Speeches by the Governor of the Bank of England

The economic prospect and the tasks for industry

Given at the Industrial Society Conference on 23 April 1980.

I must first say how pleased I am to be invited to address this conference. It is, I think, an admirable example of the Industrial Society's work that it has assembled today this group of senior management and trade union representatives to consider together how to promote the prosperity of our industry, and the employment that only such prosperity can produce.

Finding myself in the Porter Tun Room of this brewery, I am reminded of Dr Johnson's words on the occasion when he attended the sale of another brewery—Mr Thrale's. Looking around at the massive equipment of the trade, he said 'we are not here to sell a parcel of boilers and vats, but the potentiality of growing rich beyond the dreams of avarice'. This may sound a piece of Johnsonian rhetoric. But it is true that we must look at the large possibilities and the large issues.

It is in that spirit that I want today to speak of 'the facts of the British economy'. We clearly have problems. I do not intend to make exhortations that we must do better. If our problems are to be solved, it will be because self-interest drives people to do so. But to see their self-interest, there must be understanding of the facts.

Britain is still a major industrial nation. But it is true, I think, that since the war manufacturing industry in this country has been subject to many adverse pressures. Some people would, indeed, seek to put the origin of these trends right back into the 19th century. Certainly since the war there has been a decline in the international importance of manufacturing in this country. There has also been a decline in the relative importance of manufacturing in our economy—a fact which one should not, however, overdramatise. Many countries have experienced a similar decline in the relative importance of manufacturing industry, and a growth in that of the service trades. In our era, that appears to be part of general economic advance.

But it remains true that our performance has been in many respects inferior to that elsewhere. Productivity here has advanced relatively slowly: that presumably reflects relative unwillingness to adapt to new techniques. Presumably for the same sort of reason, we seem to have been failing to make full use of our capital equipment; and have failed to invest as largely as many other countries. Our overall performance in international trade has been relatively poor; and, partly connected no doubt, we seem to have been slow in introducing improved designs or new products. This is of course only a general picture, to which there are many and important exceptions—or else we would not have done as well as we have. But the general trend has been widely commented on and is, I think, undoubted.

The hard fact, as those on the sales side of industry appreciate only too well, is that constant effort is required to keep up with a rapidly changing world—to design the goods which will be in demand, to produce them at a competitive price and to sell them for an adequate return. Immediately after the war many were aware of a major problem in making good the ground lost during the war, and began to try to deal with it. It is easier to see now in retrospect that as a nation we were unprepared for the scale of change which has occurred in the rest of the world—the change in the balance of competitive power arising not only from the post-war revival of West Germany and Japan, but also from the growing industrialisation of developing countries.

Some would assert that this tendency to inferior performance has worsened and become more evident in the last few years. But in the last five years there has been another sort of development as well. It could hardly have been foreseen how great was to be the major shock inflicted on the world economy by the increase in the price of energy, and by the tidal wave of general inflation which this was to generate. This was in 1973 and 1974. Since then all over the industrial world, but particularly in this country, there has been a slower growth of demand than during most of the post-war period. This has naturally made more difficult the problems of industrial firms. In thinking about this recent situation, we must not lose to mind the long-continued trend of poor productivity, which lies close to the heart of our basic problems.

In the next year or so, we in this country—if current forecasts are to be believed—may well see an actual recession of demand and output. It is important to be clear why. Is it all due to deliberate government policy? Is there a course we could follow which would avoid it?

I think it is clear that almost all countries are greatly preoccupied with the problem of inflation; and that the first priority of governments is to master inflation. This is certainly clear to me from my international contacts. Governments therefore feel that, for the time being, expansionary policies are ruled out. As many people have pointed out, a massive increase in the price of oil reduces demand in consuming countries; and governments do not feel free to seek to compensate that by following easier fiscal and monetary policies. As a result, world demand has been growing more slowly, and will continue to do so. We in the United Kingdom are of course affected by that, and it is part of the explanation of why, if it comes—as it well may—there will be recession here.

On top of that, there are features special to our own situation. There are a number of particular reasons why demand in this country is likely to be low—consumer spending has till recently been growing at an unusual pace that could not be sustained; and stocks in the pipeline may have got unduly high. There is also the more general reason—that while, on the one hand, policy is directed at getting rid of inflation, the pace of inflation in this country is currently at a very high level. In the initial stages, the process of fighting inflation is bound to be hurtful.

