Speech by the Governor of the Bank of England

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Some years ago I had the privilege of attending an informal meeting of the Board of one of the Federal Reserve banks in the United States. The distinguished economist who addressed us said that he would speak briefly and thus deal with three subjects, and three subjects only – the past, the present and the future.

You will no doubt allow me to start more modestly. I want to begin by trying to establish where we are now – a task which, if I remember rightly, Sir Alec Cairncross once suggested was more difficult for economic policy makers than the problem of knowing where the economy is going.

I start then with the world economic environment, on which a trading nation such as this country is dependent.

It is not so long since concern was being expressed throughout the Western world about the depth and duration of the economic recession – a recession which has proved to be the worst since the 1930s.

There were many reasons why the recession was so severe; and several are connected with the severity of the inflation which, paradoxically, and to our confusion, has accompanied it. Inflation was accelerating even before the five-fold increase in oil prices, which then magnified it. Because of the strength of inflation, governments were at first held back from stimulating demand; and the rise in price of imported oil acted further to reduce purchasing power in the oil-consuming nations.

As recently as the summit conference at Rambouillet last November, concern was widely expressed about the scale of unemployment in the industrialised world, and the threat to social cohesion and stability which prolonged recession would pose. So deep was doubt regarding our powers to combat recession that to some it even seemed a question whether we should ever again experience expansion. Had we not entered a new phase in economic history, in which accustomed remedies no longer worked?

Such fears have proved ill-founded. A general recovery is now well under way in the leading industrialised countries. Japan, one of the countries particularly hit by the oil crisis, saw a revival in industrial output from early last year; the United States' economy began recovering around the middle of 1975. In Europe, Western Germany and France showed renewed expansion in the fourth quarter, while we in this country, having touched the bottom of the recession in the third quarter, have seen production rising significantly from the end of last year. World trade too has recovered much sooner than generally expected. Over the past year it has grown very fast.

The present recovery appears now to be broadly based; and although the initial burst of growth may not be sustained, forecasts everywhere are now being revised upwards. Moreover, recovery this time is starting from a base of much higher rates of inflation, even though unemployment still remains high. And, though international payments imbalances have eased since the first flush of the oil crisis, they have not disappeared. The oil-exporting countries remain in very large surplus, even if on a less extended scale than in 1975. As might have been expected in this situation, and with industrial recovery under way, the main industrial countries moved back into collective deficit in the fourth quarter of last year, and remained in this position in the first quarter. With world recession and with dearer oil, the developing countries that import oil have been going through a very difficult period in their overseas payments – a position that should, however, in degree be alleviated as world expansion gets further into its stride.

The position of the United Kingdom in the general world picture is a transitional one, for we are moving from dependence on imported oil to being ourselves an oil producer. Oil is already making a sizable contribution to our balance of payments this year. By the 1980s we should become a significant net exporter of oil.

Looking to the immediate situation one can see, I think, that everyone is now aware, in greater or lesser degree, of the futility of last year's inflationary excesses; but there are still, no doubt, further adjustments to be made before we can eradicate the false expectations which have grown up over many years. The United Kingdom's economic and industrial recovery is at an early stage, and we are recuperating from a disease which has left us gravely weakened, with many tissues still in need of repair.

Against the background of the general revival in world trade, UK exports have been performing well. Imports, on the other hand, after the long run-down in stocks, hardly grew at all in the first months of the year. As a result, the balance of payments so far this year has been much better than could have been expected. The latest trade figures now indicate some worsening. But over the year the current account deficit may well be no larger than last year, despite industrial recovery here, and despite dearer imports as a result of the depreciation of sterling. Many of our competitors are currently experiencing a worsening of their balance of payments, but such comparisons do not exempt us from the need to eliminate the deficit and earn our living in the world. If we can accept the necessity for some curtailment in our real incomes, the United Kingdom is at present favourably placed to take advantage of the world upturn.

As you will all be aware, these relatively favourable developments and prospects have not prevented in the last few months a pronounced decline in the external value of sterling. It may be part of the background that many people, both operators and commentators, appear to have misinterpreted the exchange arrangements announced at Rambouillet and took them to herald a new period of exchange rate stability. However this may be, the early months of the New Year saw renewed turbulence in the exchange markets, which adversely affected six Western European currencies, including our own.

