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 21 October 1976.

This traditional banquet, my Lord Mayor, annually affords us the occasion to review the concerns of the City and the position of the economy.

I start here in the City, where many of those present earn their living as providers of financial services, national and international. The City, my Lord Mayor, is under some attack, and it is right that I should comment on that tonight. I hope, perhaps immodestly, that I am – in virtue of my previous experience and present responsibilities – qualified to discuss it in a fair and balanced way.

The first attack is concerned with financial malpractice. This is a legitimate target and it is undeniable that malpractices occur from time to time in the financial community, as I have noticed they do in other walks of life. I detest these disfiguring incidents, as does all City opinion. It is right that we should seek to eradicate them, and I welcome unreservedly the proposals to introduce legislation in two areas of company behaviour where abuses have occurred: insider trading and directors' loans. But the scale of malpractice must not be exaggerated. The incidents are warts on an otherwise healthy system, and they owe something to the climate and temptations of frothy markets and easy gains in years now past.

Those boom conditions also led, and not only in this country, to imprudence in some parts of the financial community. Viewed in perspective, this should not be surprising; and its exposure during the ensuing catharsis of financial difficulty and readjustment is historically a feature of such episodes. It has shown clearly, even clinically, where our regulatory arrangements, legal or voluntary, needed bringing up to date or extending. This is a task on which the Bank have been engaged over the past three years and on which we will continue to work, in close co-operation and consultation, as appropriate, with the Treasury and the Department of Trade. The changes in the field of banking supervision will be well-known to you, as will also the recent White Paper on the licensing and supervision of deposit-taking institutions. Today the Secretary of State for Trade has announced that the Department of Trade and the Bank of England are to set up a joint body to keep under review the working of the present system of securities regulation. This arrangement, and the City's own collective efforts, will strengthen the effectiveness of the self-regulatory system and ensure that it operates, with the support of the law, to maintain the integrity and efficiency of the securities industry.

No improvement will wholly eliminate occasional malpractice or imprudence. But the improvements now made or in hand should bring them down once again to a minimum, and by means least oppressive and damaging to the adaptive vigour of our financial institutions. My Lord Mayor, I am convinced that this is the right way to proceed.

I turn now to the more important attack, namely, that the City has failed British industry and somehow failed the nation. Whether I look back over the past three years or try to peer into the future, I find this attack odd. Leaving aside the huge needs of the public sector, how is it supposed that industry and commerce could have adapted the pattern of their financing to the strains and stresses of the past few years without a capital market which has since early 1975 raised some £1¾ billion of new equity, and without a banking system that has readily but prudently provided additional facilities, increasingly in the form of the medium-term credit which manufacturing industry has come to need? How should we have fared without the substantial contribution – some £1 billion last year – earned abroad through the international services which the City provides? More generally, how could we have withstood the external financial strains which followed the quintupling of the price of oil, had our financial institutions not been able to attract deposits or raise loans worth many billions of pounds in the international money and capital markets?

Can all this, achieved during the most difficult financial conditions experienced since the Great Depression, be called failing the nation? I do not think so.

There are, of course, those who argue that the City's performance would be improved by a sharp increase in state ownership and intervention. I do not share this view and, for my own part, would have thought we should be better advised to reinforce the success of our existing system. It is, after all, the system which has secured London its pre-eminence as a financial centre, to which the world outside accords an admiration it does not show for all other aspects of our affairs.

But many of these matters will now come under scrutiny from the new inquiry into the role and functioning of the financial institutions in the national economy. The City will, I am sure, be ready to give a full account of itself. In the meantime, it will continue serving, and not failing, the nation.

I now pass from the City and its immediate concerns to the wider topic of the national economy as a whole. When I consider where we are now and what has been achieved since we last met, I confess to contradictory feelings. It would be right to pay tribute to the great efforts and courage shown by you, Mr Chancellor, in setting the general course of the economy. It is assuredly right to seek, as a first aim, to control inflation, to give priority to the shift of resources into the balance of payments and investment, and to restrain consumption. Nor has the strategy been without an important measure of success.

