Speeches by the Governor of the Bank of England

Given at the biennial dinner of the Institute of Bankers in Scotland on 17 January 1977.

I come tonight as a banker, and as a banker I must regard a visit to Scotland as something in the nature of a pilgrimage to the shrines of our profession. For, as is well known, we owe to you many of the most notable features of British banking; the cash-credit or overdraft system was essentially a Scottish invention. So too was the payment of interest on deposits. What may be less well known is that Scottish bankers can claim also to have invented the principle of the Exchange Equalisation Account: at the end of the seventeenth century, a little before the Act of Union, there were considerable exchange fluctuations between London and Edinburgh, and the Bank of Scotland set up a fund to steady the exchanges by purchases and sales of London and Edinburgh bills. I also discovered recently that it was the practice of the Scottish banks long ago, in times of stress, to hold each other's notes, which is the principle of central bank swap arrangements today.

But Scotland does not live on her history, and it is appropriate for me to say something about present questions. That said, I do not intend to venture on to the thorny subject of devolution, except to say that the Bank of England have, I believe, as close a relationship with the Scottish banks as with the English banks, and for my part I should be sad to see that relationship disturbed. Nor do I intend to talk about another matter which is important to you as bankers and in which we at the Bank also take a close interest – the financing requirements of the North Sea energy programme.

I want rather to say something about more general matters common both to Scotland and to the rest of the United Kingdom.

When I last had the pleasure of being your guest, it was, I recall, the day on which the result of the EEC referendum was declared. That major decision has been followed by others. I think, for instance, of the introduction of the incomes policy, needed as it was and subsequently successfully extended; and, more recently, the stop imposed on the relentless growth of public spending and the adoption of measures which we hope will restore better balance to the economy and provide a viable basis for recovery.

Last year also saw us announcing quantitative targets for the rate of monetary expansion. This brings me to my main subject tonight, namely monetary policy, which has of course to be seen as part of the Government's overall economic policy. In particular, it seems appropriate that I should discuss not so much our recent monetary actions but more generally what monetary targets are likely to involve, and give some account of the Bank's thinking on this matter.

In the past we have naturally had aims as to the rate of monetary expansion we wished to see, though before last year we did not announce them in terms of a quantified target for the money supply. At the end of 1973, for instance, we raised interest rates and introduced the supplementary special deposits scheme, with the object of achieving a reduced rate of growth of M_3. Our aim since then has been to keep the growth of money supply moderate. In the event, the growth of M_3 in the three succeeding years was in a region lying either side of 10%; and this was achieved in the early stages, largely no doubt because of the slowdown in the economy, without great difficulty. Last summer, however, there was a marked acceleration of monetary expansion, due to the concurrence of continuing high public sector borrowing, a resurgence of inflationary expectations, and increased bank borrowing associated with foreign exchange pressure. These developments forced us to a series of corrective measures. We are now back on course, and in line with the monetary aims stated by the Chancellor in July and explicitly formulated in October. Recently, we have agreed targets with the International Monetary Fund, which as you know have been framed in terms not of the growth of the total money supply, but of the growth of its domestic component – that is, of what we have come, for short, to call domestic credit expansion. I will come later to the reasons for this change of emphasis. Though domestic credit expansion is now given greater prominence, it is not of course a newcomer to the scene. We published over a year ago the figure which we provided to the IMF of the domestic credit expansion we foresaw in this financial year, and we expect the outturn to be within the figure of £9 billion then forecast.

What advantages do we see in having quantitative monetary targets? We start from the presumption, as I hardly need say, that monetary developments and monetary policy have important effects. Monetary developments affect the decisions both of firms and individuals. Too expansive a policy will unduly stimulate demand, exacerbate domestic inflation, worsen the balance of payments both on current and capital account – and thus tend to worsen the exchange rate, which, as we have seen, will also add to the rate of inflation. In the same way, too restrictive a policy, while helping with inflation and the balance of payments for a time, would unduly depress demand, swell unemployment and discourage industrial development and investment.

Second, a principal line of our thought is that it is useful to seek to be more precise about our monetary aims. This is helpful to us in formulating the aims of policy. It also appears advantageous to us to try to give the public a clearer idea of those aims. This in turn is helpful to the Bank in carrying out monetary policy.