At the first stage, which spanned the turn of January/February, sterling was on the sidelines and maintained the stability which had persisted since the late autumn. These months of comparative calm ended at the beginning of March. As you know, the slide that started then took the dollar-sterling rate down to nearly \$1·70 by the early days of this month. As against a trade-weighted average of other currencies, the value of sterling had by then depreciated by over 16%, in spite of substantial intervention which was reflected in an underlying reserves fall of over $3 billion.

Although the United Kingdom's economic performance was in many important respects better than a year previously, the stability displayed by the rate over the turn of the year could perhaps, by reasons of the ground we had lost against our main competitors, hardly have persisted indefinitely. Subsequently, there was a marked change of mood in the market, heightened by the rate passing through the psychological barrier of two dollars to the pound. This experience illustrates sharply the importance of confidence or its lack. It was in these circumstances that the Bank of England, over the Whitsuntide weekend, negotiated the massive stand-by credit of over $5 billion. My fellow Governors from the Group of Ten countries (which comprise the main industrialised countries of the world) and Switzerland, together with the Bank for International Settlements, arranged this credit promptly in support of sterling and our common interest of ensuring the proper functioning of the international monetary system, because they considered, as I did, that under market pressures the value of sterling had fallen to an unjustified level which was causing disorderly market conditions.

In the light of the experience of this crisis, it is natural that a number of aspects of policy should be called in question; and you will have seen the many, various and often useful comments that have appeared in the press. With a breathing space provided by the support generously given us, there is now an opportunity to consider, in a calmer atmosphere, how far future policy needs to be redirected or redefined.

Looking ahead over the next few years, I am equally impressed by the difficulties to be overcome and by the opportunities to be taken advantage of. First among our problems will continue to be the problem of inflation, which I will therefore discuss first. Linked to the control of inflation is monetary policy, on which I will try to suggest some directions. Lying behind, in turn, there are major questions regarding general economic strategy – including questions about the size of the public sector borrowing requirement and the directions of budgetary policy.

Before proceeding to detail, there is one very general comment that I need to make. Since the war – perhaps one might say, since the Great Depression of the 1930s – governments have put a high value on maintaining their economies in a state of reasonably full employment. It is also the case that governments have been able to exercise a degree of management over the development of their economies by utilising methods that can broadly be called Keynesian. This approach has been under recent attack: it is said that these policies have failed, that we must now seek a radically different approach. This attack is, I believe, to a degree misplaced. Certainly such policies have not always been successfully or even wisely directed. Certainly, too, a different style of management may be needed, and aspects which were unduly neglected may need to be given greater weight. In particular, our ability to maintain jobs and achieve economic expansion depends on continued success in dealing with inflation.

As I think you will know, I speak to you as someone deeply convinced of the power of inflation to destroy our society and disrupt our economy. And I know well the difficulties of putting an effective brake on the speed of the inflationary process once it is in motion. No one, therefore, is more delighted than I at the progress which has been made in the last twelve months; but equally no one is, I think, more alive to the efforts we still have to make.

Our progress is to be measured by the fact that, in the early part of last year, retail prices were rising at fully 30% a year. A year later inflation has been reduced to half that rate. One can say that what was happening last year was promising catastrophe. But what we still have is a great deal more than would be tolerable if continued for long. It would still leave us with an obvious continuing erosion of the money in people's pockets and people's pay packets. It is still about double the rate of inflation in those other countries who are our chief neighbours and competitors in the industrialised world.

Our progress thus far is no doubt due to several factors. It would, I think, be ungenerous not to pay tribute to the courage and skill of the Chancellor of the Exchequer in pursuing this aim. The agreement between the Government and the TUC on the £6 limit, and the general support it obtained, has been an invaluable feature of developments since last summer. Incomes policy, moreover, has been working in the same direction as influences from the side of demand.

A further major step has now been taken by the special Trades Union Congress which took place on Wednesday. The importance of the proposal agreed between the Government and the TUC for a second year of pay restraint has been widely acclaimed both at home and abroad, and the overwhelming majority by which this proposal was endorsed carries its own message. Equally impressive has been the general readiness of men and women throughout the country to accept the policy of restraint in the common interest of getting control of inflation.

