

Speeches by the Governor

Given to the Association of International Bond Dealers on 31 May 1979.

'Time travels'—so Shakespeare tells us through the mouth of Touchstone—'in divers paces with divers persons'. A week, we were once assured, is a long time in politics. Those of us involved in the life of financial institutions are able to take a somewhat longer perspective; but in this age of accelerating change institutional anniversaries of any description become noteworthy occasions, and, in the field of financial institutions, the tenth anniversary of your Association of International Bond Dealers (AIBD) is particularly propitious and significant.

By any standards, and even allowing for the effects of inflation, the growth of the international capital markets in whose securities you deal has been spectacular—on a scale, I suggest, which even the most far-sighted of those of you who were midwives to your Association's birth could not reasonably have predicted. The first true euro-bond was issued in 1963, and the total amount of capital raised in that year on international markets, by which I mean both euro-bond markets and those domestic capital markets freely open to foreign borrowers, amounted to the equivalent of about US\$2 billion. In 1969, the year of the AIBD's birth, that total had risen to over US\$5 billion, and the total last year was of the order of US\$34 billion.

I have no doubt that a substantial part of that growth has been due to the way in which your Association took a variety of different issuing, dealing and settlement systems which were in operation in the early years and helped to mould them into a flexible and consistent system which proved acceptable to all. To the outside world the transition may have looked deceptively smooth: but many of you, no doubt, still bear the scars of the unseen struggles by which it was accomplished. It was, if I may say so as one whose task is from time to time to seek to persuade financial institutions of just one nation to change their habits in their own long-term interests, a formidable achievement, which it gives me great pleasure to salute as I congratulate you all on reaching your tenth anniversary.

As Governor of the Bank of England, I take pride that it was in London that your birth took place, and that London-based institutions have played so important a part in your development. Your distinguished retiring Chairman, Mr Yassukovich, may bear a Polish name, may hail from a Wall Street investment bank, but no one who has seen his elegant figure flying over the Cotswold walls clad in a swallow-tail pink coat in pursuit of the English fox can doubt where his heart really lies. Whoever his successor may be, may I take this opportunity of wishing him well.

The features of London which have attracted to it so much of the euro-bond business and have enabled it to

flourish as an international financial centre despite sterling's reduced rôle as a reserve and trading currency need no repetition here: we are celebrating your anniversary, not the success of the City of London. I believe it appropriate, however, to focus on one of those features, which may well be the most important of them, and certainly has relevance to what your Association sets out to do—namely, the attitude of the authorities towards regulation of financial markets.

The Bank's philosophy in respect of regulation of financial markets starts with a presumption in favour of self-regulation. Various features of markets give rise to such a presumption. Historically, markets had their being within a confined geographical space, where those operating in a market had personal contact with and knowledge of one another, and trading decisions could be swiftly implemented. Self-regulatory rules and conventions naturally arose with a view to ensuring that all could participate on equal terms within it: those who flouted the rules or conventions soon found that the others declined to deal with them. The communications revolution may have removed geographical proximity from the list of necessary conditions for an efficient market, but it has not displaced the need that those operating in a market should have confidence in one another and be free to require adherence to appropriate rules and regulations.

This is not to say that there may not be particular markets, or particular parts of markets, which—because effective self-regulation does not take root—require to be regulated by statute, or the regulation of which may require statutory backing. But markets evolve, as do the techniques and instruments used in them, and statute remains an inflexible method of control; self-regulation, moreover, is able to go beyond the prescription of minimum standards, which is the most statutes can achieve. It is able to address itself to people's intentions and the spirit rather than just the letter of the rules. Hence the presumption in its favour.

For self-regulation to succeed, it is essential that those affected by it should have a common interest that it should succeed; this is the incentive for them voluntarily to submit to a code of practice or a set of rules. But this in turn demands that all involved should have a common perception that the code or rules are applied fairly and impartially.

Now I have no doubt that the larger a market becomes, and the less homogeneous those operating within it, the less easy is it for those conditions to be met. The community of self-interest is less obvious, and perceptions of what is fair can differ among people from different backgrounds. It is for this reason that the internationalisation of markets in the City of London

over the past two decades—internationalisation not in the sense of where the money came from or went to, but in the sense of who participated in the markets—has caused some people to doubt how long the self-regulation of such markets could continue. Such doubts were further spurred by consideration of the very different legal and jurisprudential traditions to which the United Kingdom was aligning itself when it joined the Common Market. The Napoleonic Code and the City Takeover Code may both be codes, but the modes of thought which underlie each are separated by a great philosophic gap.

