Speech by the Governor of the Bank of England

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I want to talk to you today on international financial prospects for the next five years or so. And since the world is made up of our individual countries, I hope you will allow me to start by saying something about my own.

The primary concerns of a central banker are financial; and in these respects, the position of the United Kingdom has greatly improved over the last three or four months. Good fortune must never be abused or taken for granted, but it does nevertheless appear that the state of financial sentiment has been transformed. Market confidence is being rebuilt and consolidated, whereas last year it steadily deteriorated. Underlying this is the sounder course of fiscal policy, and the reinforcement of monetary control – matters I will enlarge on. The most imperative needs of our economy are lower inflation, more investment, more productivity in industry and more employment; and we have set fiscal and monetary policies on a course which should be helpful in all these directions.

The turn-round in confidence began in November and was clinched when the stand-by agreement with the International Monetary Fund was announced in December. This was followed by the announcement of the international facility relating to official sterling balances; and, shortly after, by the raising – with very general approval as a demonstration that we do not intend to rely on short-term inflows – of an additional loan on the euro-currency market amounting to $\$1\frac{1}{2}$ billion, on favourable terms. The exchange rate has now recovered by some 10% since the low point reached in the autumn, and has remained in the region \$1.70–1.72 to the pound for most of the period since 1st January. We have at the same time been able to rebuild on a substantial scale our foreign exchange reserves, which were heavily run down last year.

Among the causes of our troubles last year was our persistently weak balance of payments. We are now beginning to see signs of improvement in this. The deficit on current account appears from the latest figures, erratic though they are, to be on a downward trend.

In large part, the present and prospective improvement in our balance of payments is due to the increasing flow of oil from the North Sea. And because of the importance of this development to our future economic prospects, I should like to spend a few minutes sharing with you my perspective on some of the opportunities and problems associated with oil from the North Sea.

The output of oil, which is already growing fast, will represent a very substantial benefit to the United Kingdom. Already this year, it is likely to benefit the current account of our balance of payments by over £1 billion; next year the figure will be considerably larger, and there will be further increases thereafter. By 1980 we expect to be fully self-sufficient; and by the early 1980s, the addition to total national resources should be some 3% or more of gross domestic product.

Moreover, these resources accrue in forms which can be particularly valuable. All the oil produced either substitutes for imports or increases exports: in effect, the gain to resources represents an addition to foreign exchange earnings. Given that the United Kingdom has suffered from persistent balance of payments problems, this is no small benefit. But in stressing these benefits, I do not lose sight of the need also to look forward to a time when the output of oil will (on present knowledge and estimates) begin to fall. The bonus of North Sea oil to the UK economy will be immensely valuable, but it will not last for ever.

In thinking about how to use this bonus, we have to keep in mind the sort of economy we need to have when the bonus is declining. In general terms, the answer is straightforward: we shall need an economy which is stronger externally and stronger internally than we now have. The essence of the problem of making effective use of North Sea oil is to convert a temporary bonus into a permanent gain.

Let me now turn for a moment to our domestic financial scene.

Although very much smaller than forecast, we have a large Budget deficit. This is indeed a common phenomenon in many countries, as you would expect, seeing that most of us are still suffering from the effects of recession.

A main reason for the size of the deficit was the rapid rise of government spending since 1973, under the present Government and its predecessor, partly by design and partly because of insufficient control. On both counts, there have now been important changes. Last year, a very determined effort was made to re-establish control – starting with cutbacks in July and further cuts in December, and including a new system of cash limits over a large part of the field. On the evidence of the figures for last year, the rise of public spending has now been stopped. This financial year it is expected to fall – by 2% to $2\frac{1}{2}$% – in real terms.

There has been general agreement that the level of taxation, and more particularly direct taxation, has been too high and is having a stifling effect on the desire to earn and to work – a view with which the Chancellor of the Exchequer has publicly agreed. The room for tax cuts this year was limited – most notably by the undertakings we gave to the International Monetary Fund. But there has been opportunity to make a beginning. As you will have seen, the recent Budget provided for sizable cuts in income tax at all ranges of income, matched in part by increases in some indirect taxes. It is possible that, as the Chancellor has indicated, we will be able to make a further cut in income tax in the summer, when the prospects for wages and prices should have become clearer.

