Speech by the Governor of the Bank of England

Given at the annual banquet of the Overseas Bankers Club at Guildhall on 3 February 1975

When the President of the United States can say, as he did in his recent message, that the state of the Union is not good, you will hardly expect a note of unrelieved cheerfulness from me. We live in difficult times and I cannot avoid discussing them, but it is no part of my purpose to add to a chorus of doom. What I should like to do is to sketch some kind of perspective, suggesting what is paramount as against what is subsidiary or on the way to being solved.

I need hardly remind you of the exceptional changes we have had to accommodate in the last twelve months. First, the impact of the quintupling of oil prices. This raised costs throughout the world and exacerbated a rate of inflation which was already too fast as a result of factors quite unconnected with oil.

The world's banking system also has had to face the formidable problems of handling the new oil moneys.

Finally, in the later part of the year a weakening in the major industrial countries faced us with the risk of a serious world recession in 1975.

Put against this, though 1974 saw the emergence of almost unprecedented difficulties internationally, it also produced a striking degree of constructive response.

Let me take first the oil moneys. Some fears were expressed last year about the way the oil-producing countries might handle them. Yet I think it is now acknowledged that they have not acted irresponsibly. They have not shifted funds capriciously from one centre to another. On the contrary they have swiftly mounted aid programmes which are large in relation to the growth of their reserves. They have lent to the International Monetary Fund, to the World Bank and other international agencies. Moreover, they are proceeding to develop their own countries and import goods and technology from the industrialised world at a startling pace. The volume of OPEC imports in 1974 is estimated to have risen by some 40% over 1973.

On the other side, the world's banking system has dealt with a very large volume of oil funds remarkably smoothly. It has not been able to do the whole job; and it will perhaps play a relatively smaller part – though still of great importance – in 1975 and 1976. But we should be grateful to the world's bankers for the speed and flexibility with which they dealt with the initial problem. This has provided time for other and longer-term channels for investment to be opened up and for the world's monetary authorities to develop both concerted and individual approaches to the problem.

In this connection the meetings in Washington last month were, I think, encouraging not merely for what was achieved, but for the evidence that the major countries were willing to modify their initial preferred positions in the interests of acceptable compromise.

The world's banking system had to face last year some individual defaults and losses, and much unhealthy rumour about the state of the international money markets. Here too there has been an official response, internationally concerted. Reporting, surveillance and supervision have in most countries been improved and intensified. This is certainly true of the United Kingdom, and we will be seeking further to improve our procedures in any way that may become appropriate. The discussion in Basle among central bank governors has produced an essential clarification of attitudes and responsibilities. Our action in establishing what I may call parental responsibility for subsidiaries and consortia has I believe been important and has elicited warm support among other central banks. The international markets, in part reflecting these developments, have shown considerable recovery of tone in recent months.

We have also seen a welcome response to recessionary tendencies in the recent expansionary measures and proposals in Western Germany and the United States. These moves provide to those countries in the most severe difficulties some reassurance as to the prospective climate in which they will be able to tackle their own problems.

In short, I would suggest that we should have some modest confidence that the international dangers, great though they are, are likely to be contained by intelligent national or co-operative effort. What will be important in 1975 will be the way individual countries manage their own affairs.

We in the United Kingdom must make substantial progress in solving two serious problems which are very much our own responsibility: our large balance of payments deficit and our rate of inflation.

Apart from the oil deficits there are large external imbalances between the major industrialised countries, which must be rectified. It will not be easy in current conditions for the deficit countries to improve their external positions, but in the United Kingdom we know that the effort must be made and progress achieved. The oil-producing countries offer very buoyant markets to which our skills and energies must increasingly be directed. More generally, after the reflationary action already taken by some of our major competitors, we may hope that a general upturn in world activity will not be too long delayed.

Our most fundamental problem remains inflation. In 1975 it seems unlikely that we shall be importing it, for the present oil price has now been absorbed, and commodity prices are more likely to fall further than rise over the next year or so. From now on therefore our inflation will be 'home grown'.

I have called inflation our fundamental problem because at its present rate it is this which complicates and exacerbates all the other problems.

I could speak of its evil effects on charities, the social services and pension funds – all of them under menace on a scale not yet fully visible to many – but let me say a word in relation to its effect on investment. We need over the next few years a substantial shift of resources into investment to strengthen our industrial base. Yet what is the present trend? Industrial investment generally, after recovering in 1973, is set for a decline. With inflation at the present rate the finance firms require to hold stocks at higher prices constitutes a heavy first charge on internal sources of finance and leaves little over for investment in new fixed assets. Second, the prospective return on new investment remains too low so that the high rates of interest which inflation has generated often make outside finance unattractive. Third, the multiple uncertainties created by inflation have robbed management of many of their trusted tools of judgment.

These effects of inflation are, I think, more important than the weak and uncertain demand prospects facing industry – prospects which would anyway be much less uncertain if inflation was under control.

The trends which I am describing are not of course peculiar to this country alone, but I describe them as I see them. They are certainly frustrating much necessary investment (with the dangers for the future that that implies) and they are now threatening output and employment. I believe that it has not yet been adequately appreciated how inhibiting inflation at present levels is likely to prove in the management of the economy.

Mr President, if I have spoken soberly of these matters it is because I fear the corrosive and destructive force of inflation. If we wish to preserve our present standards, let alone see a prosperous future, we have got to master it.