But progress has not been fast enough to meet our needs. We are still in the grip of severe inflation, and the fall in its rate has stalled for the time being. After three years at record size, a large external deficit remains. And we have had a very heavy depreciation of sterling.

We have now applied for support to the International Monetary Fund. That support would not in itself provide a solution to our problems; it is rather a measure of them. We will be discussing with the Fund the conditions they will wish us to observe in return for support; but it would be wrong to consider the policy of this country primarily in these terms. It is better to focus our minds on what we need to do anyway, in our own interests.

What is needed is again to live within our means. We must cease to be so dangerously beholden to others. Unhappily, there are no easy remedies available, and no course that is not, at least for a time, painful and destructive to some hopes. But nothing can now absolve us from the need to put our national finances on to a more stable basis.

All arms of policy will have to contribute. But I begin with monetary policy, because I regard it as having a pre-eminent place among the responsibilities of the Bank.

Monetary policy, and the money supply, remain the subject of expert, and inexpert, controversy. Myself, I take a simple view. We live at a time of all-pervasive inflationary danger. That being so, I think it must be right to aim publicly for a growth in money supply which will accommodate a realistic rate of economic growth but not accommodate, more than in part, the rate of inflation. Operating against that background, monetary policy becomes a powerful weapon in the fight against inflation.

So I believe it is right to have a publicly-announced monetary target, set in conjunction with fiscal policy, so that the relative weights placed on fiscal and monetary measures in the attainment of the target can be clearly seen.

The target for the growth of M_3 is currently 12%. Next financial year it ought to be lower than that. Over the past few weeks, by raising interest rates and calling for special deposits, we have demonstrated our determination to keep within the limit set. The purpose of these measures was twofold: to restrain the growth of bank lending to the private sector within the bounds set by the 12% target; and to secure adequate official sales of public sector debt to the general public, so as to neutralise the creation of liquidity arising from the public sector deficit and thereby also moderate the rate of monetary expansion.

In this latter context, the Bank have been criticised for their orthodoxy in relation to the marketing of gilt-edged stocks and for being slow to experiment with new methods. I confess to being sceptical over how far technical ingenuity could have overcome the basic arithmetic, but we have naturally been taking a hard look at the various possibilities. It has always to be remembered, however, that we have in this country the most efficient market for government debt that exists in the world; and for my part, I should want to be sure before agreeing to any proposed innovation, that this efficiency would be fully preserved. Perhaps I may add that, during the last month, we have sold gilt-edged stocks on a massive scale.

The fixing of monetary targets is a new development in this country; so when formulating our monetary aims for the financial year to come, it will, I think, be desirable to look in detail at the methods used in some other countries. In particular, it would be useful to consider the practice of the United States, under which targets are redefined periodically, more especially if this can be done at times when we are able to review the whole mix of policy.

Monetary and fiscal policy – and I would add incomes policy – each have their part to play, and should form a coherent whole. At present there is, undeniably, a growing question over the balance between our monetary and fiscal stances. The record level of interest rates reflects in large part the difficulty of financing, without excessive monetary expansion, the present public borrowing requirement. The current stance of monetary policy will have to continue for the time being. But it is far from costless, and if interest rates remain so high for long, they will begin to be a powerful deterrent to investment, only now showing signs of recovery. In that case, as the Chancellor has pointed out, one would have to ask whether this impact on industrial revival was acceptable or whether public sector borrowing should not be reduced more rapidly, so as to provide more scope for the borrowing of industry.

The balance of payments deficit, to which I have already alluded, is an additional reason for asking whether a quicker reduction of public borrowing will not be needed. The balance of payments is no doubt set to improve, more especially over a span of years. But we need early evidence of such improvement. If it requires a further degree of austerity to guarantee this, I believe we shall have no choice but to accept it.

Our greatest requirement is that we should put a stop to the debilitating erosion in the value of our currency, external and internal. It is clear enough how inflation saps confidence, increases uncertainty and destroys initiative. It also destroys employment. It would be easier to expand employment if it were plain that the pace of cost and price increases was being reduced. Is there not here opportunity for continued collaborative effort to bring together these imperatives – less inflation, but more employment? It cannot be too widely understood that what pace of expansion we can afford will turn on how quickly inflation can be overcome.