I am glad to say that such apprehensions have not on the whole proved justified. The many foreign financial institutions which have set up to do business in the City of London over the past fifteen years or so have shown themselves content to abide by our way of doing things. Our European neighbours have generally welcomed an injection of British pragmatism into the process of harmonisation of financial practice and institutions. Indeed, I suspect that some at least of them would have welcomed rather more of our pragmatism over questions of regulation than we, as new boys in the European school, may have thought it appropriate to push.

The capability of self-regulation to operate on an international level has been admirably illustrated by your own ten-year history. I have already made reference to the way in which, largely under the auspices of your Association, the different issuing, dealing and settlement systems that operated in the early years have been moulded and conformed into a flexible and consistent system that is accepted throughout the market. Through your Association, the rules have been updated as conditions have changed. Such virtue has had its own reward in the spectacular growth of the markets to which I have also referred.

During this conference you have been preoccupied with how your Association should develop in future—and rightly so. Some suggest that the AIBD should concern itself with policing the primary market, since they see the main problems afflicting international capital markets now—in contrast perhaps to earlier years—as relating to the primary market. There is the alternation of feast and famine of new issues, which has prompted suggestions of a new issue queue. There are the complex of problems associated with the so-called 'grey market', where premature dealings in issues before their terms are definitively set are thought to restrict the freedom of managers to negotiate such terms with issuers.

It is certainly not for me to give advice to you—the technicians and practitioners—on matters such as these. Let me simply make three observations, culled partly from my earlier experience in corporate finance, and partly from my consideration of the regulation of financial markets as Governor. The first concerns timing. The feast and famine syndrome is not a characteristic only of unregulated markets—it is the consequence of the rhythms to which all markets are

prone. Although in domestic markets it may be possible for the authorities to mobilise a queue in an effort to keep markets orderly, in markets as widespread and large as the international capital markets it is doubtful whether an effective queuing system can be imposed overall. There is no supranational authority to run such a system and even when national authorities seek to regulate the pace at which those subject to their jurisdiction tap the markets there can be no certainty that such regulation will match the highly volatile conditions which can pertain. In such circumstances the best regulator is the old principle, essential to all efficient markets, of 'caveat emptor', whether the 'emptor' be the buyer of bonds, that is the investor, or the buyer of funds, that is the issuer. The discipline of markets may be harsh, but it rightly depends on the possibility of fingers being burned.

Secondly, I would say that in any self-regulatory system it is important that rules be obeyed. If obligations are imposed on, and voluntarily undertaken by, underwriters and selling-group members, let alone co-managers—or indeed bond dealers—those obligations should be enforced. If they are not, or cannot be, enforced because the purpose they are meant to serve is not deemed important or significant, then perhaps they should not be imposed in the first place. In the 'grey market' dispute, is it the dealers who are willing to deal who are at fault, or the syndicate members who are willing to sell? And if they are willing to sell, does that tell us something about the way syndicates are composed? or about how issues are indicatively priced? In dealing with this matter I hope you will bear in mind a prejudice I have aired elsewhere against executing messengers.

Finally, I would say that self-regulatory systems must constantly be on their guard against two dangers: the danger of seeking to expand the frontiers of their jurisdiction to embrace those who do not share the community of interest; and the danger of becoming too bureaucratic, so that the process of self-regulation in effect becomes hard to distinguish from the process of statutory regulation. The best safeguard against that is to maintain a reasonable balance between the unpaid practitioners who must remain responsible for making and enforcing rules and the permanent secretariat. The latter for their part must be on their guard against the almost irresistible but profoundly dangerous temptation to justify the job they do by expanding its scope. The practitioners for their part must be willing to make the necessary sacrifices of time and effort to participate in the affairs of your Association and thus ensure that the balance is maintained.

I have no doubt that you will find a satisfactory solution to the problems which are your current preoccupations as practitioners in the international capital markets as such. I hope you will forgive me therefore if I comment briefly on the problem of international financial markets in the wider sense, which, as you know, is one with which we central bankers are currently much preoccupied.

It is, I think, universally agreed that the international markets performed an invaluable service to the world in the years after 1973 in recycling the massive OPEC surpluses. I favoured then, as I favour now, a larger rôle for official funds in balance of payments financing. But, even had recourse been made to official finance more readily, and even if that finance had been available on a much larger scale than it was, the major burden would necessarily still have fallen on the private sector. By providing bank and bond financing, it performed this task with great smoothness and effectiveness and helped to prevent world economic disorders on the scale which many in 1974 were predicting.