I will, if I may, illustrate this from my own field of monetary policy. As part of the anti-inflationary strategy, we have set ourselves a target for the rate of monetary expansion—not perhaps an unduly low target, but a definite one. This has required rates of interest which are high in nominal terms, though not high in relation to the current rate of inflation. Such rates of interest, and the higher exchange rate to which they may contribute, are inevitably hurtful to industry, as I am acutely aware. They are, however, part and parcel of the process of controlling inflation.

It is very fair to ask whether this painful period of adjustment is necessary. Are there alternative policies or easier options? It is relevant to point to the basic necessities in our situation. The Government of this country is bound to grapple with inflation, as are governments elsewhere. The determination of other countries to tackle inflation indeed underlines the need to tackle it here: if we do not match the success of others in this respect, our international competitiveness will be eroded yet further.

There are those in the bleaker of our two ancient universities, and perhaps elsewhere, who argue for the erection of a general tariff wall, behind which we could raise demand, with the object of getting growth going faster and putting unemployed resources back to work. That sounds half attractive. But it turns a blind eye, I think, to all the political dimensions of political economy. What would foreign governments, and in particular our European partners, say to such defiant turning away from normal international rules of behaviour? Could one seriously believe that high protection would not give rein to higher inflationary demands by workers in all the industries so amply protected and thus promised a sure demand for their products? And—our ultimate and basic problem—would not this country, behind such a protective wall, become not more productive, and more efficient, but less?

I conclude that we must live in the real, everyday, uncomfortable world we know; and endeavour to make that work. That will require a very great effort, because it means abandoning attitudes and assumptions that in the post-war decades have not had to be questioned, and have become entrenched.

In advanced industrial societies, the remoteness of original causes from their ultimate consequences frequently hinders our understanding and makes us react illogically. We are reluctant to accept that many developments should, and often must, affect our standards of living. We take it as a natural right that money earnings should rise to compensate for any increase in the retail price level. That claim to insurance against changes in the retail price index is peculiarly damaging, given our position as an open economy. It is inappropriate in such a situation that one particular category of money incomes in society should seek to insulate itself against it.

We in Britain are not alone in having this illusion about compensation for price increases. But we cling to it obstinately in circumstances in which it is particularly damaging to our future livelihoods and prosperity. The illusion may have been fostered by the general assumption that there was an automatic growth of output per head of some 2% or 3% a year, on which we could count to improve the living standard— regardless of what was happening to investment, innovation or markets. It was fostered, too, by a cost-plus mentality—that whatever pay increases are conceded can be passed on. Circumstances permitted this attitude to become entrenched in the immediate post-war decades; it has for long been crippling; but now, against today's competition, it has, in much of industry, become impossible.

I suspect, therefore, that the development of the next wage round could be different in some respects from this one. Already we have seen some notable examples of relatively moderate settlements being reached, and of extensive changes in working practices being adopted, in firms whose survival was in question. British Leyland may appear an extreme case. But other firms are faced with financial pressures, if on a smaller scale. We may well find an increased disparity in the scale of wage increases among different firms and different branches of industry. And it may well be that the measuring rod of the retail price increase ceases to be the dominant standard. When inflation speeded up last year, wage increases generally were in advance of the rise in the retail price index. The process of slowing inflation down may very well involve a reversal of this relationship, for a time. The speeding up of inflation involved a further squeeze on profits. It is in fact desirable, for the sake of investment and of our competitive position as a trading nation, that profits should be reconstituted. It would be a particularly important advance if there could be better understanding that moderation in *money* wage settlements would, through its effect on inflation, open up options for the economy that could lead to higher *real* wages. The basic paradox is that, if there were less concern to achieve rises in money wages, rises in real wages, and thus in the standard of living, might in fact be greater.

I recognise that the implication of my argument is that the immediate path ahead for British industry is likely to be a difficult one and that there are areas where it will be a considerable achievement to minimise decline in terms of output and jobs. I would, however, like to make one general point—a very obvious one, though sometimes neglected. It is obvious that some firms have done better than others. An individual firm is not restricted by the performance of the average. The fact that a recession is probable is not a reason for saying that efforts at improved performance must stop till the recession is over. The reverse is true: progress is all the more necessary—for the economy as a whole and, equally important, for the well being and, in some extreme cases, even the survival, of individual firms.