Third, we have come to the view that, in present conditions especially, the best way of giving a clear indication of the thrust of monetary policy is to state quantitative aims for the rate of expansion of one or more of the monetary aggregates. It is sometimes argued that this is too simple an approach, given the complexity of the financial system, and that we should therefore pay regard to a wider collection of financial and real indicators. I think the answer to that is, 'By all means look at all relevant factors when setting the target; but let us try to define clearly what we are aiming at.' The growth of the monetary aggregates, properly related to the circumstances of the time, is perhaps the best indication of monetary conditions; and targets set in terms of monetary aggregates are useful in providing checkpoints against which current developments can be compared and monitored.

I have sought to make the general case for having monetary targets. I must now say something about the factors which should, in our opinion, determine what numbers we choose as our targets.

Major considerations affecting our judgment about the appropriate rate of monetary expansion have been the pace of inflation and the balance of payments. In recent years, both have in our view called for a relatively restrictive stance of monetary policy. One purpose of announcing monetary targets is to serve notice that excessive increases in domestic costs will come up against resistance. If people believe that the money supply will be expanded to accommodate any rise in costs and prices, however fast, inflationary fears are likely to be increased. If, on the other hand, people are convinced that the rate of growth of the money supply will be held within well-defined limits, this should help to reduce inflationary expectations. Monetary policy should therefore aim to act in concert with other branches of policy, including incomes policy, in slowing down inflation. For these reasons, there has appeared to be a good case in recent years for aiming at a rate of monetary expansion below the increase in money national income. Over the last three years, as I have indicated, the money stock has risen, broadly speaking, by about 10% a year, while the money national income has risen nearly twice as fast.

Though we have agreed our monetary targets with the IMF for the period ahead, this does not mean that the targets are entirely inflexible. While we do not expect it to be necessary, it is open to us to review the targets with the IMF if they appeared to be leaving insufficient room to meet the financial needs of industry.

In general, I do not take the view that monetary targets can sensibly be fixed for all time in accordance with a predetermined formula. There are perhaps two main reasons for insisting on the need for some degree of flexibility. The first is of a somewhat technical character. In the United Kingdom we have not recently been able to observe a continuing stable relationship between money and incomes. Moreover, there can be structural changes in the financial, and more particularly within the banking, system which can change the amount of money that the economy needs. Second, and more fundamental, we need to look, as I have already said, at what is happening to the economy at large. For the true objective of policy is not to keep monetary expansion at a particular level; but to bring about a reduction in inflation and a recovery in employment, growth and the balance of payments.

I appreciate that many monetarist thinkers would, in principle, prefer an unvarying figure or – if we start off course – a pre-set approach to such an ideal figure. While maintaining a need for discretion, I do not have in mind sharp variations in the rate of monetary growth and would emphasise that the flexibility required is likely to be limited. Other central banks which have adopted monetary targets have retained a degree of flexibility, for instance in choosing bands for the rate of growth of their chosen monetary targets or in providing for the updating of the targets, as appropriate. For those who require reassurance I would suggest, too, that if we continue to have publicly announced monetary targets in the years ahead, as I think we should, changes in the targets will need to be justified; this in itself is likely to provide a protection against excessive variation.

We have stated our monetary aims for the years immediately ahead in the form of targets for the domestic component of credit expansion – not for the total growth in the stock of money as measured, for instance, by the M_3 statistics. I must now say a word as to why we thought it best – and why the IMF thought it best – to couch our aims in this form.

The difference between domestic credit expansion and M_3 mainly comprises what might be called the foreign component of credit expansion – very roughly, the balance of payments position on current account plus net private sector capital flows. There are two reasons for choosing a DCE target rather than a money supply target in present circumstances.

First, an excessive growth of domestic credit is likely to be associated with a worsening balance of payments, both directly, if surplus liquidity leaks abroad, and indirectly, if the excessive growth undermines external confidence.

The second consideration is that it is the domestic element of credit expansion that is most directly under our control. To focus attention on DCE as a control variable appears the best means of ensuring that the domestic financial situation is kept under the proper degree of constraint, especially when the need remains to rectify our external payments position.

We will, of course, also continue to keep an eye on the results in terms of total monetary expansion; and later, as the situation changes, we may again find we wish to make that our primary target variable. Thanks in part to North Sea oil, we can look forward to a situation developing when our large current account deficits are transformed into sizable surpluses. In this situation, it could be advantageous to go back to a money supply target.

