Speeches 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 16 October 1975

The year just passed has seen the world economy in worse shape than for more than a generation. For this country, it has been a year of inflation, of unemployment and of recession. For one in my position, the special cross has been the continued erosion in the value, internal and external, of the nation's currency, as our inflation has raged at a pace two or three times that of our industrial competitors.

I start with this sombre recital, not to pronounce a Jeremiad, but to suggest that there is no quick road back to a more prosperous and stronger condition. On the other hand, nothing in our situation is beyond remedy.

Tonight, my Lord Mayor, I shall try to indicate some of the directions in which I think we should move.

First, in my view, must be the defeat of inflation. We now have the accord reached in July on the £6 fixed limit for pay increases over the next twelve months, an accord welcomed by the great majority of people, who see well enough the lunacy of headlong wage increases massively in excess of any imaginable productivity gains – just as, earlier in the year, with the same instinctive good sense, they gave their verdict on Europe.

The accord on pay is a start on the climb back. No one is blind to the sacrifices, and rough justice that this policy entails. But I believe it has already changed our position for the better; and I hope we shall see a clear break in the trend of prices before too long.

We should not, however, deceive ourselves about the task that remains. The immediate aim is to reduce the annual rate of price increase to 10%. But we need to do better than that; and I hope we shall have the resolution to persevere after the first year. A real stability of prices would require that pay increases stayed in line with the increase in productivity of the economy – which, unless we can change it, is little more than 3% a year. The contrast between this figure, and the 30% pay increases we were seeing earlier this year, is some indication of the change of expectations that is needed.

In commending an incomes policy I know that I disappoint those who believe that inflation should be tackled by monetary measures alone. But if we tackled it purely by controlling demand in general, or the money supply in particular, we would cause even deeper recession, even more unemployment, and even more damage to investment. The policy of pay restraint helps to minimise these losses: that seems to me pure gain.

That said, it is also true that an incomes policy should be complementary to fiscal and monetary policies – not a substitute for them.

There is much debate over the appropriate role of monetary policy in present circumstances. For my part I do not doubt that it has an important and powerful influence on the economy – though the force and timing of its impact may be difficult to predict. I also believe that, in view of the overriding importance of moderating inflation – a problem to be seen in the context not just of this winter, but of the next two or three years – we should strictly maintain a moderate pace of monetary expansion.

So far this year, as you will know, the rate of monetary expansion has in fact been moderate. Industrial and commercial demand for bank credit has proved unusually weak, because the developing recession has made it so. The financial appetite of Government, on the other hand, has been far from weak, and there has been room for it to be met in part by the banks. In the year to date, the rise in the money stock on the narrower definition has been a little less fast than the growth of money national income. On the wider definition, the money stock has risen much more slowly, by little over 10%: this I would regard as showing rather adequate restraint.

The most recent figures, coupled with the rise in interest rates, are indications that it is becoming more difficult to maintain so moderate a pace. The underlying reason is quite simple – the size of the public sector borrowing requirement. Until its growth can be halted and then reversed, we shall need to exercise especial vigilance in our monetary management. The alternative of readily accommodating a further acceleration in monetary growth must, I believe, be rejected.

I should not conceal, my Lord Mayor, my anxieties about the public sector borrowing requirement. For some time the requirement has, on more than one occasion, proved much in excess of what was only recently forecast and assumed as an element of policy. I recognise that this has been due in part to the steeper decline in the economy and I accept that there are no absolute standards in this matter. But it is surely clear that such large unplanned increases will have to be brought under control, and that the deficit itself will need to be severely reduced over the next two or three years. I think it is now generally recognised that the reduction in the deficit will require not only the cautious planning of public expenditure for some years ahead, but also a mechanism of control over expenditure which is effective in the short run. We surely do not want a situation, in a few years' time, where the only way of controlling a bursting economy would be to impose a yet higher burden of tax.

We are living also with a continuing deficit in our external finances. Although the deficit on current account has been reduced for the time being, particularly in the first half year, by conditions of recession, we are still living beyond our means.

Accordingly, we still need to divert more resources to improving the balance of payments, as also into productive investment. I use the jargon of 'diverting resources'; but none will, I hope, miss the implications. Our resources are finite, limited, too small for the many estimable purposes which cry out for satisfaction. When we divert some of them to exports or to investment, we are laying the base of our future employment and living standards; but they are not there for consumption, either public or private. If, conversely, they are consumed, they are not there for exports or investment. It is this competition for resources which makes economy and efficiency, whether in the public or private sector, so vital to our hopes.