I believe that the wider recognition of what I have been trying to say would greatly improve the chances that the behaviour of all members of our industrial society would be reasonably constructive and not unreasonably destructive. We follow the destructive path if we seek to load further cost burdens onto industry, to undermine its ability to invest or to destroy the confidence of its customers in its ability to supply.

Most of the problems facing industry have to be tackled within industry itself—tackled with sympathy and understanding, but with realism. The management of industrial change in the years ahead calls for outstanding skills and sensitivity. There will obviously need to be close consultation by managements with the unions and employees not only so that greater efficiency is accepted, but so that it can lead to the preservation of firms' markets and later to their expansion. There can be no blueprint for success: different industrial situations call for different approaches. What is clear is that success in any industrial situation requires an adequate perception of the problem, and the possibilities that it opens up, and an atmosphere of trust and confidence among those who are striving for a solution.

In this latter respect, the initiative of the charter on management/shop-floor co-operation that has been taken on the occasion of this conference seems to me particularly welcome and timely. I wish it success. It relates in particular to building up the frank communication which is a necessary basis for the trust that should characterise all relationships, even where there is disagreement, between management and shop-floor.

In this connexion there is one particular aspect to which I would like to refer, namely the nature of the financial information that is communicated. There is a proper tendency for emphasis to be placed in pay negotiations on trading and profit performance in real terms, whereas the information provided to shareholders in company reports and accounts has hitherto been, more often than not, largely on an historic cost basis. But the latter basis almost invariably shows a better outcome than the former, and it would be surprising if those involved in pay negotiations were not on occasion confused, and indeed mistrustful, when they see that employees are being tendered a different account of company performance from that made available to shareholders. It is with this aspect in particular in mind that I welcome the new inflation accounting standard that has been promulgated by the accounting profession, ensuring that from next year onwards published accounts will, save for small companies, invariably include a profits statement on a current cost basis. I believe that this will also be of considerable benefit in focusing attention within firms on appropriate inflation adjustment in management accounts.

Finally, I return to my wider theme. A major improvement in performance is surely within industry's reach. It will depend critically on what can be achieved by those within industry itself. We need in particular to make full use of such key groups as engineers and skilled men, and reward them appropriately. Their role is vital, but their capacity for self-respect and pride in achievement can be eroded if apparently small store is set on their contribution. The way forward would be materially eased by greater appreciation in society at large of the importance of industrial capability—North Sea oil cannot provide a substitute, nor provide us with an endless widow's cruse in support of an unearned standard of living. It would be to preach to the converted to observe in this forum that social attitudes to industry appear less sympathetic in this country than elsewhere. But the lesson needs emphasis, and has been particularly well made by Kenneth Adams: 'A society which does not deeply believe in the worthwhileness of the activity by which it lives, and therefore does not hold that activity in reasonably high esteem, faces a major moral dilemma which will prevent it having a hopeful and positive attitude towards its whole future'.

Banking supervision and the Banking Act

Given at the Financial Times luncheon for representatives of the foreign banking community in London on 20 May 1980.

In considering what might form the matter of my remarks to you today, it occurred to me that at an occasion given by the Financial Times for representatives of the foreign banking community in London, it would be particularly appropriate to speak of the Bank of England's supervisory role in relation to banks and other deposit-taking institutions. This has been a subject necessarily of greatly increased importance and interest ever since the events, both here and in other countries, of the early 1970s. More recently, here, the Banking Act 1979 and its implementation have aroused considerable interest among commentators, bankers and deposit-takers. I think there has been more than a little misunderstanding and misapprehension among some in these groups about the Bank's responsibilities in this area and about the manner in which it intends to carry them out.

The images that some have presented of the Bank in this debate call to mind the ghosts that appeared before Scrooge in Dickens' *Christmas Carol.* There is the ghost of Christmas Past—a romantic image of a benevolent and benign Bank of England presiding over an exclusive 'club' of bankers where everyone knew how to behave and thus where no one ever needed to be reminded what to do. It all, as the song has it, came naturally. Then we have the ghost of Christmas Present—a baleful Bank blinking in the bright light of a new Banking Act and deciding that it must carry newly-discovered convictions about how banks should run their businesses into the furthest corners of the banking system. The last spectre is the ghost of Christmas Future—a malevolent Bank wielding its authority arbitrarily as the willing tool of a doctrinaire regime, setting out to manipulate a helpless financial sector into becoming a mere extension of government.