My Lord Mayor, my message, although sombre, is at heart a hopeful – not a hopeless – one. We are at a testing time – a time which is testing policy and its adequacy to our national needs; testing the determination of government and testing the ability of our people to set aside division and recrimination and unite in a common and sustained purpose of national recovery.

There is no cause for despair. Unless I err greatly, people everywhere long to end the humiliation of our decline and are ready for the struggle.

It will mean the end to many illusions – that we can enjoy more than the value of what we ourselves produce by our own labour; that we can safely divorce effort and reward as we have been tending to do; that we can allow inflation to raise taxation on incomes and reduce it on consumption; that investment will be financed without adequate return to firms or reward to savers.

We shall, I think, travel further and in the end faster if we also moderate our expectations. It will already be a considerable achievement if we can again make the economy work well. That would be no failure in idealism, but a victory necessary for any advance in material or social well-being. It is the way back to health, to confidence in ourselves and to the confidence of others in us.

Given at the annual dinner of the Northern Society of Chartered Accountants at Newcastle-upon-Tyne on 28 October 1976.

. . . May I say first what a pleasure it is to be in the North East here in Newcastle. It has, as you may know, been for close on 140 years the home of one of the Bank's branches. Over the years I also have had personal connexions here. . . .

Mr Chairman, the nature of my responsibilities leads me to spend much of my time in involvement with the state of the economy, and with that aspect of economic policy which is most directly the province of the Bank of England, namely, the course of monetary policy over the country as a whole. I have very recently, on the occasion of the Mansion House dinner, expressed some views on these matters, which you may forgive me for thinking it would not be appropriate to repeat before you on this occasion.

As I said then, it will already be a considerable achievement if we can again make the economy work well. It is a precondition for any advance in material or social well-being. The good functioning of the economy rests on the good functioning of individual firms and companies – a matter, Mr Chairman, in which members of your Institute [of Chartered Accountants in England and Wales] have an essential role. I make no apology, therefore, for making this the theme of what I have to say tonight.

I like to think, Mr Chairman, that my long years of practice at the Bar as a specialist in company law and in subsequent occupations in the City have given me a particular insight into the range and scope of the responsibilities of your profession. Your most familiar task is, of course, the preparation and presentation of accounts to management, to shareholders and to the public, and your most familiar role that of auditors setting the stamp of approval on accounts. No one here is likely to forget your manifold other roles as financial directors and management consultants; in the field of taxation; and as advisers to your clients in every aspect of financial management.

As I see it, the essence of your work consists of making intelligible the reality which lies behind the figures and of expounding that true and fair view to which your profession is wholly committed. This is supremely important, for reliable information clearly presented is at the base of right decisions.

Yet in recent months, both the City at large and your profession have been under some criticism. It is unhappily the case that (to parody Mark Antony) the evil men do leads immediately to wide and critical publicity and the good is often buried in the small print. Every year the accounts of companies totalling scores of billions of pounds are prepared and approved by members of your profession. This mass of properly presented balance sheets tends to be forgotten because of occasional lapses which receive disproportionate publicity. I believe that the integrity and competence of the profession need have no fear of comparison with that of any other country; but this is not a time for complacency – and the criticisms which have been made need a response. I would like to suggest one or two areas in which, as it seems to me, your profession might be able to bring about improvements or help all of us who are concerned in these matters to do so.

The professions in this country are for the most part self-regulating. In support of this, they accept a rigorous training and the disciplines and restraints inherent in their callings. It means, among other things, that they must set and maintain standards of the highest quality. In your profession, the technical standards are now not only national but international in scope. The setting of accounting and auditing standards, the acceptance of them by the members of your profession, and the imposition of sanctions if they are not strictly followed, lie at the root of your profession's reputation. You have recently decided to put in hand an inquiry to examine the changes which may be needed in these fields. This is a wise and timely move which will be widely approved.

