Speeches by the Governor of the Bank of England

Given at the biennial dinner of the Institute of Bankers in Scotland held in Glasgow on 22 January 1979.

You have shown me a flattering partiality by your invitations over these last years. In 1975 I was privileged, with my wife, to be one of your guests at your centennial dinner here, when the Chancellor of the Exchequer addressed us and was able to point to the benefits of North Sea oil which were then in prospect, and also to comment on the referendum on the Common Market whose positive results became available that evening.

I was also your guest at your biennial dinner two years ago in that other place. On that occasion—shortly after the agreement with the International Monetary Fund—in the course of some rather unremitting observations about monetary policy and the importance of monetary targets, which you were good enough to endure with Scottish fortitude, I observed:

> 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.

I think I can say that events since then have justified that expression of faith. There have of course been difficult patches, and firm decisions have indeed been needed; but monetary developments have been kept broadly on track during the period, while the exchange rate has shown a gratifying stability. These factors have been a helpful contribution to other aspects of policy, for example, in permitting a renewed expansion of output and ensuring a substantial reduction in the rate of inflation. But you will want to know where we stand now and where we are going from here. Perhaps, in view of the immediate difficulties and uncertainties, you will permit me a somewhat circuitous approach to these questions, and thus a wider view of the terrain.

I start with the theme of North Sea oil, partly because the banks, and not least the Scottish banks, have played an important part in its development and partly because the possession of so vast, albeit finite, a resource in a world so heavily dependent on oil is an economic factor of crucial importance.

The enterprise of bringing North Sea oil ashore and the financing of that enterprise are, of course, major success stories in which both the oil and the financial technologies involved have shown themselves highly adaptive. Capital spending for development and exploration in the North Sea is currently running at more than £2 billion a year and has created both a need for finance and a very large new market for British industry. Well over half of the cumulative net amount spent on North Sea investment so far has come from the resources of the oil companies themselves, but these companies have come increasingly to rely on outside sources of finance, and bank lending in particular. It is a tribute to the flexibility and vigour of those involved that this massive development has not been held back by any constraint on the provision of finance. On the latest estimates, UK banks are probably now meeting about a third of the outstanding financing requirement in support of North Sea operations and UK companies are now meeting about two thirds of North Sea supply orders. Both these proportions are considerably higher than two or three years ago, and the expertise and capabilities that we have now developed surely equip us to achieve still higher UK shares.

Our horizon should not of course be limited to the North Sea, important though it is. Oil and gas exploration and development elsewhere in the world are assuming increasing importance and we now have, as our own production approaches self-sufficiency, an excellent opportunity to develop UK exports of supplies, equipment and related financial services. I emphasise the importance of such enterprise. As a mature industrial nation, a key element in our future prosperity will be the extent to which we can develop and exploit our capability in new areas of activity where we have a competitive edge. The challenge and the opportunities are there.

I want to turn now to the way we are using the benefits derived from the exploitation of North Sea oil. It is one thing to deploy massive expertise successfully and another to ensure that the benefits therefrom are prudently used. The significance of North Sea oil is that it provides us with an unparalleled opportunity radically to improve both our industrial capacity and our whole economic performance—and with it a vital test of our will to do so. It is a chance which, in the nature of things, is unlikely to recur.

There was a good deal of debate four years ago about the priority of different claims on the resources to be released by the exploitation of the North Sea. Much of the concern then, very properly in my view, was to use these resources to strengthen our domestic capital base and to improve the balance of our external assets and liabilities. Yet we now see that the contribution of some £5 billion made by North Sea oil to our GDP over the past four years has been very largely matched by the strong growth in personal consumption recorded last year—a growth satisfied importantly by imports. This reflected the combination of the very rapid growth of nominal earnings, the reduction in taxation and the relatively strong sterling exchange rate (itself partly a consequence of North Sea oil) that has helped significantly to moderate the rise in prices over the last two years. Even though personal consumption had been depressed for the preceding three years or more, and though we could not expect to see output and activity start to revive except on the basis of some rise in consumer spending, we cannot in my view regard the pattern of demand in 1978, and only a marginal surplus on the current account of our balance of payments, with much satisfaction.

Looking ahead, however, the combination we had last year of fast increases in earnings and a much lower rate of price inflation cannot persist. Without doubt the best outcome now would be a moderation in the growth of nominal earnings which would underpin rather than undermine the substantial progress that has been made in bringing inflation down and which would check the erosion of our competitive position.

The sadness of this winter of discontent, however, is that it is taking us in precisely the opposite direction. Inflation is being refuelled and threatens the competitiveness that we so much need to maintain both in overseas markets and at home. The rise in costs is not moderating. Pressure on labour costs is now worsening and companies are in general in no position to absorb sharp further increases; and it has to be emphasised that, in this situation, the unavoidable consequence of action designed to prevent such excessive cost rises from being passed on in higher prices will be some forced curtailment of profits, production and employment.

It is not a central banker's prejudice or apprehension, but a fact of economic arithmetic, that a rise of some 2% to 3% in national output accompanied by a rise of 10%, 12% or 14% in earnings must increase the cost of that output, causing accelerating inflation, or increased unemployment, or some combination of these evils. For a time, because of some stroke of good fortune like North Sea oil, or falling world commodity prices, real earnings may be able to rise faster than output. But what requires constant proclamation is that the only route to sustainable higher income and wealth for the nation as a whole lies through increasing output per man.