The new agreement, indeed, opens up the prospect that the rate of rise of retail prices can be halved again by the end of next year, and thus brought more nearly into line with the performance of our main competitors.

The further period beyond that will no doubt also have its problems. A day so soon after an achievement of this nature is not the time to ponder too minutely the form they may take. But after the corner we have turned, it is right that everyone should know that we need to pursue the campaign against inflation till virtual stability of prices is achieved.

There will, inevitably, be difficulties ahead in pursuing this course, as there have been so far; and it would be fair to observe that other countries also find the task not without difficulty. But our historical record has been poor; and we clearly ought to aim at progressively lower figures for the pace of inflation.

Unless we can greatly improve our economic performance, we cannot expect the productivity of the economy to expand on average by more than 3% a year. This then represents the sort of increase in real wages which we can expect to achieve and maintain. Even if we cannot achieve an absolute stability of prices, it is clear that annual pay settlements will need, in money terms, to remain very moderate; this does not mean that the rate of the real increase in pay would be less.

What I have been saying is no more than arithmetic. One cannot always fully see how to deal with difficulties ahead and I offer only a few possible pointers.

First, it is, I believe, fair to say that the recent agreements between the Government and the TUC have been valuable because of the fact that the size of pay settlements has a major influence on the course of prices, and because this fact has now been widely accepted. This greater general awareness is an encouraging development and I hope it will prove to be a permanent gain.

The next stage of the restraint policy extends to the middle of next year. I have spoken in terms of a need, after that, for continued moderation in the pace of nominal pay increases. This need not imply a continuation of the kind of agreement on pay restraint that now exists. It could be argued that a more flexible approach is indeed necessary. The general problem will perhaps be to revert to a freer system without opening a door to excessive general rates of increase in pay.

This brings me to my third point. It is a fact of life that unless inflation continues to be strictly contained, prospects for employment cannot be assured. The implications of this relationship may, I think, deserve to be more fully considered. Government policy affects the rate of economic expansion that is achieved: and though this is not fully within the power of governments to control, it is normal for a government to give some public indication of the sort of expansion rate that it has in mind. I suggest that there may be a case for expressing the rate of expansion which is envisaged in terms, not of the increase in real output, but of the growth in money national income.

This approach has been suggested by others from time to time. It may be a helpful idea to bear in mind for a future some way ahead. Further thought would need to be given to how the general principle might have to be applied. It could, for instance, provide a useful background to any general discussions on policy between the Government and the two sides of industry. It would also serve as a continuing indication that economic strategy will no doubt need to be especially cautious until it is clear that inflation has been brought under control.

We have to be single-minded in combating inflation; but not single-handed. Incomes policy has proved valuable, but it would be foolish if we placed all our reliance on it. No one should, and I certainly do not, underestimate the continuing and direct relevance of prudent management of demand in the economy, including a prudent monetary policy.

I am fully aware of differences of opinion, and different shades of emphasis, with some allotting to monetary policy a unique importance in the control of inflation. There are, equally, different views as to the precise principles which the monetary aims of policy should embody. Some would wish to operate by some formula laid down in advance – even enjoined by statute on a new monetary authority.

There have been other voices who, from various quarters, have urged the case for our expressing the monetary aims of policy in terms of a target figure, or alternatively a range, for the rate of expansion of one or more definitions of the money stock. The aims of policy thus formulated could be, and would need to be, restated, at longer or shorter intervals, in the light of the emerging situation. Some countries have found this a useful way of conducting monetary policy. The possible advantages are, I believe, that it may make clearer what the aims of monetary policy are, and may give the public a greater sense that the authorities are committed to the achievement of their stated aims. More generally, it may therefore have a useful effect on expectations, and may validate the belief of the public that inflation is being kept under proper control.

It is to be expected that the adoption of such a practice is not completely without attendant disadvantages, as would, I think, be generally recognised in the experience of countries which have adopted this approach. It is clear that close adherence to a target applying to one of the dimensions of monetary policy, namely the stock of money, may provoke greater instability in the other dimension of interest rates. The difficulties of adopting such an approach appear particularly great in a country like the United Kingdom, which is a much more open economy than is, for example, the United States, and where we have preferred to have much of the national debt in the form of long-term liabilities.

