Speeches by the Governor of the Bank of England

Given at the Financial Times World Banking Conference on 15 January 1974

... 1974 has opened on a new and different world, with a massive shift in economic and financial power in favour of the oil-producing nations. The resulting problems are common in differing degrees to most of the industrialised world.

I should like to spend the short time available to me in looking at some aspects of this country's position in these new conditions.

Of course, at the present time we have our special difficulties, but I do not propose to dwell on the immediate problems, not because I wish to minimise their scale or importance, but because I think it may be more useful if I look beyond them in a longer and wider perspective.

Our medium-term problems are serious, but they can be solved if we face them squarely. Let us take a look at them.

First among our problems over the next few years is the question of oil supplies. The immediate prospects now appear better than a month ago, and certainly the present prices have altered in some degree the economic arguments for keeping oil in the ground. But our needs are on an expanding scale and the supply prospects in future years are to some extent inevitably uncertain, and an element of uncertainty is likely to remain at least at the back of our minds. If at any time oil failed to come forward in the quantities required, supplies of all the things we produce will inevitably be restricted.

Equally serious perhaps is the deficit on our balance of payments. Last year the current account showed a large deficit which, this year, will be further greatly increased by the rise in the price of oil. The deterioration on oil account will, of course, affect industrial countries. But even before that factor became important, our balance of payments deficit on current account in the last quarter of the year was running at a rate equivalent to 4% of our national product. There is no doubt that this non-oil deficit must be corrected as soon as possible.

To do so will clearly require – whatever one assumes about export and import prices – a considerable diversion of resources. Assuming we get enough oil to allow a normal increase in national output, a considerable proportion of that increase will need to be diverted to increasing exports and saving imports. Domestic consumption will need to be constrained for some time for this reason alone.

There is a third major problem which needs to be included. Given our dependence on foreign supplies of oil, it is evident that we must develop domestic supplies of energy with whatever speed is possible. The oil in the north seas is coming to be regarded as our great asset – our own share of that manna from Heaven with which the good Lord so abundantly endowed the deserts of the Middle East. And so it is; but it has to be got, and that will be expensive. So too will be the development of atomic power, and the development of the new coalfield in South Yorkshire. Yet these are clearly investments we should undertake urgently – in our own interests and in the interests of neighbouring countries less liberally endowed with new sources of energy, who will naturally look to us to help them with their own equally pressing problems.

Investment in developing our domestic sources of energy is thus bound to constitute another heavy claim on national resources over the next decade. Even after we have restored our balance of payments to reasonable balance, there seems likely, therefore, to be a continuing necessity to keep domestic consumption under some restraint.

But the outlook is not unrelievedly dark: by way of balance it is necessary to look at the longer-term prospect. In that perspective, after some years of relative austerity – I am speaking primarily of postponing some of the increase in the standard of living to which we have become used – the position of the United Kingdom could well be transformed into one markedly more favourable than that of many other countries. The intervening period is not long. The restraint and the investment are, I suggest, surely well worth while. It should also be remembered that while some of our problems are peculiar to ourselves, other countries, including our partners in the European Community, face some of the same problems; and there is great scope for us to help each other in solving them.

I now return to the point that the recent increases in the price of oil are bound this year, and for a period of years to come, to cause a current account deficit on our balance of payments. Similar considerations apply to all countries which import oil.

The counterpart of this development is that many of the oil-producing countries who have a low absorptive capacity for the goods we can offer in exchange will be running very large balance of payments surpluses. Even last year, the unspent portion of their income probably amounted to $10 billion. This year it may well amount to $60 or $70 billion. These vast sums will be seeking investment opportunities – in the United States, in this country, and elsewhere in Europe – and will constitute a vastly larger flood of investible funds than any the world has yet experienced.

There is, of course, no reason to suppose that these funds flowing from the oil-producing countries will be automatically matched to the deficits of the oil-consuming countries. This is true for the developed countries and it is even more true for the developing countries. As Dr Witteveen was suggesting this morning, these problems constitute a large challenge to the International Monetary Fund and will inevitably colour the discussions about international monetary reform this week in Rome. I was interested to see that Dr Witteveen spoke of the possibility of devising new methods under the Fund for rechannelling the flow of funds; and there may well be room for comparable arrangements under the Bank for International Settlements or by other specially devised machinery.

But whatever is done under official arrangements, a lot of the funds are going to find their way into the world's capital markets. Many of the oil-producing countries are likely to wish to place part of their funds in national markets, but I think that it is also reasonable to expect that activity on the euro-currency markets will greatly increase. There will surely be many opportunities for devising arrangements which, as far as possible, match the needs of lenders with those of borrowers – perhaps particularly in this country and the rest of Europe.

In this country certainly for a number of years – until we have developed our own energy resources – we shall need to continue to borrow abroad on a considerable scale. There is indeed likely to be an increased tendency for borrowers in this country to look to external rather than domestic sources of finance, and for banks and other financial institutions to be intermediaries in this process. It will, as always, remain highly important that, in doing so, we should seek to borrow on appropriate maturity terms. But we should welcome the fact that there will be large sums seeking profitable investment opportunities.