Some current attitudes, expressed in absurdly high claims, in the frustration and even destruction of production, and in disregard for the position of those with less industrial or physical muscle, do nothing whatever to increase our standards of living. They are irreconcilable with any rational economic strategy or social purpose.

Adam Smith, one of the greatest sons of the university of this city, paid close heed to men's desire for bettering their condition: in his words, 'a desire that comes with us from the womb, and never leaves us until we go into the grave'. But you will recall that this quest for self-advancement and the competitive urge to which it gives rise are moderated in Smith's view of society by man's rational and moral faculty which enables him to create and participate in institutions which work to the common good.

We all want to see an early end to the present strife and chaos. But we should be under no illusion that there can be any long-term and durable solution that does not involve substantial change in the structure of our pay bargaining. It is not for a central banker to determine where the answer lies, but I have no doubt that finding and applying a satisfactory answer has now become an indispensable condition for the maintenance, let alone the improvement, of our present living standards.

What is squarely within my bailiwick is a responsibility for the currency. I referred earlier to the major contribution made by proper restraint of the money supply within a published target to the restoration of financial stability. This, together with appropriate fiscal restraint, has not lost but gained in importance in the present climate. Despite the addition to inflationary pressure that is now in prospect, there must be no loss of resolve in adhering to these now, when they are most needed.

Given at the annual banquet of the Overseas Bankers Club on 5 February 1979.

We are nearing the end of a decade marked by world-wide economic turmoil—an inflationary boom, a sudden leap in the price of oil, a further spiralling of inflation, and deep and prolonged recession which has left world economic activity and trade even now relatively subdued. We have seen the severing of the link between the dollar and gold and the break-up of the fixed exchange rate system followed by general and sometimes disorderly floating. We have also seen the emergence of large and persistent balance of payments disequilibria—surpluses and deficits on a scale not previously experienced.

Simultaneously there has been a continuous and rapid growth in international banking activity. Banks' external assets have grown at an annual rate of rather over 25% since 1970; continuous growth on this scale of almost any financial magnitude must demand our attention.

Tonight I propose to consider some of the connexions between international bank lending and the economic turmoil of the 1970s. To what extent should the international banking system itself cause us concern and to what extent should developments in the international markets more properly be regarded as a manifestation of fundamental problems in the world economy?

There are those who argue that, if they continue to develop their external business on the scale that I have just described, banks will threaten to undermine the stability of the entire international system. The argument may be mounted on perhaps four points. First, it is suggested that the expansion of international bank lending fuels world inflation, by adding to the world supply of money in a manner separate from and additional to the action and interaction of the domestic monetary policies being followed in the major countries. Secondly, it is suggested that the international credit markets are an independent source of speculative pressures which disrupt foreign exchange markets. Thirdly, it is argued that bank lending to deficit countries lessens their will to take adjustment measures and thereby helps to sustain world inflation. And fourthly, there are concerns related to prudential questions and the risks of over-exposure in international bank lending.

In considering these arguments in turn, I should like to begin with a very simple point—obvious when stated, but nevertheless a source of a good deal of confusion and misapprehension. The point is this: international bank lending is not the product of some distinct and autonomous financial system, separated from the major domestic monetary systems of the world and possessing a life of its own. In fact, as I do not need to remind the practising bankers gathered here tonight, the reverse is true. There are patently very close links between the financial markets across the world. These links derive from the fact that the same banks do business both in their own domestic economies and from bases in other countries. The closeness of the links is clearly illustrated by the arbitrage margins. For the past four years, the difference between the marginal cost to banks of three-month funds in the euro-dollar and domestic US markets has remained virtually zero.

This suggests to me that the international banking markets are essentially an alternative channel for financial flows—a very visible and a very efficient channel, but a channel nevertheless—rather than a separate monetary engine. Perhaps it is helpful to think of the international banking system as performing the function of an intermediary between different domestic economies in much the same way as any financial intermediaries perform specialised functions within a single domestic economy, matching differences in supplies and demands for credit. And just as in an evolving domestic economy those forms of intermediation which are most efficient or most attuned to the needs of the time will expand the fastest, so has it been for international bank lending.

Similar considerations apply to the second charge against the international banking markets: that they provide a pool of liquidity which facilitates disruptive speculation. It is true of course that because the dollar is the major reserve and vehicle currency, a US deficit on current account may often involve an addition to non-resident holdings and thus to international liquidity. It is not the case, however, that the existing state of the US current account of itself has any significant effect on the rate of increase in euro-market lending: one has only to look at the record of relatively steady expansion of the markets during periods both of large surplus and large deficit for the United States. It may be that external holders of outstanding euro-dollar deposits are marginally quicker than those of domestic dollar deposits to convert these into another currency at times when the dollar is weak. But this is bound to be an effect of altogether second order significance. With a large, sophisticated, open economy such as the United States, the opportunities for speculation are virtually limitless. What determines the extent to which funds will move is not the nature of any particular channel for them but the position of and prospects for the US economy and US policy on the one hand and those in other major countries on the other.

None of this is to suggest that the statistics of international bank lending in recent years are not telling us something. I am merely airing my own prejudice in such cases against executing the messenger; that is taking action to reduce the efficiency or scope of the intermediaries, rather than examining more fundamental questions such as the appropriateness of monetary and fiscal policies and the extent and causes of maladjustments in the system.