Over the last year or two, as the OPEC surpluses have dwindled and the world payments scene has become once again dominated by the familiar pattern of surpluses in Western Germany, Japan and Switzerland and a large deficit in the United States, questions have been raised as to the implications of a continued rapid expansion in international bank lending. Is it perhaps contributing to world inflation? Is it frustrating the proper working of the adjustment process by unhelpfully delaying actions by deficit countries to improve their external account? I myself remain to be convinced that, looked at overall, it has been international bank lending which has led to serious problems on these scores. It is clear, however, that as the underlying situation changes, it is right to look anew at the international rôle played by the world's banks. In Basle in the months to come the central banks of the Group of Ten countries and Switzerland will be carrying out an analysis of these questions.

While I have yet to see evidence that there are seriously adverse economic consequences of international bank lending to tip the scale against its undoubted benefits, I have long been concerned about the possible prudential risks in an international market growing at 25% per annum. It is for this reason that we at the Bank have continually pressed for improvements and greater co-ordination in the supervision of the international banking markets. I have been glad to see that there is a growing realisation that this is the central problem. Over the last five years, the authorities in all the major centres have strengthened their supervisory techniques, and, building on previous work, we have now committed ourselves to take steps to consolidate the balance sheets of our banks on a global basis for supervisory purposes. This will, I am sure, be a major step forward in our ability to assess any risks being run in international bank lending and to improve the supervisory control which each of us exercises over the banks with headquarters in our own centres. I hope too that others will be able to follow in our footsteps in developing and publishing analyses of maturity transformation in international bank lending.

It may be that our discussions over the coming months will throw up other areas of potential concern. For

example, to what extent are the international lending activities of the banks of some countries moving off-shore to avoid requirements imposed on domestic operations? What problems does such a movement cause for the authorities concerned and how should they tackle them? Again, we shall have to consider how the latest disturbing developments for the price and supply of oil affect our approach to international bank lending.

But the process of analysis and diagnosis is not one confined to international or national authorities: it is one in which everyone operating in the markets in question has a part to play—not least because they are likely to be vitally affected by the outcome. And while the preoccupations I have been discussing relate primarily to the lending activities of banks, you can be sure that some of the light of enquiry being beamed in that direction will reflect on their activities in capital markets.

We all of us, I think, subscribe to the principle that free markets are beneficial, but we know from experience the paradox that markets must be restrained to continue free. The greater the self-restraint, the less the need for official intervention. If individual banks maintain their normal prudential criteria in international lending—and for that matter in the sponsorship of new issues—then there will be no need for supervisory authorities to intervene to tell them to do so. The threat or fear of escalating outside regulation should be a more potent power for good than such regulation itself. The question was posed forcibly by Lenin in his question 'Who is to control whom?'. Is it to be those operating in the market exercising self-control, or is it to be those outside imposing it? The one answer that will not work, to parody the cry of St Augustine, is 'God, give me self-control—but not yet'.

That I have been able to invoke both Lenin and St Augustine to my argument within two sentences is a sure sign that I should draw to a close. There can be few better modern examples of the advantages of market mechanisms than the international capital markets. The stimulus of intense competition has led to the development of a varied and sophisticated range of instruments to satisfy the credit demands of a wide variety of borrowers and the investment needs of a heterogeneous group of investors, and this has fuelled the growth of which you all have been the beneficiaries. I have tried to suggest the necessary place of self-discipline in controlling such expansion. The course your Association has steered in the first ten years of its existence suggests that I have been preaching to the converted. I do not doubt that the next ten years will produce challenges even more daunting than the last; but by the same token I do not doubt that in 1989 one of my successors will be congratulating you on a second decade of success.

Let me first thank you for the generous terms in which you have proposed the toast to the Bank of England, and coupled it with my name. You have been very kind and indeed flattering, but, as Adlai Stevenson once said, 'a little flattery does one no harm, provided one doesn't inhale'. I must say too how grateful I am for the opportunity to join the members of your Association on this delightful and important occasion. I say delightful for reasons which will be abundantly clear to all who are enjoying your hospitality. I say important for, although it was only six years ago—a term of years I have some cause to remember—that the Deputy Governor spoke at the Association's first annual dinner, your precocity is such that leasing is now a very significant part of the service provided by the City to industry and commerce. The leasing business has shown itself to be inventive and adaptive—it has become commonplace for companies to finance the use of items of equipment in this way, and nowadays, I understand, it is even possible for the very shirt on a businessman's back to be leased as well. In this, I hasten to add, I do not speak from personal experience, for the clothes I stand up in are my own.