Mr Chairman, I have tried to put the problems of the bankers among us in a broad perspective, and have spoken both of matters that particularly concern us in this country and of international concerns. The developments of which I have been speaking are going to be with us for a long time. They are, I believe, calculated to increase the importance of world banking, and, despite some current scepticism, I think may also tend to enlarge the City's rôle as a banking centre.

Given at the dinner of the Institute of Bankers at Bristol on 5 February 1974

. . . The difficulties recently experienced by some deposit-taking companies are by now well known. I need only remind you in outline of how it all happened. Some commentators begin by referring to the way that the growth of these institutions was stimulated by the expansionary credit conditions that prevailed in 1972 and 1973. There is some point in this, given the fact that it has been possible for deposit-taking institutions to flourish without full official recognition as banks and without the supervision that goes with it. But do not let us forget at this time that many of these institutions at the fringe of the banking system laid their foundations during the régime of quantitative controls over the banking system proper, and are not simply a growth of the subsequent period.

Quantitative controls meant that there was increasing scope for banking-type business undertaken by companies to whom the controls did not apply; and by creating a kind of free market alongside the controlled one, they enabled such institutions to establish themselves and to charge the higher interest rates which they needed for profitable growth. Thereafter, the activity in the property market, and the inflation of property values, provided new and lucrative opportunities for these institutions and postponed the competitive pressure that they would otherwise have felt from a banking system no longer subject to direct controls. So the rapid expansion continued and accelerated until a colder climate, associated in part with the tightening of credit conditions generally, left some weak positions exposed and provided the necessary reminder that considerations of liquidity and of management control cannot safely be given second place.

Many large money market depositors responded to the first exposure of weakness by withdrawing funds from a wide range of secondary banking companies, to the detriment of some whose reputation and prudence in management should ordinarily have sufficed to allay apprehension. In conformity with long-established practice in the City, the Bank of England moved into this situation so as to protect where possible the depositors (especially the small ones) and to prevent a further spread of mistrust. We accordingly established with the London and Scottish clearing banks the necessary machinery to monitor the developing situation and to provide where appropriate financial support to replace the money market funds which were being withdrawn. Thanks to this machinery, the situation was stabilised. I should like to take this opportunity of thanking the clearing banks for their prompt co-operation in an exercise in which all have an interest.

You will not be surprised that there are some lessons to be learned from this experience. But there is such a thing as trying to learn one's lessons too quickly and I propose tonight to suggest only some broad lines of approach.

First, there are the lessons for the secondary banks themselves; and all of them, however much or little they may have been affected, will have found something to learn. To be rather more specific, in the case of most of those we have assisted, experienced teams from the clearing banks or from firms of professional advisers have been reinforcing the management. Under guidance from the supporting consortium, these teams are imposing improved standards and disciplines. In some cases, more reliable and stable sources of finance are being developed. In others, the quality of assets is being upgraded. The process of adaptation for the institutions concerned is thus under way.

Secondly, I think this episode raises a question about the rôle of the large depositors in the wholesale money markets. Often deposits seem to have been placed in response simply to the offer of a high rate of interest and without any closer relationship than the passing of a name, without commitment, by a broker. When unease developed, deposits were often withdrawn with the same apparent lack of discrimination with which they were put there in the first place. More initial discrimination, and a more thorough assessment of a company with whom money is placed, which would provide the basis for a more steadfast relationship, would seem to be required if a market of this kind is to work satisfactorily.

But, thirdly, there are, of course, the lessons for the authorities. I would not have you think that all the remedies lie with the secondary banks and their large depositors and none with ourselves. Self-regulation and self-discipline can achieve a great deal. The record of the British banking system is adequate witness of that. But self-regulation can be put to too great a test if competition from the less-regulated and less-disciplined is too easily permitted. This brings me to the degree of prudential regulation and supervision which the authorities should exercise over deposit-taking institutions. Here, it is hard to avoid the conclusion that we shall have to extend our present arrangements. To some extent this will happen of itself, as a natural evolution from the special exercises which the Bank of England and the clearing banks have undertaken. Some of the secondary banks will be subject to surveillance for some time to come. Others will, I am sure, be very willing to accept official guidance and advice. In this way our informal methods will be extended beyond their previous frontier. In addition, we shall all have to be clearer about what is a 'bank'. Our present system of progressive recognitions, while possessing undoubted merits, has become complicated and not easily comprehensible by the public, especially in a context where certificates have been given to institutions, which are not banks, certifying that they can be regarded, for the purposes of money lending legislation, as carrying on a banking business. It may also be right to tighten up the law regarding the use of words like 'bank' and 'bankers' in descriptive and advertising material.

Let us see how all this goes. I see no need to rush into some elaborate statutory system of supervision which might only succeed in appearing to render trouble unlikely at the expense of stifling initiative and innovation. Our special strength as a financial centre has lain in the responsiveness of our informal regulation to changing methods of business and I should myself be slow to sacrifice this positive advantage. In the end some more formal framework may be required, as the harmonisation of practice relating to the establishment and supervision of deposit-taking institutions is progressively achieved within the EEC. But I think we should approach this with care and think it all through in consultation and debate with the banking industry. In the meantime we will develop our supervision as I have suggested. . . .