I speak as a user. The Bank of England, as you will know, are concerned among other responsibilities with the strength and dependability of banking institutions and exercise surveillance of them. In discharging this task, we rely not only on our own prudential examinations but importantly on the work of the accounting profession in preparing and auditing the accounts of financial institutions. Having regard to the special importance of this task, I am inclined to think that some guidelines should be set as regards both the size and experience of firms of accountants before they are permitted to accept banking audits. There are precedents for this type of restriction both in this country and abroad, and I suggest that it is a matter which your Institute might wish to examine. I am strengthened in this view when I read from time to time the reports of investigating accountants or of inspectors appointed under Section 165 of the Companies Act. It seems to me that these reports from time to time draw attention to deficiencies in companies' accounts, which are not simply visible with hindsight but which should have been revealed in the auditor's reports for previous years.

Inflation has brought a new dimension to your responsibilities. The true and fair view is harder to reach. I know that, as long ago as the spring of 1971, when inflation was running at under 8%, your Institute took the initiative in proposing that published accounts should reflect the effects of inflation; and that you were among the first of the accounting bodies of the world to begin work of this character. These efforts were halted for a short time by the Sandilands inquiry but that, in turn, gave the subject a new impetus and direction. There is now a general recognition that adjustments are needed to take account of the eroding effects of inflation.

As we move over, in the wake of the Sandilands Report, to current cost accounting, it will be particularly important to ensure that the figures are properly presented and do not avoidably give rise to misguided criticism. A sustained effort of explanation will be needed as the new numbers appear, looking at first sight perplexing and certainly different from what management, investors, and the public at large are accustomed to. All parties concerned with company accounts will in fact have to adopt and get used to new sets of criteria. This is where the accounting profession has a vital part to play, both in itself adapting to the change and in helping to develop, to promote and to put into practice comprehensible standards for current cost accounting. Not the least of its tasks in this respect will be the need to present and explain the figures in such a way as to make them intelligible to all who work in industry – employees as well as management.

The most important application of what I have been saying lies in the field of profits, and in particular in their interpretation. It will be of great importance for all concerned to have as accurate a picture as possible of industry's profits, and for this we shall depend heavily on the information you provide. There is now, I think, widespread acceptance of the view, which I entirely endorse, that profits in this country have been far too low. Economic recovery will need to be based upon exports and investment. An upswing in investment, however, will be sustained only if there is an improvement in the prospective return on it. Over the past few years, the return on investment has fallen to dangerously low levels. This has been a world-wide phenomenon, but it has been especially marked in the United Kingdom. Using a measure of profitability consistent with the spirit of current cost accounting, the pre-tax rate of return on net assets has fallen from around 11½% in the mid-1960s to 4% in 1975. Not only has this had damaging consequences in itself – low investment and, until 1974, increasingly heavy erosion of liquid assets – but it has induced a tendency also to take too low a level of profitability as the norm against which the adequacy of the return on capital is judged.

I do not want to embark on a disquisition on why profits have been so low. I would hazard a guess that the members of your profession know the reasons better than most people. Some of them obviously come directly within your purview, such as the use of historic cost price calculations; and this may have been a factor contributing to the unprecedented squeeze on corporate liquidity in 1973 and 1974. Companies have certainly been able to make some progress since then in rebuilding that loss of liquidity, though at the expense of investment and stockbuilding. But if recovery is to be sustained, new investments will certainly be needed. The majority of these must be financed from retained profits.

There is another reason why higher profits will be required – in order to improve the return to shareholders. As the Diamond Commission has pointed out, these include a very wide and diverse body of indirect shareholders comprising everyone who has an insurance policy or a funded pension. For too long there has been an inadequate return on the actual investment made by industry and an inadequate reward for the savings invested in industry. This will take time to correct, but the fundamental need for higher profits must not be lost to sight as we grapple with our immediate problems.

The country is dependent for its well-being on the success of our industries. All of us, in one way or another, have a part to play in the national effort. Your profession, Mr Chairman, has the special responsibility of ensuring that we are all resting our attitudes and our decisions on a true and fair view of the realities. . . .