As you know, the DCE limits we have agreed with the IMF that we will observe are £9 billion in the twelve months to April 1977 and £7.7 billion in the ensuing twelve months. So far, we have done well in pursuit of this aim. Since the end of September we have made extremely large sales of gilt-edged stocks and, mainly as a result, I would hope that DCE in the quarter to mid-January may turn out to be very small. For reasons I have already indicated, we found it necessary to take restrictive measures last autumn, raising minimum lending rate and reintroducing the supplementary special deposits scheme. One purpose of these measures was to reduce the rate of increase in bank lending, and there are signs that this is beginning to happen. This will help to retain DCE below the agreed limits.

We are aware of the strains on banks, such as your own, and on your customers that this produces. As we see it, the company sector has been improving its profit situation, but from a low base. Investment has also been recovering, but again is still low. In aggregate, companies' financial position has therefore been improving – and is likely to continue to do so. But the situation increasingly varies from company to company. The oil companies are beginning to reap the fruit of their massive investment; and profits in exporting have been generally much improved by the exchange rate movements over the last year. For many small firms, however, and big firms in industries not export-orientated, financial prospects may be less favourable. We do not want industry to be starved of funds, but neither can we risk the injection of excess liquidity into the system. We shall therefore continue to keep monetary developments under very close review.

There is a further observation I should make on targets. When we see that the situation requires adjustment to maintain the desired trend, we can respond quickly, but I must emphasise that the financial system takes time to adjust fully to our actions. Attempts to push too hard for quick results would be thoroughly destabilising. It is not always desirable to react to a single month's divergence, or possible to get back on course within a few weeks.

From what I have said, you will see that for the period ahead the authorities have a framework for firm decisions, and for keeping a grip on monetary developments. This should be a helpful contribution to other aspects of economic policy. . . .

Given at the annual banquet of the Overseas Bankers Club, on 31 January 1977.

In the depths of winter, and at the beginning of the year, there is a natural human tendency to look for turning points in our affairs: first to hope, then little by little to believe, that the worst is behind us and that as the days grow longer our difficulties will melt away. In the United Kingdom at present, after a particularly difficult year, this temptation seems especially strong. There are, happily, some real grounds now, not for a violent alteration from despair to euphoria but for a more temperate change of mood. Despair is certainly a worse counsellor than hope: but euphoria can be as treacherous as despair. What I should like to try to do tonight is to strike a balance between possible attitudes to the future.

I turn first to the wider international scene. Here certainly it is encouraging that the pause in the growth of the major industrial countries seems now to be coming to an end, and that inflation rates generally are now lower than they were a year or so ago. But having said that, one cannot be satisfied with the present or the immediately prospective situation. Inflation rates remain historically high in virtually all countries; and dangerously high in many. This is all the worse since hardly any dent has yet been made in the enormous total of nearly fifteen million unemployed throughout the industrialised countries and, indeed, in a number of countries unemployment is still rising.

There has been only a relatively modest contraction in the surplus of the oil-producing countries. This has meant that the non-oil developing nations, squeezed between slack demand for their products and the still rising costs of their imports, continue to run an enormous aggregate deficit which shows little sign of diminishing, while within the industrial countries the distribution of surpluses and deficits remains dangerously unbalanced. The dangers are all the greater since the industrial countries as a group will inevitably continue to have a large deficit as counterpart to the surplus of the oil-producing countries, so that the deficits of the weaker industrial countries are abnormally large and continuous.

If we are to achieve some improvement in this position, 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 reassess their policies and to take whatever steps may be appropriate for them to bring their economies back towards balance. I shall say something about the United Kingdom's efforts to this end in a few moments; but looking around the world, one sees that most of the larger countries in a weak position have, in fact, been taking corrective action.

Second, there is a need for adjustment by the stronger countries which, in present circumstances, set the pace for the rest of the world. It is difficult for a deficit country, already suffering from high unemployment, to take restrictive action in the interests of restoring balance. So also it is difficult for a stronger economy to judge how far it can go in stimulating demand without risking a rekindling of inflationary expectations. Nobody wants a sudden and sharp stimulus, with the danger of consequent fall-backs later. But the time would now seem ripe for a co-ordinated, steady and sustained expansion by the largest and strongest economies, with the aim of bringing unemployment rates steadily down over the next two or three years and providing a complementary adjustment to that being sought by most of the countries in deficit. The United States has already given a lead.