Your industry has developed within a relatively short period from infancy to the degree of maturity represented by over £1 billion worth of new business in a year. This achievement, Mr Chairman, has reflected an adaptability to changing conditions that has greatly helped British industry and commerce in meeting some of the exceptional difficulties of recent years. As you yourself have indicated, we estimate that last year your members financed some 8% of investment in vehicles, ships, plant and machinery, and almost a quarter of companies' external financing needs. The importance of a ready availability of finance for industry on reasonable terms hardly needs emphasis, and your members can take satisfaction in their contribution to it.

There is little doubt that equipment leasing, having reached the position it now has, will continue to play an important rôle in the network of financing arrangements for British industry and commerce. But neither you, Mr Chairman, nor I, would expect continued growth at the exceptional pace of the last year or two. This did indeed owe something to special factors, such as the position regarding tax allowances on leased cars, which, as you have mentioned, is now to be changed. Moreover, one of the consequences of your expansion is the increasing publicity you have attracted. Included in this is a concern lest the rapid growth of equipment leasing should carry with it some risk of instability. Whether or not this concern is pursued in the press, the implied question is a serious one both for the authorities and for yourselves; and public concern would be justifiably greater if it were felt that the question were not being so regarded.

Leasing transactions involve a degree of risk for both the lessor and the lessee, and the Bank, with its supervisory responsibilities now taking statutory form in

the Banking Act, is particularly concerned with the risks taken when the lessor is either a deposit-taking company or in a group relationship with such a company. These risks include the basic credit risk on the lessee, the risk of ignoring the fact that the deferred tax liabilities of the lessor may become payable, for example if it proves to be impracticable to maintain the level of new leasing, and, for operating leases, the risk that residual values will be significantly lower than predicted. It is clear that more deposit-taking companies are writing leasing business either directly or through associated companies and that leased assets are becoming an increasingly significant element in total assets. With our concern for the development of high standards of financial prudence, we must therefore continue to take a close interest in your business.

It is the Bank's conviction, however, that the supervision of financial institutions can most successfully be achieved with the positive co-operation of the supervised. So we try to learn from the practitioners in the market in order to identify the best standards which have stood the test of time and experience, and then encourage the application of those standards by all. It is in that tradition that we will continue to seek, with your help, to improve and refine our understanding of the art and practice of leasing.

I would not, however, want to suggest that oversight of deposit-taking companies or their associates by the Bank diminishes in any way the importance of movement towards appropriate self-regulation in your industry. As you well know, we in the Bank favour such self-regulation partly because the development of financial markets, in equipment leasing as well as elsewhere, is essentially a flexible and adaptive matter, whereas control by statute is unavoidably much less flexible.

I know that your members are concerned that high standards of practice and behaviour should always be observed. Nevertheless, with the rapid growth of the leasing industry, a significant proportion of new business appears now to be written by newcomers with much less experience than your membership of the intricacies and risks of this business. In this situation, it seems to me that anything that your Association could do to underline the seriousness with which the matter of self-regulation is taken within the industry would both underpin public confidence and confirm that official monitoring is complementary to self-regulation rather than the principal form of prudential surveillance in this field.

I would like at this point to pay tribute to the initiative shown by your Association in collecting and publishing the statistics which enable us to chronicle your progress. It is a matter for congratulation that you assembled and processed the 1978 figures within some six weeks of the end of the year. I am sure that you will maintain that

standard. There is now also a need for parallel improvements in the official statistics, so that investment financed by leasing can be more clearly identified in the national accounts and your own position as part of the financial sector can be properly recorded. Work on this is, as you know, in hand and I am confident that the official statisticians will be able to count on the co-operation of your members.

Reverting now to your part in the finance of industry, it is certainly clear that you are meeting a manifest demand. Equipment leasing appeals to a wide range of companies by assuring them of the use, rather than the ownership, of specified equipment over a defined period on terms programmed in advance to suit their requirements. More specifically, equipment leasing has lowered the cost of capital for companies that do not have taxable profit immediately, but foresee such profit later, by enabling them to take advantage of the accelerated depreciation allowances claimed by the lessor. Furthermore, equipment leasing has provided an important alternative method of financing at a time when companies have been necessarily reluctant, given high inflation and uncertain inflationary expectations, to commit themselves to fixed-rate debt, but diffident also about increasing their dependence on overdraft facilities unrelated to the prospective economic life of plant and equipment.