I believe that all these factors need to be carefully weighed. It is, in my view, important that we should not close our minds to any innovations in policy that would help in the task of controlling inflation. A quantification of the monetary aims of policy should not be adopted as an easy option. Such a procedure would seem to provide greater assurance that corrective action would be taken in time if this was required. From one point of view, this would be an advantage; from another, a potential obligation. Corrective action, if needed, could take either a monetary or a fiscal form: either further steps would have to be taken to finance the public sector deficit or, if these appeared disadvantageous, measures would be required to reduce the deficit.

The fundamental requirement is, of course, that monetary trends should remain moderate: second only to that is the need for public confidence that this will be the case. In fact, the recent rate of growth of the money supply has not, I believe, been inappropriate.

I have mentioned fiscal policy, and will come later to the question of public expenditure. Before I do so, I should add another word on fiscal policy in general, and more particularly its relation to the prospects for the economy as a whole. The present indications are that the economy will continue to expand, but not at an excessive pace. There are, however, two danger signals. We are now in a phase of recovery when economic forecasts, in this country and abroad, appear subject to being revised in the upwards direction. Moreover, even if many parts of the economy continue not to be faced with overloading, there could, in the very favourable conditions for exports now prevailing, be some manufacturing industries unable to meet all demands. Unwelcome though it would be, the better course might be to restrain demand at home; and restraining fiscal action may be needed. These possible contingencies should affect our state of preparedness. If, later on, the need for restraint arose, and if (and this is a theme to which I will return) there appeared good reasons not further to increase the burden of taxation, we might then be glad if plans had been made to curtail future public spending.

You yourselves, as members of the Chartered Institute of Public Finance and Accountancy, are of course more concerned with the finance of local government and public corporations than with the central government's finances.

But local government budgets are a major part of the public finances, and the fact that responsibility is spread over more than 500 authorities poses particular problems in relating local finance to the needs of the economy as a whole.

No one will be more aware than yourselves of the scale of the efforts now needed, and I think being undertaken, to trim local government spending to the new winds of greater financial austerity. I think we are all aware that this can involve difficult choices about services of real value and the calling in question of some established procedures. We must all sympathise with those of you involved with these problems but we must also, I am afraid, urge you to stand squarely to the difficult decisions you have to carry through.

You have, I know, also been considering the report, published last month by the committee presided over by Sir Frank Layfield, who spoke to you yesterday. He and the members of his committee are to be congratulated for producing such a comprehensive review of a complex subject within a remarkably short space of time.

There are many points of concern to the Bank of England which we have noted with interest, and general agreement. I am thinking, for instance, of what the report has to say on the burden of rates that falls on non-domestic rate payers; of the importance of local authorities having a capacity to borrow in the market in their own name; of the need to reconsider the proportion of local government outstanding debt now in short-term form; and of the importance of local authorities as owners of land and the need for realistic valuation of such assets.

The main issue raised in the report is whether we should go further towards centralisation; or alternatively should seek to restore greater autonomy to local government bodies. It would be premature for me to take sides on this question.

It is represented that greater autonomy would involve an extension of local taxation. The common reaction to this idea is liable to be one of alarm at the thought of yet another imposition by the public sector on our private purses. If it were really to be accompanied by a parallel reduction in central government taxation, this reaction might be misplaced, though there would inevitably be costs and pains in transition and extra costs in tax collection.

The Layfield Committee itself laid great stress on the need in our present circumstances to control all forms of public spending, and it is tempting to conclude that increased local autonomy would mean reduced central control, and hence higher public spending. Yet I suppose many of us would hesitate to take this argument to its logical conclusion.

These questions will no doubt receive intensive debate. The resolution of the conflicting considerations may perhaps only be achieved by some compromise, to which one of the members of the Layfield Committee has indeed sought to point a way.

Many of you here today will have followed the discussion in the press and elsewhere on the size of the public sector borrowing requirement, and on the associated questions of its relation to monetary policy and to the level of public spending. In part this reflects concern about the problems of financing the public sector deficit, which I have at least touched on earlier. In part it reflects concern lest the Government should spend too large a share of the national income; and on the second question I would like, in conclusion, to be allowed to offer some observations.