I turn now to the task of raising the level of investment, and the City's role in that task. The City has been under attack for not providing finance for industry; and industry has been under attack for not investing more. Both attacks, I think, are in substantial measure misdirected.

Assuredly, the level of productive investment needs to be raised – not merely in correction of the present downswing, but above the historic trend. But this cannot be achieved merely by providing a flood of finance. The reality is more complex. Investment must start in the enterprise itself with the search for good projects, and these must afford the prospect of a good return. It is only at this point that the question of finance arises; and if an adequate return can be foreseen, there is little reason to think that finance will not become available.

The main bulk of finance will undoubtedly continue to be provided through the established channels – to whose recent performance both the Chancellor, and the Chairman of the Stock Exchange, have alluded. I am encouraged, too, by yesterday's announcement that a wide range of institutional investors have been considering the desirability of acting in consort to provide additional methods, if required, to increase the availability of equity capital. A representative working party has been set up with the intention, I understand, of reporting by the end of the year. This initiative deserves a warm welcome.

Without the prospect of adequate return, finance always will be difficult – as it properly should be. What is then missing is not a City response, but profitability in the enterprise. Institutional investors in the City also have their obligations – obligations to pensioners and those saving through insurance, to safeguard, and seek a proper return on, the sums placed with them. The report of Lord Diamond's Commission, which has perhaps not been sufficiently noticed, shows how widespread the beneficiaries are – as many as thirteen million people involved, either as members or pensioners, with occupational pension schemes; and fourteen million saving through life assurance.

Industry needs profits for two reasons – both as an inducement to embark on the risks of investment, and as a source of funds to finance it. In the past, three quarters of manufacturing industry's funds have come from internally generated sources. However we improve the availability of external finance, profits are bound to remain an essential source.

The rate of profit earned by companies has been known to be declining for some time. Traditional accounting methods have, however, failed to reveal the low level to which profits have fallen. The proposals of the Sandilands Committee will be the subject of wide discussion, and some will have reservations on particular aspects. But there can be little doubt that, for most manufacturing and commercial firms, they provide a better basis for assessing a company's position.

Allowing for inflation, the rate of profit earned by companies may have been halved since the early sixties, even if one discounts some of the exceptional fall last year. Notwithstanding the importance of last year's stock relief, the fall in the rate of profit on an after-tax basis has probably been as great. I leave it to others to debate the question of precisely what profits industry needs; but it would seem clear, I suggest, that the decline has gone too far. The recommendations of the Sandilands Committee are still being considered by the accountancy profession, and the provision of accounts that make better allowance for inflation will take some time. But the broad implications are immediately plain; and will, I am sure, increasingly influence from now on, the assessment companies make of their position, and what their policies should be.

Consideration will also need to be given to whatever implications the Sandilands Report has for price control; and since they concern the longer term, it would be helpful if they were considered sooner rather than later. The immediate need, I suggest, is for a system of control less detailed in its application. What is needed for the future is a prospect that profit levels may be rebuilt. Wherever possible, however, higher profitability will need to come, not by raising prices, but by better productivity. This, I suggest, is the heart of the matter.

As well as increasing our capital stock, we need to look at how we are using what we already have. Is it not true that we could get considerably more out of it if restrictive practices were lessened, and if overmanning were reduced? There might be as much to be gained by using our existing capital more efficiently, as by raising its rate of growth. These considerations apply equally to the nationalised as to the private sector of industry. Here too it is important that capital should be efficiently used, and that the prospect of adequate return should dictate the pattern of investment.

A new phase of industrial strategy is soon to be discussed in the National Economic Development Council. It would be helpful if these discussions could create a climate of opinion in which the private sector's contribution was more fully valued and the confidence of industrial management could be rebuilt. I believe that a clearer recognition of the importance of profits would be helpful in its own right, and as a token of much else besides. Without an improvement of confidence, and a reversal of the erosion of profitability, I greatly fear we shall not get the kind of expansion of output – nor, consequently, the expansion of employment – that we need.

In the course of last year there has, I think, been growing awareness of the difficulty of curing unemployment without first curing inflation. There is now need for a similar awareness of the difficulty of increasing employment without raising profits from their present low level. It may indeed be a key to our problems. Such a change would benefit not one sector alone but all our people; it is for this reason that I have stressed its importance.