It is sometimes suggested that a further attraction of equipment leasing is that it affords off-balance-sheet financing, leaving capital gearing and the cost of other forms of finance unaffected. This view does, however, need qualification. If the proposed new standard on accounting for leasing, when it eventually appears, were to recommend that leased assets be capitalised in lessees' balance sheets, leasing would no longer be 'off-balance sheet'. But whichever way that question is resolved, lessees will be bound to disclose in their accounts information about their leasing commitments; and it is these commitments to future rental payments which are important. For while equipment leasing will in some cases ease pressure on capital gearing, it will at the same time raise the ratio of interest and rental charges to corporate income. That is to say, it increases income gearing, which can be a far more serious constraint than capital gearing for many companies.

The underlying problem, of course, is not so much the cost of capital or the balance-sheet structure but the very low real rates of return being earned by industrial and commercial companies on their existing capital stock. These low rates of return have, as we all know, contributed importantly to your rapid growth. But you will all agree, on wider grounds, that companies need to earn much higher post-tax real rates of return on their total trading assets than the range of 2%–4% seen in recent years. The return nominally attributable to equity has not been quite so low, but this is of small comfort. For shareholders have not seen the market value of their equities keep pace with inflation, with the result that the cost of raising new equity capital has remained high.

Our future economic advance will depend heavily on the growth and improvement of our capital stock. But this will only come about if industrialists can look forward with reasonable confidence to a real rate of return in excess of the cost of capital on their new investment. A complicating factor here is that the extent of the recent deterioration in real rates of return may be inadequately perceived, in particular because many companies have adapted, and have indeed been able to adapt, their processes of accounting, pricing and investment appraisal only incompletely to the inflationary environment of recent years. There seems little doubt that pricing and investment decisions have been distorted by the widespread persistence of historic cost accounting—a further manifest of the damage done by inflation—and the present efforts of the accounting profession to promote general movement towards the adoption of inflation-adjusted accounts is in my view much to be welcomed.

The deterioration in real rates of return in the 1970s was not of course confined to the United Kingdom and has indeed mirrored the world recession. Looking ahead, the prospects for world output and activity, now again affected by the rising cost of energy, do not suggest an early general improvement in capacity utilisation. Moreover, the room for manoeuvre here, in terms of national economic policy, has become fairly narrow. For it has had increasingly to be recognised in recent years that the effectiveness of policies designed to increase demand in the short term is often severely limited by a resulting exacerbation of inflation.

All this means that an improvement in rates of return will depend especially on improved efficiency at broadly present levels of demand and on moderation of pay increases. These two, productivity and pay, often appear in the United Kingdom to lead independent lives of their own. Yet the relationship that is struck between them is crucial to our international competitiveness, to rates of return on capital and, through these, to the level of employment and real wages.

While an improvement in productivity is the ultimate key, this cannot happen overnight; and to secure an early improvement in our relative cost position in the short term, we must look principally to moderation in the pace of earnings growth. If greater moderation can be achieved, the pressure on profit margins and on employment should be contained. Until it is achieved, any idea of a material recovery in the pace of economic activity in the United Kingdom is, in my view, illusory.

Meanwhile, the authorities themselves are responsible for maintaining monetary and fiscal restraint consistent with a steady reduction in the underlying rate of price inflation.

Their continuing aim must be to reduce monetary growth rather than to allow it to accommodate inflation. I therefore welcome the Government's commitment, announced in the Budget speech, to a lower monetary target. Given the uncertainties of the

immediate situation, and the fact that bank lending has recently been rising so strongly, we did not feel that monetary growth could be brought down sufficiently quickly without supporting monetary measures. Minimum lending rate was therefore increased from 12% to 14%. Monetary policy imposes an ungrateful responsibility. But it is in no one's interest that this responsibility should be burked.

The weight on monetary policy may ease later on, as the accompanying fiscal policy gathers strength. Even

so, the prospects for the economy generally may remain subdued. The outlook for the world economy has worsened, following the latest rise in oil prices, while the recent trade figures emphasise only too clearly the magnitude of the task ahead. This is a stern message. But there is an element of hope too—for the prospect would be greatly improved if, within the next year, there was evidence that the underlying rate of inflation was really coming down. If this came about, the chances of resumed growth would certainly be very much better.