Our worst domestic problem has been inflation. Each country has its own way of trying to deal with this, and I know that many of you will be sceptical of the efficacy of deals with organised labour – which are sometimes called 'incomes policies', or agreements on pay restraint. This approach is certainly very far from a sure-fire method. On the other hand, the role of the unions is larger when a large part of the work force is unionised – as 45% is in our case, compared, I believe, with about 25% in yours. Ultimately, the defeat of inflation depends on the strength of the popular will to defeat it. We now have that will. And we have made progress, though not enough. Two years ago, retail prices were rising at the rate of 25% a year. A year ago, we had reduced it to half that rate. Progress since then has been interrupted, not by rising domestic costs, but by the depreciation of the exchange rate last year. Now, with a more stable exchange rate, we ought to be able to make further substantial progress – depending on the course of domestic costs, and in particular wages. Negotiations for the next stage of incomes policy are now about to be engaged.

You would expect of me, as a central bank governor, to emphasise that reliance on methods of direct pay restraint provides no substitute for proper control over the monetary aggregates. Since I do indeed take that view, let me give you some indications of our record. Over the last three years, the increase in our money stock on its broader definition (which we call sterling M_3) has been under 10% a year. This is roughly comparable with the increase in your M_2, which has, I believe, averaged 8% or 9% a year over the same period. Considering that our pace of inflation has been much higher, this implies that monetary restraint in the United Kingdom has been pressed with considerable determination. Indeed, the money stock in the United Kingdom has, over the last three years, increased at little more than half the pace of national product at current prices.

These figures may come as a surprise. It is certainly true that we have had short periods of more rapid expansion of the money stock – most recently last year, in the disturbed conditions of the summer and autumn. The relatively short-lived expansion of the money stock last autumn has since been reversed, as a result of the measures we then took; and for the last financial year as a whole, M_3 will show an increase of well under 10% – well within the targets we, like you, are now setting ourselves. For the present financial year just started, we look to a growth of M_3 of 9% to 13%.

This brings me towards the end of the points I thought I could usefully make to you concerning my own country. Let me now turn aside to look at international financial prospects over a wider horizon. The broad picture I start with is one of large imbalances in the pattern of external payments. This raises both adjustment problems and financing problems. There are very many other countries, aside from the United Kingdom, in both the developed and developing world which, in the three years since the emergence of large OPEC surpluses, have accumulated external debt at least comparable in proportion to the debt incurred by the United Kingdom. And most of these other countries have no prospect of any structural change similar to that in prospect for the United Kingdom, which will help to bring about the early restoration of their external positions.

This cumulating international indebtedness adds immeasurably to the problems of international economic and financial management and distinguishes the present situation from that which we faced three years ago. If, in the years to come, this situation were to be seriously mishandled by any of the various agents in the international monetary system – by governments and their officials, by the international institutions, by us central bankers, or by you commercial bankers, who have played, and must continue to play, a major role in international financing – there would be considerable consequences both for world economic activity and for the stability of the international financial structure. I take this situation as my principal theme, and I want to emphasise strongly that, in speaking about it, I shall be trying to look at it on a time scale beyond the immediate future, and from the angle of vision of a central banker, who must have in view the actions and reactions of governments, international institutions and banking systems (including central banks), all of which have, in my judgment, important, and interconnected, parts to play.

Perhaps even to you I might begin by recalling some of the salient facts about the recent pattern of imbalance.

The major element is, of course, the continuing large current account surplus of the OPEC countries, initially rather smaller than originally predicted, but nevertheless in the three years after 1973 totalling no less than $140 billion. And because it is now largely concentrated on the low-absorbing OPEC countries, we must expect a large OPEC surplus to continue as a dominant feature of the international financial landscape for some considerable time to come.