I acknowledge willingly the genius of Dickens' imagination, of which violence and associated extremism were an essential ingredient, but I think you will forgive me if I eschew caricature and seek to describe a more complex and less alarming reality.

Let me begin by saying a word about the Banking Act itself. It has two main roots. First, the need to introduce effective supervision over a wider range of financial institutions than had previously been the responsibility of the Bank. The events of 1973 and 1974 made clear the dangers of a system in which many deposit-taking institutions were effectively unsupervised and where the public perception of the status of different kinds of deposit-taker was extremely blurred. I regret to say that there appear to be a number of people whose memories of that period have become suprisingly selective. Second, there was the obligation on the United Kingdom to give statutory effect to the principle established by the first European Community Directive on Credit Institutions, that there should be a prior authorisation procedure before any institution can engage in the business of taking deposits from the public. This principle springs from a concern to protect depositors—a concern underlying both the Directive and the Act. Accordingly, under the Act all institutions which seek to take deposits must be authorised. Clearly, not every such institution is a bank. A judgment, a discrimination, about which is and which is not is therefore inevitable. Hence the so-called two-tier structure and the relevant tests in the Act.

The implementation of legislation about banking supervision necessarily brings with it a degree of formalisation which did not previously exist. Nevertheless, it is right to emphasise that we shall still not have a rigid or legalistic system. The terms of the Act provide the Bank with flexibility in interpretation and in the day-to-day supervisory processes. And of that flexibility we shall, of course, properly avail ourselves. For I am sure it would be generally agreed that flexibility is preferable to a system of supervision in which detailed rules and regulations are rigidly codified.

The range and variety of the institutions in the London market and the continuing evolution of banking structures and practice make such flexibility essential. A detailed statutory codification of prudential criteria would make it impossible to take proper account of these factors and would run the serious risk of putting the supervisory system and the institutions subject to it into a straitjacket. The Act as actually drafted is, in contrast, designed to fill a gap in the regulatory arrangements exposed by the events of 1974, whilst allowing the Bank to maintain its customary open and adaptive approach to those it supervises. Although certain passages provoked some controversy, the Bill as a whole attracted, as you will recall, a wide measure of support from all parties and its passage into law was generally welcomed by the financial community.

Perhaps the most important structural feature laid down by the Act is the two-tier system. This structure has as its objective to distinguish that kind of business which is recognisably a fully-fledged banking operation on the one hand from that which is something different on the other. The distinction in practice between the tiers is more one of function than of status. At present, detailed procedures for granting authorisations are being gone through, with, I believe, the degree of thoroughness and fairness which you would expect from the Bank. In this task the Bank has been presented with some difficult decisions at the margin.

Let me say a little more about how we see the borderline. It is not intended, and was never intended, to be a great divide. We are concerned, as we have always been, to permit and encourage progression for those institutions which may wish to move from the licensed deposit-taker category to that of recognised bank. Clearly, not all will wish to make this move. For the Act provides that the distinctive attributes of a fully-fledged bank are not only, on the one hand, the high reputation and standing that it will have built up over time in the financial community, but also, on the other, the provision in reasonable depth of a wide range of banking services in this country—a criterion which many institutions will have no interest in meeting.

Therefore, classification as a licensed deposit-taker is not to be seen of itself as impugning the status of an institution—and certainly not the integrity and competence of its management or the good name of the institution generally. This point is worth repetition. As further lists are published, it will be very clear that a wide variety of institutions is covered in the category of licensed deposit-taker. For example, it will include a number who, for very good reasons, have not sought, or do not want, to provide the range of services which go to make up the business of a fully-fledged bank. In addition it will embrace a number of institutions of overseas provenance, including branches of major foreign banks which are of undoubted standing and reputation but which have not been in business long enough in the United Kingdom to have built up their range of services here to the level required of a recognised bank. In these circumstances the Bank of England would not expect the market to make crude judgments of creditworthiness based merely on the distinction between recognised banks and licensed deposit-takers. Indeed, I should regard the market as failing in professional expertise if it were to base its assessment on this distinction alone. There can be no justification for charging a particular institution, which in every other respect remains unchanged, more for its money following publication of its name in the list of licensed deposit-taking institutions. The division between licensed deposit-takers and recognised banks has, as I have already suggested, a marked functional character and some licensed deposit-takers will undoubtedly be stronger and of greater repute than some recognised banks. This should be clearly understood by all institutions involved, both at home and abroad.