I have spoken of the need for reciprocal adjustment policies first, because I believe that these have the highest priority: they are due – indeed, overdue. But the magnitude of the adjustment task, between the oil-producing and oil-consuming nations of the world, and among the industrialised countries themselves, is still too great to be accomplished quickly. It is inevitable that many countries, however valiantly they pursue the path of virtue, will have substantial deficits to be financed for some years to come.

Here lies a third task – and one that will have to be shouldered jointly by official and private institutions. Gathered here tonight are leading representatives of the world's banking community who have managed the unprecedented financing task of the past three years with exemplary efficiency and smoothness. Many deficit countries have, indeed, relied very heavily on bank finance to the relative exclusion of the regular facilities available from the International Monetary Fund. If we are to continue to see an orderly financing of the world's irreducible deficits over the next few years, the balance – as I foreshadowed last year – will now have to change somewhat. Official facilities will have to be used more widely.

At one time, the international banks probably regarded a borrowing country's undrawn IMF facilities as important collateral. Now, I suspect that the emphasis is changing. For many countries, the extension of private borrowing will depend increasingly on the utilisation of official credit facilities, with their attendant conditionality provisions. In this way, an informal collaboration between official and private finance seems likely to grow. This is a welcome development; but it may not be sufficient. It is for consideration whether there should not be some enhancement of the range of official facilities now available.

I turn now to the United Kingdom, hoping our friends from abroad will forgive a little introspection. Can we find some green shoots here in our native snow? I believe the answer is 'Yes', though I give it with all caution and would rather whisper than shout it.

1976 was a bad year for the United Kingdom, a year when, by an inevitable retribution, we paid for earlier errors. Many of its unhappy features are still with us. Inflation and unemployment both remain much too high; such recovery in output and investment as we are seeing is still slow and hesitant. The balance of payments is still in deficit. The public sector's need to borrow remains exigent, while at the same time our system of taxation imposes too heavy a burden on initiative at all levels of society. Our most fundamental problems, therefore, are still with us.

We have, however, gone some way towards tackling them. By a variety of actions we have now, I believe, established firm financial control both domestically and externally; and though financial control is not a sufficient condition for economic balance and prosperity, it is certainly a necessary one. With your indulgence, may I review some of the recent developments?

First was the way in which the Government have both gained control over their expenditure programmes and embarked on the very necessary, but painful and difficult, path to reduce the programmes themselves.

Second was the authorities' espousal last summer and autumn of an announced target rate of growth for the money supply. I have recently spoken at some length about the thinking underlying this approach, and I need say no more tonight than that I am sure it provides an important and positive contribution to policy. We can certainly claim to have demonstrated clearly, by the monetary measures we took last autumn, our determination to stick to target rates once announced. You will perhaps allow me the satisfaction of remarking that most of those who then proclaimed the impossibility of our achieving our target for the current financial year now accept that we are, in fact, likely to do so.

As a result of these fiscal and monetary measures, the Bank have recently been able to sell government stock on a very considerable scale; the rate of expansion of credit has been contained, and it has also been possible for interest rates to come down from last autumn's crisis level.

These adjustments in our domestic policy stance have had important consequences for our external monetary stability. The International Monetary Fund has, as you all know, made available to us a standby of \$3·9 billion, and exchange market confidence has notably revived.

Several recent developments have marked an official recognition that some contraction of sterling's international role is necessary. Late last year we had to reduce substantially facilities for the use of sterling to finance third country trade. This has, I know, caused some difficulties for many long-established trades, especially as it was naturally not possible to give any prior warning. The necessity for the changes has nevertheless, I think, been widely understood, and I believe that the transition to new arrangements is proceeding as smoothly as could be expected.

More fundamentally, we reached agreement in Basle earlier this month on arrangements which will involve a deliberate phasing out of sterling's residual reserve role, while at the same time ensuring that the exchange rate and the reserves will be protected from any potentially de-stabilising effects of outflows from official sterling balances. Such movements have never, I believe, been an initiating factor in disturbing the exchange rate, but there is no doubt that the potential overhang has at times been unsettling to the market. The new agreement should therefore provide a helpful degree of stability to sterling.

The foreign currency bonds which we shall be offering to existing official holders will, I hope, prove attractive and contribute to a reduction in the reserve role of sterling. There will, of course, be no compulsion and no infringement of the holders' rights to manage their own portfolios. Private holders will not come within the scheme, but it should give them an added assurance of stability in future. Nor, of course, do we intend or wish in any way to discourage overseas direct investment in the United Kingdom. It is, however, our firm intention to finance any future deficits by fixed-term borrowing, rather than by volatile short-term inflows.