My Lord Mayor, if I have dwelt on the difficulties along the road to better health, I have done so in a spirit of good hope. I end as I began. There is nothing in our situation that will not yield to intelligent, patient effort, undertaken in a confident, indeed I would say unbowed spirit. In this task the City, represented by so many of you here tonight, and in which I am privileged to have my present position, will make its own formidable contribution in the future as in the past – ready to adapt and innovate in its methods but unalterable in the values which are its bedrock.

Given at a seminar on 'Banking Tomorrow' held in Luxembourg on 27–28 November 1975.

Banking supervision: statutory control or self-regulation

I was delighted when you asked me to come here today to talk about the supervision of banking. I ought to emphasise that in what I shall say I shall be expressing my personal views. A few years ago banking supervision would not have been considered a lively or topical subject on which to talk: indeed for many decades it was an unexciting and largely dormant issue. But more recently much greater attention has been given to it. I will not dwell on the reasons since they are not the subject matter of my talk, but factors in the international field were the onset of rapid inflation, with consequent erosion of banking capital; the adaptation to generalised floating on the exchange markets; and anxiety as to how banks and financial markets would accommodate the surpluses of the oil-producing countries. In individual countries there were additional factors. In the United Kingdom, for example, problems arose from the increased activity in the sterling wholesale money markets, from the rapid expansion of credit, and from the concentration by some financial institutions on lending for purposes connected with property. All these developments have naturally stimulated discussion about the nature and extent of banking supervision and the appropriate role of the supervisory authority.

The approach to banking supervision in the United Kingdom has been somewhat different from that in other countries, partly because of the way banking developed and partly because of our traditional disposition to use unwritten, rather than codified, systems in some areas of our national life. So it may be helpful if I comment briefly about our own arrangements and about the philosophy which underlies them, before I pass to some more general reflections on the appropriate balance between statutory control and self-regulation in the supervision of banking.

The Bank of England is unquestioningly accepted as the institution responsible for banking supervision in the United Kingdom, but that role does not derive from specific statutory authority. It rests instead on long and uncontested usage rooted in the close relationship and understanding which exists between the Bank and the banking community. The Bank was not, as were its counterparts in many other countries, created as a central institution within an already existing and relatively developed commercial banking system. Instead it grew up as a commercial bank, albeit one with special privileges, and only gradually assumed a position of leadership over others.

As a consequence we have at present no Banking Act, no generally applicable legal definition of a bank, and no statutory requirement that a banking institution must acquire a licence before it opens for business. But, as you may have heard, the UK Government recently announced that they had decided in principle to introduce legislation which would enable the United Kingdom to provide for the prior authorisation of deposit-taking institutions, in line with the requirements of the proposed EEC directive on the harmonisation of the regulations relating to credit institutions. The form that the legislation will take is still to be decided, but we hope that the announcement of the United Kingdom's decision in principle will assist progress towards the adoption of the directive. I trust that it will be possible to preserve within the new statutory framework the valuable features of our present philosophy and approach to the supervision of banks, while giving the authorities greater powers over other deposit-taking institutions.

Although there is no Banking Act in the United Kingdom, there are a variety of statutes under which specific aspects of banking business require official authority or certification. Over the years this legislative background has become rather complex and was recently described by Sir Jeremy Morse as a 'definitional jungle of banking, moneylending and deposit-taking'. Some of the statutory recognitions have attracted a significance they were not intended to bear and, because of this, institutions which were really banks only in a very limited sense have come to be regarded by some as banks in the full sense. For this reason the present series of miscellaneous recognitions has clear disadvantages (including the absence of clearly defined responsibilities on the part of the various official bodies concerned); although taken together the statutes do provide a means of progressive official recognition of financial institutions until they reach the stage of fully-fledged banks. So on balance we feel that the time has now come to change and simplify our system while still maintaining in some measure the principle of progression in the old arrangements. Accordingly, I look forward to a much clearer definition of the line between those institutions which are banks in the full sense and other deposit-takers.

There are other features of our arrangements which are non-statutory in nature and which are particularly relevant to a discussion of self-regulation.

In the first place, our approach is participative in that we think the best way to judge what constitutes sound banking is to observe the behaviour of banks which have established a reputation over many years for prudent management, and to develop our standards accordingly.