Balance of payments maladjustment has indeed been central to many of our troubles over the past five years; and I turn now to the third charge against the international banks: that they have sustained deficit countries too comfortably.

It is certainly true that since 1974 banks have lent extensively to countries which needed to borrow by reason of their balance of payments positions. The sudden onset of the OPEC surpluses, unrequitable in the short term, meant that large counterpart deficits had to be financed by one means or another if the world was not to be subjected to severe deflation. Had the oil-producing countries possessed highly developed and sophisticated financial systems, they might in due course have converted a good part of their surpluses into long-term lending. In fact, as we know, the surpluses were largely placed at very short term with the world's major banks. The recycling was therefore done at one remove, as it were, with the banks undertaking the necessary maturity transformation and bearing the risks attached to the final borrowers.

In the last year or two, however, the situation has radically changed. The OPEC surplus has dwindled—partly because of greatly increased imports by the oil-exporting countries, but partly, alas, because of the slow recovery of the rest of the world from the 1974–75 recession. Other surpluses have arisen within the industrialised world which bid fair to prove now at least as significant as those of OPEC; but at the same time the United States has moved from large surplus to large deficit. This has greatly eased the balance of payments position of the rest of the world. With a continuing flow of international bank lending, many countries have recently been borrowing not merely to finance their current deficits but to add to their reserves. And we are all familiar with the low spreads, longer maturities and larger borrowings which characterised an unquestioned borrowers' market in 1978.

I do not believe that we need feel any urgent cause for alarm at the inflationary potential in these developments—though there are prudential aspects, which I shall touch on shortly, which need to be watched closely. The world is still running at relatively low levels of activity, and most deficit countries have in fact been prepared to take some appropriate domestic action rather than aim simply to finance unmodified deficits from the banks year after year. Nevertheless, the position is clearly different now from that in the immediate aftermath of the oil price rise. We should be looking for an increasing rôle for official finance, especially from the International Monetary Fund, to help guide deficit countries towards adjustment; we may hope for further developments in the informal collaboration between the banks and the international institutions which is already proving helpful in relation to countries in difficulties; and we may perhaps look to some movement by the banks back towards their more

traditional rôle of concentrating on specific commercial, rather than balance of payments, lending. But most important of all, we need to see real progress in the adjustment process, on both current and capital account, among the major countries, both those in surplus and those in deficit.

Here there are some encouraging signs. There is now a good deal of evidence that the US current account deficit is likely to be substantially reduced during the course of 1979; and I hope there may be some reductions in the surpluses of the major creditor countries. Unfortunately there is not yet much sign of corresponding improvements in the overall capital accounts of either creditor or debtor countries. But there have been some hopeful developments in their international lending activity. While the growth in international lending by American banks slowed in 1978, the banks of Western Germany, Switzerland and Japan have come more to the fore. More importantly, total external lending directly from these countries, taking bank credits and bond issues in dollars and in domestic currencies together, has been expanding. Nevertheless, the size and persistence of surpluses on current account has been such that it is clear that much more remains to be done. Although the focus has shifted from the surpluses of the OPEC countries to the surpluses of countries such as Western Germany, Japan and Switzerland, what we have is still, in part, a recycling problem. As long as large surpluses on current account persist, there will probably be a need for banks, in the surplus countries and in the international markets, to play a major recycling rôle.

I come now to the last of the areas of concern often expressed over the international banking markets: the prudential. Clearly the expansion of overseas lending in recent years raises many questions for the supervisory authorities and for the banks. We at the Bank of England have long been alive to these and, with others, we have, I think, made much progress in the development and improvement of monitoring and supervision. In the light of what I have said tonight, you will not be surprised that our fundamental approach is very much to regard the international markets as primarily extensions of the domestic markets. My colleagues in Basle and I have long established the principle of parental responsibility; that is that parents should have ultimate responsibility for subsidiaries, and that central banks should be responsible for supervising the lending activities of banks of their own nationality, wherever the lending is conducted. We are currently developing ways in which this principle can be extended, for the purposes of prudential supervision, by means of consolidated accounts for each bank on a world-wide basis. We are also discussing in Basle ways in which maturity transformation statistics, such as we have for a number of years collected and published in London, can be developed for other centres. I firmly believe that it is in this manner, by steadily increasing the transparency of the operations of the international banks, that most can be done to allay any concern about international lending and to foster a further healthy development of it. I am encouraged by the strength and closeness of the collaboration in these matters among the central bank Governors in Basle and by the fact that we are generally agreed on a common approach.

I have dwelt tonight on some of the reasons that have led me to doubt that the international activities of the banks have been a major cause of the difficulties we have encountered in the 1970s. More positively, let me stress the invaluable part that private international lending has played, and must continue to play, in sustaining the world economy against deflationary pressures and in making available the funds which have been needed in a disturbed world on a scale far beyond the reach of official resources. For their part, especially important in the disturbed context of today's world, the authorities have a two-fold responsibility. It is first to continue to collaborate to provide a healthy prudential framework in which that lending can usefully continue. The second responsibility, even wider and more basic, is to foster closer co-operation between the major countries in pursuit of appropriate economic objectives and mutually compatible policies—so that the demands made on the international banking system are not too great. On this basis I am confident that the world's banks will continue to make a major—indeed essential—contribution to international welfare in a more peaceful environment than that in which we have lived for the past five years.

