inflation accounting were more widely adopted. It is not my intention to dramatise the immediate situation; but if it were allowed to continue, the consequences could spread progressively; and would be all the more serious for our being so unfamiliar with them. This leads me to suggest that the first question for employment prospects may now be, not (as in most post-war years) should we or should we not stimulate consumer demand; but how do we safeguard British industry, and with it the jobs it provides.

It is perhaps worth standing back and asking ourselves why the position has now got so serious.

Profits have been squeezed in the last two years by statutory restraints; and it is widely accepted that price control now needs, at least, to be relaxed. Elimination of the productivity deduction for instance would stop the position of companies from getting worse. But it would not make it much better.

The basic fact is that inflation has hit companies particularly hard: the price of the materials which industry uses has risen much faster than the general price level. In the two years up to the middle of this year, industry must have had to find £6,000 million to finance stock appreciation. To meet this, and to pay tax on the notional profits thrown up in this process, industry has had to borrow on an unprecedented scale. This does, I think, indicate something about the size of the problem, and the point where it is most acute.

I am well aware that measures of relief to industry raise complicated issues. The case for them must rest on a conviction that neither a curtailment of industrial investment, with its consequences for the longer term, nor the immediate train of recession and unemployment it could start, would do anything but harm to everyone in the country.

Monetary policy

It would now be right for me to say a little about the role of monetary policy. Over the past year we have had two objectives: first, to lower the rate of monetary expansion to keep this arm of policy in line with counter-inflation policy generally; and second, to maintain the attractiveness of sterling internationally, and so help to finance the external deficit. We have had to work through periods of some tension, in conditions of some novelty; but broadly our objectives were achieved. We have had to maintain a level of interest rates onerous both for industry and for the housing and property fields. But we have allowed rates to come down a little in so far as this was consistent with our overriding objectives.

In the year ahead, I would hope to be able to avoid large divergences from recent monetary trends. How difficult this will prove may however depend in part on what steps prove possible to relieve firms' financial difficulties; and in part on the public borrowing requirement, which will be easier to finance if inflation is seen to be slowing down.

Role of the City

My Lord Mayor, it is fitting for me to conclude with some reflections on the role of the City. The Chancellor has paid generous tribute to its work, which is I think both just and needed. Too often, the City is portrayed as if it existed only for the benefit of the rich, and of the get-rich-quickly. This is a travesty, and inhibits public understanding of what the financial system is, and the functions it performs. As the Chairman of The Stock Exchange has rightly underlined, much of the work of the City, whether through pension funds, life insurance, banks or other means, is concerned with savings – their collection, their safe handling, and their employment with Government, commerce and industry. It matters to millions that this be done well.

The mixed economy requires a properly working capital market. If recently it has not worked well, one should see where the causes lie. The present depression of equity values, so far from demonstrating an irrational pessimism, reflects in truth the low level of industrial profitability to which I have referred, and also a still persisting anxiety about the future course of policy.

I am grateful for the Chancellor's appreciation of the City for its overseas earnings and for its handling of the finance needed for our balance of payments. I wish these contributions were more widely recognised. Half of the increase in oil-producers' surplus funds this year has been placed with banks located in London, and a good proportion of it in sterling: this has happened only because we have a flexible and sophisticated financial system whose skill is trusted the world over. This is not just juggling with money. If we were not able to attract and retain funds, our terms of trade and living standards would already be in jeopardy.

All this is, if you like, an aspect of the theme of national unity. We all need to recognise and be grateful for the diverse contributions of all the people of this country to our national economy. It so happens that the contribution of those whom this gathering represents is a critical one, especially at this time; it deserves understanding and acclaim.