The deficit counterpart to this OPEC surplus has been very unevenly distributed among oil-importing countries. Indeed, a handful of oil-importing countries have run sizable current account surpluses. The three largest such economies – the United States, Japan and Western Germany – together with Switzerland and the Benelux countries, have shown a cumulative aggregate surplus, over the 1974–76 period, of nearly $40 billion.

Most other countries have necessarily incurred deficits. In the United Kingdom, Canada, France and Italy – taken together – the deficit over the same period amounted to some $50 billion. Other OECD countries ran a similar aggregate deficit. Non-oil developing countries collectively recorded an even larger deficit – of nearly $80 billion.

By and large, the world has coped with these enormous imbalances far better than most people expected, thanks in no small measure to the very constructive part played by the international banking system in the recycling process. And despite a worrying undertow, there has been no general relapse into restrictions on international trade and payments; and no outbreak of competitive exchange rate manipulation.

But we certainly cannot afford to relax. There is not much evidence in present forecasts to suggest an early general movement towards a better distribution of surpluses and deficits. The persistence of the general pattern of imbalance means that we are managing to live with our problems rather than succeeding in solving them. The danger is that, as time goes by, and the indebtedness of the persistent deficit countries mounts, these problems will become more insistent, and the risks of trade destruction or financial disruption could then become serious.

I believe – and I want to emphasise this – that, except perhaps for one or two smaller individual countries, that time is still a long way off. But there is no denying that it is nearer now than it was three years ago. It is crucially important, therefore, that governments should turn their attention to the more effective operation of the international adjustment process, as no doubt they will be doing at the important international conferences planned for later this month and next. There are here a number of problems which interlock and are not easy to solve.

The starting point for accelerating adjustment must be the oil imbalance itself. In terms of the actions available to the oil-importing countries, a faster reduction in the counterpart deficits to the OPEC surplus can only be achieved through greater economy in the use of oil, both by conservation and by the development of alternative sources. Collectively, the industrialised oil-importing countries have not hitherto done enough in either of these areas, and I very much hope that the new United States Energy Department will provide a new impetus to more effective energy policies in your country, and that this will prove to be contagious.

But however vigorous, it is likely to be some time before action in the energy field has a major effect on the international payments imbalance, and for the more immediate future, attention is likely to focus on improving the distribution of surpluses and deficits among the oil-importing countries. And here there are, it seems to me, a number of things which must be done.

First, there is an onus on the deficit countries everywhere to take whatever steps may be appropriate for them to bring their economies back towards balance. I have already said something about the United Kingdom's efforts to this end, and looking around the world, one sees that most of the larger countries in a weak position, which are also those countries suffering from particularly high rates of inflation, have in fact been taking corrective action.

Restrictive policies – though necessary – are not of course easy for deficit countries, which are typically already suffering from exceptionally high unemployment. And if the burden of adjustment is left entirely to deficit countries, this would be likely to impart an undesirable downward bias to world expansion and trade. Moreover, carried to extremes, pressure on deficit countries to adjust in present circumstances could precipitate just the disruption which it was intended to avoid. There is, therefore, a parallel need for adjustment by the stronger countries which currently set the pace for the rest of the world.

In terms of the level of world activity, faster growth in the surplus countries is clearly a more constructive approach. But, just as it is difficult for deficit countries to initiate adjustment, so too it is difficult for a stronger economy to judge how far it can go in stimulating demand without the risk of rekindling inflationary expectations. Here also, there is a danger of carrying things to extremes. If too much emphasis were placed upon the expansion of demand in the stronger oil-importing countries, the result could be a resurgence of inflation that would be contrary to all our interests; at the same time, the overall oil imbalance would tend to become even larger. Nobody wants a sudden and sharp stimulus, with the danger of subsequent relapses into deflation. But, given the tensions that could emerge if adjustment is left wholly to deficit countries, it is essential that the stronger countries play their part; and, following the lead recently given by the United States, I am hopeful that we may look forward to a steady expansion in the largest economies over the next two or three years. The threat of inflation must, however, mean that such help as we can expect from this quarter will be somewhat limited in relation to the overall size of the problem of imbalance, and this, I believe, carries the implication that the externally stronger countries will need to continue to play a very important role in the financing of world deficits.