Given at the Financial Times World Business Conference 'Finance and Trade in the 1980s' in Frankfurt on 14 February 1979.

When I agreed to take part in this World Business Conference, my first thoughts were that I would be presenting an apologia for the United Kingdom's decision not to join, at this stage, the intervention arrangements in the European Monetary System (EMS). As that system has, however, encountered what used to be called in the early days of broadcasting a 'technical hitch at the transmitter', I feel more easily able to range rather wider in the thoughts I shall present to you.

I think it is important to do so because there is a certain tendency in Community affairs to believe, or at any rate to hope, that to bring about monetary or indeed any other form of integration, a term which is itself often left undefined, it is only necessary to hit upon and introduce appropriate mechanisms and procedures to support those mechanisms.

I shall first, therefore, offer you some thoughts on the ways in which I conceive of 'integration' taking place in the monetary sphere. As a general principle, I have a strongly held belief in what I would call the organic path towards integration within the European Community. In practically every field of human endeavour we can observe an organic process at work. Over the centuries great ideas have germinated in this

or that nation and these ideas have profoundly influenced all branches of human effort: the arts, the sciences, political theory, or even, at an everyday level, styles of football and pop music. The list can be made endless. My point is that sometimes these ideas take quick root and then travel very rapidly across the world; at other times they may still be good ideas but are planted prematurely and may in consequence wither, or lie dormant until, their time having come, they germinate and flower.

This process, in my opinion, is just as much at work in monetary affairs as it is anywhere else. New needs develop, fashions change, past mistakes are identified and corrected; in this dynamic process countries learn from each other's experience, good or bad, and from time to time a common perception emerges which is adapted to the particular circumstances of the day. This method of mutual education may not always be a conscious one, but as every parent knows the learning process often works best when it takes place subconsciously.

In what ways do I see this common perception, this organic process evolving in the monetary sphere? I detect amongst my fellow central bankers of the European Community a convergence of ideas during the last five years or so which is quite marked. Put in its simplest terms there has been a reaffirmation of the elementary principle that 'money matters'—that is to say that monetary policy is not merely a handmaid of fiscal and other policies but an important instrument in its own right. This is not to say that all central bank governors in Europe have suddenly, overnight, become out-and-out monetarists. Nor are they all profoundly committed to monetary targets, about which I shall have more to say later. But what is clear is that the bitter evils of inflation—and the adjective is not too strong in my own country at least—have brought us all to a common realisation, indeed a determination, that some form of what I might call 'pragmatic monetarism' is a necessary, though not sufficient, condition for the success of our countries' domestic economic policies. The vital point is that the intrinsic depreciation of a currency—which is a way of describing inflation for what it really is, stripped of money illusion—can only come about in the longer run through an excessive nominal growth of money assets. Which assets, how long the period, where lies the prime determinant of excessive growth, are all legitimate subjects for economic and sociological argument; but the difficulty of attaching scientific precision to these concepts is no excuse for inaction. That is the common lesson we have all learnt and each of us, as best he can in the conditions of his own country, is acting on it.

Next, I believe that there is a welcome convergence of ideas in Europe on a number of aspects of external monetary affairs. When the Bretton Woods system broke down, it crumbled in stages. I believe that central bankers were probably, even at the outset of generalised floating in 1973, more sceptical as to the benefits it would bring than were some of the more vocal academics and public commentators. It was recognised, of course, that in the circumstances there was no real alternative to some degree of floating. Thus, while probably no European monetary authorities were at any time unreservedly in favour of a pure float of their currency's exchange rate, a more or less managed system of floating was adopted in the hope or belief that such a system would relieve countries of the strains and stresses to which they were then becoming increasingly subject.

Since 1973, I would say that the central bankers' instinctive doubts about the magic or merits of floating exchange rates have been steadily strengthened by experience. Three important lessons have been driven home.

First, changes in exchange rates tend to make a weaker, and less rapid, contribution to the external adjustment process than had justifiably been expected in the days when the Bretton Woods Agreement had been functioning properly. Probably, this was in large measure because under Bretton Woods a step change in parity was usually associated with a set of supportive domestic measures; with floating rates changing frequently, this association was not, and perhaps could not be, maintained. Indeed, for a time credence was given in some quarters to the fiction that in a floating rate régime unpalatable domestic measures could be avoided or evaded.

Secondly, and this was the opposite but equally important side of the coin, the weakness and tardiness of the response of activity and trade flows to exchange rate changes was not matched by any weakness of cost and price responses. On the contrary, price and cost effects may well have become quicker and stronger; and since changes in costs, prices and exchange rates can interact in a cumulative way, descriptions in terms of vicious and virtuous circles have been offered.

Thirdly, the combination of muted real responses and sharper price responses may well have contributed to deflationary effects on economic performance generally. Countries whose exchange rates depreciated were sooner or later forced to adopt deflationary policies in their attempts to curb inflation; countries whose exchange rates appreciated were chary of what was in certain quarters thought to be old-fashioned Keynesian demand management, being restrained in their expansionary responses by an understandable desire to avoid the inflation being experienced elsewhere. Furthermore, it cannot be doubted that the pervasive uncertainties about the future course of exchange rates had a dampening effect on business confidence and therefore on investment; and this too made its contribution to a soggy economic performance.