Secondly, the fact that we look to the banking system to help us decide what is good banking enables us to be flexible and pragmatic in our attitude. Banking is not a static business, and has constantly to adapt to changing circumstances. Moreover, different types of banks will need to be differently run and it is a mistake to attempt to judge all banks by the same criteria. As you know, in London we have as great a diversity of banks as anywhere. We have the domestic clearing banks, the head offices of deposit banks operating largely overseas, accepting houses, other merchant banks, consortium banks, branches or subsidiaries of foreign banks, and so on. In all these different groups good management predominates, but not necessarily uniformity of practice. This diversity means that the supervisory authority must keep its approach equally flexible and varied.

Having described some of the features of our arrangements for banking supervision in the United Kingdom, I should like now to consider more general issues of statutory control and self-regulation in the supervision of banking, in a wider context than that of the United Kingdom.

I take it as axiomatic that some form of special supervision of banks is necessary, both for the protection of depositors and because a well-run banking system is so vital to the economic health of modern society. And the very fact of supervision can help to maintain the confidence on which banking so vitally depends. So the degree of freedom permitted to normal commercial companies would not be suitable for banks; and the fact that there has been relatively little banking legislation in the United Kingdom has not by any means meant that we in the Bank of England have taken the view that no supervision is necessary. It is more a question of method and of where in the spectrum of supervisory arrangements one sets the boundary between how far the law should apply and how much should be left for self-regulation; and by self-regulation I do not mean an absence of supervision but rather that supervisory arrangements should be largely left in the hands of the practitioners, including of course the central bank, rather than in the hands of government officials.

My second general point is that it is a mistake to assume that supervisory arrangements which are effective in one financial centre will prove equally appropriate in another; and this applies in particular to the alignment of the boundary between the law and self-regulation. Banking systems in different countries vary enormously and we do not, I think, need to look for a Utopian system of banking supervision which will apply at all times and in all places.

Subject to this general caveat, I propose to consider where the boundary might be set between statute and self-regulation from a number of different aspects. The first is the standing of the supervisory authority. Many would hold that a statute was necessary to remove any doubt in the minds of the public, and more especially the banking community, about the standing of the supervisory authority and the nature of its powers. Again, some might assume that a body which had no statutory support for its actions might be cautious to excess in its dealings with the banking system. It might hesitate to intervene, even when it judged intervention to be necessary, for fear of being rebuffed; and it might be less sympathetic to aspiring institutions and draw back from granting recognition, when it was not confident from experience that the new institution would accept its authority.

Such arguments suggest the establishment of the supervisory authority in law. But there are some powerful arguments on the other side. For example, it is by no means clear to me that a non-statutory supervisory body will in practice be more cautious than a statutory one in its dealings with the banking system. A statutory body will have to stand on the strict letter of its powers and may have to consult its lawyers to ensure that it is acting in accordance with those powers (otherwise its actions may be challenged in the courts), and this may lead to delay and lack of decisiveness. A non-statutory body feels no such formal inhibitions and can rely on its own judgment to act quickly when it considers circumstances warrant. A non-statutory body can also use more discretion in deciding what action is needed in each case rather than having to rely on rigid or inflexible prescriptions.

As I have already said, in the United Kingdom the banking system has over the years accepted the Bank of England as its supervisory authority. I find no reluctance amongst the banking community to accept that authority, and I make only one qualification in stating that enshrining in law the Bank's supervisory role would not enhance the effectiveness of banking supervision in the United Kingdom. My qualification is that if the Bank's supervisory responsibilities have to be extended permanently to a range of deposit-taking institutions beyond the ranks of banks proper, then statutory recognition of this extension of the Bank's role would be required. Our prospective legislation may have a bearing on this point.

The next aspect to be considered concerns the range of institutions to be supervised. Here again there seems to me to be a distinction between banks in the full sense and other deposit-takers. A system of licensing these latter institutions may be necessary to establish their identity and to maintain some check on their activities in the interests of protecting depositors; and such a system can link the granting of the licence to the acceptance of supervision. I see advantage in this. But for those institutions regarded as banks in the full sense, such a statutory basis for supervision may not be desirable because it could foster a more legalistic attitude in other areas of their business, as I shall discuss shortly.