This intention has been underlined in the past week by the \$1·5 billion loan raised for the Government. We must be prepared for a continued external deficit for most of this year; and this may be on a scale too large to be financed by the balance available this year under the IMF standby. We therefore thought it prudent to ensure that our needs would be covered by medium-term finance. The terms under which the loan was made available by a group of very large international banks are an indication that the markets believe we have turned a corner. This can also be seen in the foreign exchange markets where the Bank, reversing the experience of 1976, have been able to take in sizable inflows in replenishment of the reserves. It is important to remember that in large part these inflows will have been due to the unwinding of a very substantial adverse position built up over the past year and the once-for-all running off of sterling traditionally employed in the finance of third country trade.

This series of steps, in combination, has made our external position much sounder and gives us a better chance to cope with our problems. But to pretend that the immediate future will be easy would be a delusion. The borrowings we are making will provide a breathing space. But they have got to be repaid. There is still a deficit in the balance of payments; its rapid elimination, a cardinal aim of policy, is still to be achieved; so too with inflation, where much will depend on the negotiations for the next stage of incomes policy. We need as a first step at least to halve the rate of inflation again; this may prove far from easy. While the balance of payments remains uncorrected, and inflation too high, we cannot afford to restimulate the economy. Greatly strengthened though our position has been, we face a further year of austerity and restraint, and consequent delaying of our economic, and industrial, recovery.

Looking further ahead, however, there is indeed a prospect that the situation will ease. I am thinking of the time – further ahead, yes, but not that much further – when our balance of payments should be in substantial surplus, largely because of North Sea oil. The uncertainties of forecasting are very great. Nevertheless, we can perhaps see enough to envisage a world rather different from that of the immediate past and to discern the shape of the problems which that world will bring.

We are at a point of transition. Last year, North Sea oil affected the current account of the balance of payments adversely. The imports needed to develop the oil fields, together with interest and profits going overseas, exceeded the value of the oil produced. This year, as output grows rapidly, there will be a sizable, positive contribution. There should be a net gain to the current balance of well over £1 billion compared with last year.

By the early 1980s, the additional resources at our disposal each year from the North Sea could amount to some 3% of GNP. The challenge will be to use the additional resources wisely in circumstances when there will, as usual, be no shortage of claims on resources.

It will be wise, in my view, to ensure that there is, over the next half-decade or so, a massive improvement in our net external asset position. We have accumulated, and are still accumulating, a huge burden of medium-term external debt: some $20 billion of borrowings already drawn on or arranged will fall due for repayment between now and 1985. In addition, further medium-term repayment obligations will be generated as a counterpart to the reduction in liabilities held as official sterling balances. There is also a strong case for a higher level of reserves. We must therefore move into very substantial current account surplus, and stay there for years, while this major transformation of our external financial position is being accomplished.

I know there are figures which show that the potential benefits to the balance of payments from North Sea oil and gas are such that the transformation I am talking about can be managed without great difficulty. But these are figures which assume that all the benefits from the North Sea go to improve the balance of payments. In fact, there will be a series of difficult choices to be made and many contrary pressures. There will need to be conscious decisions to ensure that sufficient resources do go into improving the balance of payments; and I am saying that we shall be poor stewards of our national wealth if we do not recognise this as a first claim on additional resources.

The really important, indeed crucial, aim is to get our present industrial economy functioning properly; that will take all our energies and determine our future prosperity. For the oil will not, of course, last for ever.

We could, I suppose, if we were sufficiently short-sighted, let ourselves for a while become dependent on oil to pay for our imports; and allow conditions to develop in which our industries turned away from exporting and ceased to develop. If we did this, our future thereafter would be bleak indeed. To prevent it happening will require a positive, sustained firmness of purpose, and a general confidence that the necessary conditions for industry to prosper will be maintained. Above all, this means that inflation must be conquered. Only on that basis can we provide companies with confidence that exports will remain competitive and investment, especially for exporting, will be worth undertaking. Only on that basis can unemployment be brought down. The exploitation of North Sea oil itself will generate few jobs.

In short, it is not true that when North Sea oil flows in a big way, our problems will be over; and it would be dangerous if we allowed ourselves to think so. It will give us new opportunities; I hope that we have learned enough from previous mistakes to use the opportunities provided and to start now to think what this involves. . . .