The experience of the post-Bretton Woods period, as I read it, underlined the costs of exchange rate instability. The view emerged, first perhaps in Europe but now more widely, that a greater stability of exchange rates should somehow be ensured. On the one side there was the feeling that a greater exchange rate discipline had to be accepted. On the other side there was the feeling that exchange rate stability alone could create the settled conditions necessary for that renewed business confidence without which adequate investment would not take place.

So here again, though in this instance from slightly different starting points, there has been a certain convergence of thought in Europe. I use the word 'convergence' advisedly because it has been rightly stressed by many governments that economic convergence is a necessary concomitant of monetary integration. To me it seems that a convergence of thought leads to a convergence of behaviour in the face of changing economic and monetary problems and hence to a convergence of aims. It is through this route that I conceive of a gradual monetary integration in Europe. Unfortunately, and here is the rub, since conditions are so different, divergent policies are often needed in order to work towards a convergence of end-results; and the lack of such convergence is the root cause of many of the Community's current economic problems.

I will not attempt here to go into all the reasons why there are divergencies in end-results. Obviously, there are certain factors which are either not susceptible to change at all or only very slightly so—geographical location, the endowment of natural resources, the historical stage reached by each country in its industrial development, its demography and so on. But all these factors, important though they are in determining the standard of living which any zone of our European Community can expect to achieve, do not invalidate my proposition about the way in which integration should develop. The problem, in this respect, seems to me to reside in the fact that the speed of transmission of ideas and behaviour is, for obvious reasons, a variable one; it tends to be fastest amongst those who are responsible for conducting a nation's affairs or managing its businesses, because they are constantly meeting and having to negotiate or trade with their opposite numbers; the pace is much slower amongst the economic agents on whom in the end a country's performance eventually depends, namely, its labour force. Moreover, the speed of transmission, and of acceptance, varies from country to country—some evidently finding it more difficult than others to accept change. I still believe, however, that the mutual learning process about which I spoke earlier is at work in all areas and I do not despair of its working for the common good.

If, as I have so far argued, integration must take place by an organic process, then, determinists would say, it will simply evolve of its own accord. To rely simply on this hope or belief, however, would be an intolerable abdication of responsibility on the part of governments and central banks. The need is to assist the process at the right time and, so far as is possible, to discourage false starts.

With hindsight, of course, it is now patently clear that the European Economic Community's first attempt at monetary integration after the summit meeting of December 1969 came at the wrong moment—precisely because it almost coincided with the crumbling of the old order in the international monetary system about which I have already spoken. Nevertheless, the authors of the far-reaching proposals adopted at that time would have needed superhuman prescience to foretell what lay in store in the 1970s. For instance, in the second half of the 1960s, the nine countries which now comprise the EEC together averaged real growth of 4½%, unemployment of around 2% of the active population and inflation of under 3½% per annum. Moreover, there was no very large divergence from the average amongst the countries concerned. In the last five years the average growth rate has fallen below 2%; unemployment has more than doubled; and the average inflation rate has trebled; and this general deterioration reflects much wider disparities of performance by individual European countries.

So it is that, when we turn to the present day, an altogether different prospect confronts the European Community from the days when European Monetary Union was first launched. A static 'snapshot' taken in 1978 would, as I have shown, compare unfavourably in most respects with the same photograph in the album of 1969. Viewed dynamically, on the other hand, the conjuncture in 1978 was generally pointing in a better direction for the EEC countries than at any time at least since before 1973. In particular, there were: narrower inflation differentials between the EEC countries; signs of renewed growth; a somewhat more balanced distribution of balance of payments surpluses/deficits; and a convergence of ideas and aims to which I have already alluded. There was also the powerful influence on opinion within the EEC of the destabilising effects which the behaviour of the dollar, and the reactions of the US authorities to that behaviour, were having on the European economy.

Thus in 1978 circumstances were at the same time encouraging and difficult; and the difficulties were themselves of a kind to challenge a positive response. It was, therefore, in a profound sense natural and appropriate that the heads of state or government of the EEC last summer endorsed the view first propounded by the President of the Commission that the time had come to make a fresh effort at European monetary integration. It is little wonder that, this time, they set their sights on less ambitious end-targets but tried to make greater provision for enabling their immediate plans to be effective and durable.

Perhaps the most interesting feature of the subsequent discussions and negotiations which led up to the European Council's resolution in December is that, though they had to be conducted under great time pressure, certain fundamental economic and political issues were put squarely on the table in a way which, I believe, was less evident in 1969–70, when all the talk was how to move fastest to permanently locked exchange rates between the Community currencies. I would single out the following as the more crucial of these issues:

- in terms of what should the desired exchange rate stability be achieved?
- how should the system set out to meet the imperatives of containing and reducing inflation and the clear need of getting the European economies firmly on the road to recovery?
- what should be the nature and size of the financial arrangements to support the intervention system?