The crucial point to consider is: how much of our money do we want to be left to spend ourselves, and how much do we want governments to spend on our behalf?

There is no question that we want the Government to spend a lot of our money for us: but equally there is no doubt that we want to spend a lot of it ourselves. There are many different forms of public spending – education, health, defence, nationalised industries, transfer payments such as old-age pensions and unemployment benefit, financial assistance for industry, etc. Some categories of public expenditure are clearly essential: we may need more of them. Some are more debatable at the margin: perhaps we could do with less, having regard to the fact that they have to be paid for in the form of taxes. It is essentially a question of balance.

For government spending is a claim on our national resources, and resources are limited. The national potential increases only slowly – say by 3% or 3½% a year, unless we can make the economy rapidly more productive than in the past. And there are some prior claims. Part of the increase in real incomes must go to increase exports or to save imports. Part must go to productive investment – public and private. After these prior claims, the residue is still more limited. And if government consumption takes much of it, little is left for the ordinary consumer to spend himself.

This was the rationale behind the programme of expenditure cuts announced by the Government earlier this year. These were essentially reductions in the planned rate of growth of expenditure programmes in total, rather than absolute cuts – though living within the new ceilings is liable to involve absolute reductions in some areas. Notwithstanding the reductions, total public expenditure is still expected to rise over the coming years when rising debt interest obligations are taken into account.

The need for a change of direction was, I think, very clear. The revised programmes were introduced against a background of figures which seem to me to speak all too eloquently for themselves. In the three years from 1972/73 to 1975/76, the United Kingdom's gross domestic product rose by under 2%, whereas public expenditure increased by nearly 20%. Taking expenditure on goods and services along with transfer payments – where the increase was steepest – one can thus say that the increase in public spending was much more rapid than the increase in domestic product. The ratio of public expenditure to gross domestic product went up from 50% to 60%; and the marginal rate of deductions from the pay of the average wage earner rose to over 40%.

It would, of course, be difficult to determine whether this outcome corresponded with what the average citizen wanted; but in the face of the figures I have cited, it seems reasonable to ask whether there has not been an imbalance. Others have pointed out that, of the rise in public spending between the financial years 1970/71 and 1974/75, the greater part was not foreseen or fully allowed for at the beginning of the period. This is sometimes cited as evidence of a failure of control; but the truth is, of course, more complex. Much of the increase not originally allowed for was due to decisions taken subsequently. Contingencies are always likely to arise which call for increases in spending, and this likelihood needs to be taken into account.

The revised procedures regarding public spending, which have recently been introduced, are likely to result in a better outcome in future. The system of cash limits should result in much closer scrutiny. It appears likely that the contingency reserve will prove a limit which has to be lived with rather than expanded. And the initiative taken to obtain much better figures of central government and local authority spending should enable corrective action to be taken in time. The fact that recent returns have suggested that local authority spending is on too steep a trend has been treated as a cause for alarm. But it can be taken as a favourable omen that the trend has been detected at a relatively early stage.

Improved monitoring arrangements cannot by themselves guarantee effective control. It would certainly be very harmful if the present planned ceilings were not to be very strictly and literally observed.

This, indeed, is the first principle. I would propose as a second principle a presumption against increases in tax rates; and that the reduction in the public sector borrowing requirement should be accomplished by adjustments, if necessary, on the expenditure side. If there appears a fair chance that the expansion of the economy is going to require budgetary adjustments, the bias, I suggest, should, in view of the time lags, be in favour of adjustments to spending made in advance, to avoid the risk of later having to put up taxes further.

It is true that in the past eighteen months or so we have been cushioned by public spending from an even worse slump than the one we experienced. But now, with recovery well under way, we must ensure that room is kept available in the economy to ensure that that revival is maintained.

The approach I have tried to suggest does, I believe, represent the preconditions needed to enable industry to take advantage of the present exceptionally favourable opportunities. A sustained revival of industry lies at the heart of our national recovery. You may care to reflect that it provides the only secure base for any future expansion of social services.