Another necessary element in the process of accelerating adjustment among oil-importing countries is through exchange rate changes. To be effective in reducing the export-dependence of some of the stronger industrial economies, such changes would need to go beyond those necessary simply to offset differences in rates of inflation. But it is clear that, in the conditions that have prevailed recently, exchange rate adjustment is not a panacea either. In the short run, there is a tendency for markets to produce a bandwagon effect, with exchange rates moving well beyond what is appropriate on grounds of competitiveness. Depreciation on account of current account deficits is thus less readily offset by compensating capital inflows. For deficit countries, as we have recently experienced in the United Kingdom, the price consequences of falling exchange rates work against efforts to reduce inflation, so that the effectiveness of the exchange rate change may be reduced, even over the longer term. And there may be a converse tendency in surplus countries. Certainly, one cannot rely upon exchange rates to produce a rapid correction of imbalance. I conclude, therefore, that while exchange rate adjustment is a part of the solution, it too is not the whole solution.

I have dwelt on the adjustment process at some length, because this is an important part of the problem ahead. But I do not wish to suggest that the problem is easy, or that the adjustments which it would be realistic to expect of individual governments will quickly produce a relatively balanced position.

The responsibility for adjustment policy lies with governments rather than with commercial bankers. But how well, or how badly, governments and official agencies manage to deal with the underlying imbalance will have a crucial bearing on world activity, on inflation and on unemployment; it will decide, too, how far we remain successful in preserving an open international system of trade and payments. So, too, it will determine the climate for commercial banking activity in both national and international markets. A complete solution to the situation would require a series of complementary actions – as I have said – in the fields of energy policy, and differential demand and exchange rate management. And there are perhaps some signs that the world is at least moving in the right general direction in these various areas. Nevertheless, with the best will in the world, we cannot look to the early elimination of imbalance, given its present scale. One solution might be to accept a longer period of adjustment than would normally seem desirable, with the object of avoiding an excessive deflationary bias to world activity. This, however, raises difficult questions regarding the appropriate criteria for granting loans, and for the acceptability of growing debt burdens by borrowing countries. Whatever solution is found, there clearly seems need for continuing international financing on a very substantial scale and for a considerable period ahead; and it is to the nature of this financing need that I now turn.

Perhaps the most striking characteristic of the huge international financial flows so far, is the extent to which they have been channelled through the international banking system. Thus, over one third of the cumulative OPEC surplus – some $50 billion – has been channelled into bank deposits. Similarly, to take an example on the lending side, well over one half of the aggregate deficit of the non-oil developing countries since 1973 – around $45 billion – has been financed by net borrowing from the banking system. This is four times the amount that these countries in aggregate have borrowed through the International Monetary Fund and the International Bank for Reconstruction and Development.

This heavy reliance on the banking system has aroused varying degrees of concern on the part of both the regulatory authorities and many commercial bankers themselves.

One can well understand how this reliance on the banking system has come about. The OPEC countries regard their surpluses as the transformation of their finite national resources from oil in the ground into financial assets. They naturally look to avoid risk by investing initially in the safest and most liquid forms. Borrowing countries, in their turn, have been happy to resort to the banks, where finance has been readily available and without policy strings. It is a notable fact that, during this period, drawings on the IMF have been confined very largely to the Fund's facilities – both special and normal – with a relatively low degree of conditionality. Nor can one claim that the banks themselves have played a totally passive role: faced with depressed domestic loan demand, they have had a considerable incentive to search for other assets.