I would like to comment on each of these in turn. The first question—in terms of what should exchange rate

stability be achieved—may seem oddly phrased given that the Bremen communiqué spoke of the European Currency Unit (ECU) as being the centre of the system; but it links closely with my introductory remarks about the convergence of thought. The point at issue was whether a system for stable but adjustable intra-EEC exchange rates which were free, however, to fluctuate *en bloc* against the outside world was optimal and durable. I myself am unequivocally in favour of a stable exchange rate for sterling, and in terms of our effective exchange rate index we have been notably successful in achieving steadiness over the last two years. Moreover, as one believing that the United Kingdom's future lies with Europe, I favour any arrangements that will help to bring about a greater stability between all the EEC currencies. The fact remains, however, that an EEC currency bloc which fluctuates significantly against other leading currencies will have markedly different terms-of-trade effects for different EEC countries, the United Kingdom being one of the countries most affected in this way; and it will also tend to put stresses on the intra-EEC intervention system because reversible flows into or out of Europe will be much more marked in the case of some European countries than of others.

This, however, poses a certain dilemma—one linked with the common view about the importance of monetary policies already referred to. On the one hand, if, for the sake of the EEC system, these differential flows are absorbed by appropriate market interventions, then there will be a serious risk of a greater or lesser degree of loss of control of the monetary aggregates in the intervening countries—this was our own experience in 1977. Should the flows be subsequently reversed, then once again very uneven domestic monetary tensions will manifest themselves in the different countries concerned. On the other hand, if the differential flows are absorbed by movements in exchange rates of the EEC bloc against third currencies, then tensions will appear within the EEC bloc and large interventions may prove necessary to maintain the agreed relationships between the currencies in the bloc.

This dilemma could not be satisfactorily resolved by any predetermined rules and for that reason there is very little that has been built into the intervention arrangements with regard to third currencies, in particular the dollar. Much will therefore depend on how in practice the EEC monetary authorities respond to the changing pressures to which the bloc may be subject. In this respect, the change of attitude and the steps adopted by the US authorities at the beginning of last November, together with the close co-operation that has taken place between them and, notably, the West German authorities, are encouraging signs. Nevertheless the dilemma will remain and there is no point in pretending that by striving for a zone of stability, Europe can somehow insulate itself from its world-wide trading partners.

I turn now to the second question—how should the system meet the imperative of reducing inflation and the need for getting the European economies firmly on the road to recovery? It seems to me evident that all members of the Community, none more than the central bank Governors, are resolutely agreed that cutting inflation is a pre-condition for resolving the other economic problems besetting the European economy. A perfect convergence of thought, and therefore behaviour, has not yet, on the other hand, been reached about the extent to which demand management can safely be practised without endangering the first priority of reducing inflation. The differences which subsist are perhaps only ones of degree. We must not, after all, forget the very serious efforts which were made last year to agree on a concerted strategy for growth, efforts which bore their fruit at the Bonn Summit immediately after the EEC Summit in Bremen.

Nevertheless, these remaining differences had considerable consequences for the debate on where the onus for adjustment should lie. It has consistently been the British view that in its intervention régime the EMS should seek to place a more equal burden of adjustment on debtors and creditors than has been seen in the 'snake'. It will always be the case—and rightly so—that debtors have an inescapable need to adjust their policies because their reserves and ability to borrow are not inexhaustible. Moreover, if they borrow from official sources like the International Monetary Fund or the European Community they will be expected to follow certain policy prescriptions. For creditors, on the other hand, the only stimulus to adjustment is the expansionary influence on their domestic money supply, of which I have talked earlier. In the short run, however, that influence may be offset by other factors at work domestically, or may be tolerated by the authorities concerned. Certainly there is no immediate domestic compulsion or effective outside pressure on them to act. For these reasons, therefore, we sought to incorporate in the intervention and settlement arrangements some provision which, however imperfectly, relieved the countries in a weak position from carrying an excessive part of the burden of adjustment. In this way we believed it should be possible to keep strong the anti-inflationary forces within the system while at the same time avoiding any bias towards the contraction of output.

To achieve our aim, we conceived the idea of using the new concept of the ECU as a means of putting an inducement to adjust on strong countries whose currencies were manifestly diverging most from the Community average which the ECU represents. In the end result, as you know, a compromise was reached on the so-called ECU divergence indicator which did not go as far as we would have liked but which will establish a presumption that countries whose currencies are diverging from those of the others should take prompt action to slow down or halt the divergence, whether by economic and more especially monetary policy measures or by intervention in several currencies in the market. This diversified intervention will, in some sense, spread the effects on the partner countries more widely than the automatic rules which obtain under the existing 'snake', rules which will be carried forward into the 'parity grid' element of the new intervention régime.

Last, the financial arrangements. These can be classed under two heads. First, the credit arrangements directly

associated with the intervention régime and the settlement obligations arising out of it. So far as these are concerned, the new system will be supported by very much larger credit facilities than exist at present, and the duration of the short-term facilities has been quite significantly extended. For my own part, I thought it important that at the end of the day there should be seen to be very substantial facilities backing up the system so as to make clear to the markets that ample resources were available to countries in case of need. On the other hand, I think these facilities have to be regarded—and will in general be regarded—as a safety net and not as a permanent truss for countries which might get into difficulties. For this reason I do not share the fear of some that the orders of magnitude of the credit facilities which were being negotiated were such as to create an inflationary danger for the Community.