I have mentioned the standing of the supervisory body and the range of institutions to be supervised. I now turn to a third aspect, namely, how far the law should extend into the detailed administration of supervision. Should rules and regulations have the force of law or be left to the discretion of the supervisory authority and to self-regulation? This seems to me to be largely a question of relative effectiveness: and whilst I concede a role for a law which clearly defines the boundaries of the field, I see grave disadvantages in extending that law too far into the details of supervision – although, here again, I speak mainly with the experience of the United Kingdom in mind: in some countries the law may need to be extended rather further than I think is necessary in my own.

There is, I think, an important distinction between rules worked out by the professionals, albeit with a concern for the public interest, and rules worked out by the governmental process. In the latter case, flexibility is often lost and the supervisory authority is less able to react quickly or to adapt to change. Furthermore, I think it likely that more exacting standards will prevail when the spirit, rather than the letter, of the standards is the guide. Where rules and regulations have the force of law, it is more difficult to avoid the situation where the whole duty has been fulfilled by an exact compliance with the regulations than with conforming to the highest standards of banking practice established over time by the best banks.

Indeed, I attach very great importance to fostering a sense of responsibility in the banking system. Banks themselves have the principal part to play in setting and meeting their own prudent standards. The role of the central bank is not to tell them how to run their business or to solve all their problems: it is to ensure by way of supervision that they are conducting themselves in accordance with the best standards. Where, as in the British system, recognition of banks rests partly on the acceptability of aspiring institutions amongst the established banking community, full recognition should be obtained only when an institution has shown that it will behave with the degree of responsibility that is the hallmark of the existing circle.

Finally, we must remind ourselves that banking supervision uses resources: indeed its costs are readily apparent while its benefits tend to be of the intangible variety which make cost accountants suspicious. In a country where the banking system is compact and a sense of responsibility is high, the creation of a large supervisory staff to ensure compliance with legal requirements would be wasteful of resources. It would be no guarantee against fraud, and its existence could well weaken the sense of self-reliance and self-regulation.

To instance the United Kingdom again, our supervisory system is based on the belief that a bank is only as good as its senior management and that it is more useful to seek to influence a bank's policy from the top than to try to monitor its procedures from the bottom. Our supervisory arrangements centre on regular discussions with the senior management of banks. These discussions enable the bankers to reveal their present preoccupations and future plans in confidence, and enable the Bank of England to form an assessment of the quality of management and to influence it. This system has recently been well described by Professor Revell of the University College of North Wales as 'vicarious participation in management'.

May I now attempt to summarise. First, in banking the importance of confidence and the protection of depositors make some form of supervision desirable and essential. Secondly, we are unlikely to find an ideal system which will suit all countries. Thirdly, the boundary between the law and self-regulation needs to be fixed in the light of the traditions and development of each financial centre, but there is a stronger case for the statutory underpinning of supervision than for detailed legal rules and regulations: higher standards can often be achieved by compliance with voluntary codes of conduct.

Each country must accept its own responsibilities and examine its own arrangements. Thus, in the United Kingdom we recognised last year that changes were necessary in our supervisory arrangements. We have already significantly reinforced our methods of examining banks' activities, we have extended the scope of supervision to other deposit-takers, and we are planning to introduce licensing of such institutions.

But although banking supervision is essentially a function of national authorities, recent events have made it clear that in this, as in many other areas, the interdependence of the modern world requires a high degree of international co-operation. Such co-operation is more likely to be effective if it is based on mutual understanding of strengthened national arrangements, on mutual trust between supervisory authorities and interweaving of independent systems, than on attempting to place an umbrella, designed without regard to existing national differences, over all national systems. This type of umbrella is precisely of the kind which the EEC Commission's current proposals in my view have sought to avoid. We have seen important advances in co-operation in the last year. Let me mention some of them. There is the informal liaison group of officials dealing with banking supervision in EEC countries, a group originally suggested by Mr Dondelinger. There is also the work in Brussels on the Commission's proposals – which I trust will soon bear fruit in an agreed directive. For a somewhat different purpose and amongst the wider community of Group of Ten countries, there has also been the establishment of the so-called Blunden Committee, concerned with the more international aspects of banking supervision and regulatory practices.

The problems facing banking supervisors in the future will be those they have always faced, of keeping up with developments, fostering the good and discouraging the bad. Above all, this requires a mechanism nationally and internationally which commands the respect and confidence of the banking community.