Despite the problems, the intermediation of the international banking system has played a big part in bringing us to this point without serious mishap. Indeed, the experience of US banks with foreign lending, as I understand it, seems so far to have been more favourable than with domestic loans. However, the past cannot be taken as an infallible guide to the future, and I believe it is right now to ask the question: How far can this pattern of financing properly go on?

In many ways, it would be helpful if more of the flows, which – as I have said – will continue to be necessary, could be channelled directly from lending to borrowing countries, for example, through equity and bond markets or through more inter-government lending. In particular, if project financing were to shift to an equity, rather than a fixed debt, basis, this could provide considerable easement of debt servicing problems. And there are market factors that will tend to encourage some of these developments. Nevertheless, there is no doubt in my mind that the demand for bank intermediation will remain very strong.

The more substantive doubts, which some have raised, concern the willingness of the banks to continue in this role, and of regulatory authorities to allow them to do so on anything like the recent scale.

As far as the banks are concerned, I think it most unlikely that we shall see any sudden contraction of the gross amount of international lending. The damaging consequences – not least to the banks themselves – of any abrupt action of that kind are well recognised, and the banks have already demonstrated their sense of responsibility in dealing with any difficulties that have emerged, where necessary by stretching out or renewing their lending.

But, as I have emphasised, the need is for a continuing net flow of financing; and here there must be more uncertainty if one looks beyond the next couple of years or so. For the immediate future, any more restricted attitude towards bank lending by banks themselves, or their banking supervisors, is likely to be confined to lending to one or two particular borrowers. But against the background of continuing large imbalance, I can foresee the possibility of a situation in which country credit limits would be more generally approached. And the burden of my song is that we should begin to provide now against that possibility.

There are three broad areas in which I believe it may be appropriate that action should be pursued.

First, one of the facets of the recent situation has been the inadequate information available both to the banks themselves and to the authorities, with regard to the amount and structure of bank lending. Great strides have already been made – with our own strong encouragement in the Bank of England – to improve statistics in this area, the latest step being the information on the geographical distribution and maturity structure of a new and wider definition of bank lending now being collated by the Bank for International Settlements. This will, I am sure, be of considerable help in improving awareness of what other lenders are doing. I myself attach great importance to this, because I think you will tend to take the right decisions if you have adequate information.

Second, I believe that we should encourage a closer co-ordination or parallelism between bank lending and finance from the official international institutions. This need not – and probably should not – take a legal form, but we need, in my view, to think very carefully about whether it could not be more structured than it is at present. So far as the World Bank is concerned, co-financing arrangements with banks have already been developed. More recently, there have been some instances where banks have felt able to lend after a country has successfully applied for conditional IMF credit. These are promising developments. A greater involvement of the international institutions could provide a degree of policy assurance that is presently lacking, and could enable the banks prudently to lend where they might otherwise be reluctant. Though it would, and should, entail a shift of emphasis away from bank financing, it would at the same time lay the foundation for a continuing important role for the banks. And from the standpoint of the international institutions themselves, co-financing and parallel financing would in effect expand their resources, making their policy conditions easier for the borrower to accept. I hope that the Fund and World Bank will actively explore the possibilities in these areas in the period ahead, though lending to governments by the IMF and banks in parallel would, of course, have to depend on the willingness of the government concerned to deal with both.

Finally, if there is to be, as I believe there must gradually be, a shift of emphasis from bank to official financing, then it is incumbent upon the official side to ensure that appropriate financing facilities are available. This subject, too, will no doubt be debated in the coming international conferences.

Let me say in conclusion that my message on the international situation is certainly not one of alarm. There is, as I see it, no easy time ahead. But attention has increasingly been directed on the general question of imbalance, and the more serious pitfalls can be avoided through sensible international co-operation, not just on the part of governments and official institutions, but also among the world's commercial banks, and between them and the national and international official agencies, including central banks. Perhaps this is the thought that I would leave with you. It is a commonplace to speak of economic interdependence between nations; the present and prospective international financial situation, I believe, requires recognition of a broader interdependence, including the interdependence of the institutions engaged in international activity, whether they are in the public or the private sector.