The other kind of financial arrangements, where it must be said the outcome of the negotiations has so far been disappointing, concerns the question of resource transfers within the Community and the redistributive effect of the Community budget. The greater one's vision of monetary integration within the Community the more clear should it be that the Community budget should perform the same kinds of function as are taken for granted in the budget of a unitary state. The problem within the Community, of course, is not that the Community budget has no redistributive effect—it certainly does through the Fonds Européen d'Orientation et de Garantie Agricole (FEOGA)—I use the French acronym—but that this redistribution is in many cases regressive and therefore actually harmful to closer integration.

There are, it is true, a number of Community transfer payments which are helpful—the expenditure on the Regional Development Fund is a prime example. So far, however, these mechanisms have all rested on the expenditure side of the budget and that means conscious efforts—sacrifices, if you will—by certain member states in favour of others. That such sacrifices have been made should not be forgotten and the Government of the Federal Republic has, to its credit, shown the way. Nevertheless, the national analogy demonstrates that taxation is at least as powerful a redistributive tool as expenditure; and, moreover, that once any system of taxation is agreed it can be left to operate automatically and unseen.

Just as in all advanced countries taxes levied on individuals are a function—usually a progressively increasing function—of income, so at the Community level the present erratic system might be changed so that those states which are the most prosperous in terms of gross national product per head should pay more per head than the less prosperous. Similarly, expenditure should be devoted much more to areas of real need and not concentrated so heavily as at present on FEOGA including the financing of agricultural surpluses—which themselves are an indictment of the agricultural policy of the Community.

Now, I myself do not believe that the future success of the intervention arrangements in the EMS is very heavily dependent on the progress which the EEC will make on this redistribution question. But I certainly believe that the EMS is potentially a much wider-ranging enterprise than simply a 'super-snake'. As I have indicated, I think that all the EEC countries have clearly demonstrated a determination to achieve more exchange rate stability, especially in relation to each other. The precise means whereby this stability can best be brought about have been, and no doubt will continue to be, hotly debated. But differences from time to time on the means will, I am certain, prove much less important in practice than the deeper agreement which has been reached on ends. In the perspective of history the intervention arrangements may prove less significant and far-reaching than the idea launched in 1978 for the ultimate development of a European Monetary Fund; some degree of reserve pooling; the general improvement in co-ordination and convergence of European monetary and economic policies; and the co-operation with other countries in creating more stable world monetary conditions—to be symbolised one day perhaps by the European Fund and the ECU. For all these developments to occur, however, I am sure that fair and satisfactory answers to the budgetary questions will also have to be found as a matter of priority. Without such answers, I doubt whether significant progress can be made towards integration; indeed, even the present degree of European co-ordination of economic policies could be put at risk.

In the continuing discussions which will take place on the EMS, the Bank of England will continue to play the constructive part which they did in what I consider to be only the first round of negotiations, that culminated with the European Council of 5th December last. Though the United Kingdom announced that it would not participate in the intervention arrangements at their outset, we nevertheless are in a real sense taking part in the preparations for the EMS as a whole. It is clear that the policies which we need to pursue in our own interests will ensure that our actions in the monetary field remain in close harmony with developments amongst the rest of our Community partners.
To return to my opening theme, I would consider that as a practical demonstration of monetary integration at work.

Given at the annual dinner of the Birmingham Centre of the Institute of Bankers on 14 February 1979.

If you believe, as I do, that there are horses for courses, then Birmingham should, for reasons I shall adumbrate, be a favourite stamping ground for Governors of the Bank of England. I have, I must add, seen the course before—most recently when I visited the International Motor Show so successfully held last year at this fine

National Exhibition Centre. May I say what a great pleasure it has been to meet here again tonight Sir Robert Booth, who may justifiably be called its parent.

I should begin by offering my sincerest thanks to you, Mr President, and to the Birmingham Centre of the Institute of Bankers for your hospitality and for inviting me here to speak to you tonight. Whatever the merits of Birmingham's claims to encompass the geographical centre of the country, it is certainly the focal point of the nation's industrial heartland. Many would argue, too, that the Industrial Revolution really began not far from here when in 1709 Abraham Darby first smelted iron, using coke as fuel, at Ironbridge Gorge; and today the proportion of your region's output and employment derived from manufacturing is higher than that of any other region in the United Kingdom. It always needs to be remembered that the country's financial system, for which we at the Bank have particular responsibilities, exists not in a vacuum, but to facilitate the country's industrial and commercial activities. The concentration of such activities within your region and your city give a particular significance to your successes, your problems and your preoccupations. We at the Bank are aware of them—an awareness which has a tangible expression in the person of the Bank's Agent at their Birmingham Branch, Mr David Nendick, the President of the Birmingham Centre of the Institute of Bankers, and our host tonight.

The other particular affinity that Birmingham has with the Bank of England is the prominent part your city has played in the development of banking and other financial institutions in the United Kingdom. I refer not only to the origins in Birmingham of two of the clearing banks, but also to the formation here of the first building society, in 1775, and of the first—albeit only—municipal bank in 1916. You hardly need reminding that, outside London, Birmingham has more banks than any other city in the United Kingdom.

With these industrial and banking characteristics to your city's background, it is, I think you will agree, natural that I should address my remarks tonight to both the industrialists and the bankers of Birmingham.

It seemed last year that, with the benefit of North Sea oil, we were recovering from the shocks that followed the sharp rise in the price of oil in 1973–74. The rate of inflation had been reduced to less than a third of its alarming peak in 1975 to a rate that, while still unacceptably high, was at least not significantly worse than in many other countries. There was ground for hope that—given continuing restraint—this recovery could be consolidated and extended over time.

Some features remain encouraging. Although world exchange markets generally were exceptionally disturbed during 1978, sterling has had a relatively quiet ride. In effective (trade-weighted) terms, sterling has now been notably stable for some two years. I am well aware that this has not involved an equivalent stability with respect to individual currencies. Even so, the fluctuations faced by UK exporters have been significantly less than those confronting exporters in many other major countries. Perhaps the single largest factor behind this general stability has been North Sea oil, but an indispensable support has been adherence to our monetary targets which has helped to reinforce the pound on the foreign exchange market, just as at home it has helped to maintain its internal value.

Now, however, at home the turn in industrial relations this winter and in the level of pay claims has caused inflation to assume a more threatening posture. If we are to retain our hold on what we have achieved, a great effort will be required of all of us.

Recent events have shown the defects of the present structure of pay bargaining, especially when bargaining is not guided by realism about what the nation can afford and some regard for the rights of others. We do not know how much manufacturing output was lost in January alone. Just as real—and indeed more real to many—is the welfare lost by actions closing schools or reducing medical care at our hospitals. These are clear and immediate consequences of the kind of strike action we have experienced. Excessive pay demands, greater than any growth in real output which this country could achieve with continuous production, would cause the rate of inflation inevitably to begin to climb again. In these circumstances the rise in domestic prices cancels the nominal gains which are thus shown to be illusory and the inevitable disappointment starts up pay demands again.

The destructive potential of such a situation is immense. This was recognised after the headlong course of 1974–75. Over recent weeks that more rational approach of the last three years seemed to have been forgotten. Today's events allow us to hope that more sensible attitudes are re-emerging. I am glad also to see the publication yesterday by the Confederation of British Industry of its contribution to the debate.

But other supports for the maintenance of stability remain essential, especially after these recent shocks to confidence. The authorities have a responsibility to prevent inflation from accelerating into hyperinflation; when action is necessary, the prompter it is, the easier the transition back to sustainable growth. Fiscal and monetary targets have therefore to be maintained. This policy cannot, of course, undo the damage caused by strikes or inflationary settlements; the bills for that damage have to be met in terms of loss of output and increased unemployment. But an attempt to avoid or mitigate that cost by expanding money supply further or by lax fiscal policy would merely serve to undermine the financial stability and confidence that have been achieved since 1976 and in so doing would lead to even higher unemployment.

Holding firm in these circumstances to monetary and fiscal targets and limits is not easy. It has, for instance, already obliged us to raise minimum lending rate to 14%, an increase as unwelcome to us as it is to you. Yet I need to remind you that our monetary policy already involves an expansion in the money supply at a rate of 8%–12% per annum.

If we fail to contain inflation now, because the treatment is unpalatable, it will be worse tomorrow. The resulting distortions in the economy will get bigger and the eventual cure even more difficult. Indeed

inflation is often seen as a form of drug whereby an economy reconciles, and even perhaps soothes, excessive pressures placed upon it. The analogy is apt, for inflation soon becomes addictive, and the drug that may seem initially to dispel harsh realities not only becomes habit-forming but also ravages the body upon which it preys. So the apparently easier course, of accommodating to a higher level of inflation as the lesser and more comfortable evil, will in the end prove the more unpleasant.

The economic process essentially involves commitment of resources against an uncertain future. Inflation, which by its nature is never regular and predictable, disrupts that economic process. Businessmen and customers not only undertake commitments that are distorted by the need to protect against inflation, but also hesitate to enter into some new commitments at all. It should escape no one that over the last decade the high and volatile incidence of inflation has been accompanied by an upward jump in the average level of unemployment. It is by cutting inflation that a country takes the first step towards sustaining a higher level of activity and a lower level of unemployment.

If the coming year is a hard one, as I expect it to be, there will be some who would seek to represent it as the result of a collision between excessive pay settlements and the maintenance of firm, as opposed to more accommodating, monetary and fiscal limits. But the real collision is between the level of those settlements and the level of growth of productivity in our economy.

You will not, I am sure, suppose that I have failed to consider what controlling monetary growth, rather than allowing it to accommodate inflation, means for industry. I am well aware that a combination of accelerating labour costs and firm monetary and fiscal policy would put industrial profits between the hammer of increased costs and the anvil of more difficult markets.

But the severity of the impact depends importantly on the whole mix of fiscal and monetary policies. Where exactly the pressures should fall most heavily is a matter of judgment of economic and social priorities; but in the longer run there is little future for this country, as the Government have recognised in their industrial strategy, unless priority is given to encouraging business and industry. Profit margins have fallen to disturbingly low levels in recent years, and seem even more vulnerable in the present context. Both in judging the balance between fiscal and monetary policies, and in framing the detail of the former, this needs to be kept constantly in mind.

Mr President, I have not sought to minimise our present troubles, but I should mislead you if I were not to end on a more hopeful note. It is surely legitimate to sense now, born of trouble, some shift in our attitudes which gives promise of a more constructive ordering of our affairs. We need to find a way there: on it depends in particular the prosperity and success of your industrial, commercial and banking interests, and thus of your city itself. I give you the toast 'The city of Birmingham'.