I will turn now, if I may, to the development of our banking supervisory responsibilities more generally. The fairness and consistency that we seek to apply in the execution of the authorisation procedures must obviously also imbue our approach to the fulfilment of our wider day-to-day supervisory responsibilities. The Bank needs to have general principles on which to base its supervision so as to be able to treat different institutions evenhandedly. At the same time, in applying these principles to individual institutions, the particular circumstances of each must properly be taken into account.

It is inevitable that there will be occasions—for we have to have regard to the system as a whole—when the requirements of supervision will seem to conflict with what a supervised institution or a group of such institutions sees as its best interest. By and large, however, a successful supervisory regime will want the banking system to breathe comfortably and will seek to ensure that its basic tenets are essentially consistent with the institutions' own perception of commercial prudence. It must certainly be the Bank of England's endeavour to carry the weight of banking opinion with it on the general supervisory principles to be applied, for it is the spirit in which they are followed which matters: prudent banking can never be ensured by the mechanical application of a particular set of rules.

It is for these reasons that the Bank continues, within the new statutory framework, to attach great importance, as it always has done, to consulting extensively with the banking community as it develops its supervisory guidelines.

Through the discussions we are conducting on the consultative papers which have been published in recent months, we are seeking to maintain this traditionally participative and flexible approach by the Bank to supervision.

I would like to say a word or two about these consultative papers. Let me first emphasise most strongly that they are just that: consultative papers—not tablets of stone.

Three such papers have been prepared. The first, on the measurement of capital, draws on the conclusions, published in 1975, of the joint working party of the Bank and the London and Scottish clearing banks. This paper has been extensively discussed with the banking community. In the light of these discussions, the paper has been revised, as I would expect it to have been, to take account of the banks' comments. This will be clear when the new version is published.

The second consultative paper, on foreign currency exposure, follows from the abolition of exchange control last year. For forty years these restrictions had themselves provided some elements of prudential constraint. Once they had been lifted we felt it right to set out rather more explicitly the Bank of England's view of what might be the appropriate prudential arrangements for dealings in foreign exchange. The risks for banks in this area have greatly increased in the last decade and monitoring arrangements similar to those envisaged in the consultative paper are, of course, in place in other major banking centres. As the paper states, the Bank will take fully into account comments which are made in the course of consultations before a revised document is produced.

The third paper, on the measurement of liquidity, was issued recently together with the Green Paper on monetary control. Discussions on it with the British Bankers' Association have just begun, but they are not meant to be exclusive and we shall welcome comments from others.

I would like to say more about the liquidity paper. Liquidity adequacy is a particularly complex and elusive concept. It is also a subject where the debate among the banking community, at least in the United Kingdom but probably also abroad, has not been engaged with the degree of intensity which the subject deserves. There are real problems of how the age-old principles of prudent banking should be applied in the circumstances of some important changes in financial structure and markets and in the light of recently developed banking techniques. It comes as no surprise that an attempt to pioneer and provoke thought should cause controversy. We welcome a wide-ranging and probing discussion of this subject, which should be conducted in a calm and open-minded way.

We have suggested in this paper the development of an integrated test of liquidity. By this I mean a test which, while taking proper account of the diversity of the assets and liabilities of different institutions, produces a general system of measurement which can be applied to all institutions but assessed in the light of the particular circumstances of each. We have no desire or intention to apply these measurements in such a way as to place some classes of institution at a disadvantage relative to others. Of course, as a supervisory authority, we have to address ourselves not only to the adequacy of the liquidity of the individual institution, but also to the liquidity available to the system as a whole. We further believe that a careful assessment needs to be made of the degree to which the modern techniques of liability management and mismatching of liabilities and assets of fixed term are being underpinned by adequate levels of liquidity in individual banks, both domestic and international. These are all complex subjects on which conclusions will not be easily reached, but they raise important issues which we consider should be thoroughly discussed with the banks. Our paper represents first efforts to elaborate some of these ideas and seek the response of the banking community to them.

There have been suggestions that this group of papers marks a new approach by the Bank to its supervisory responsibilities. This is true only to the extent that the Bank now has a formal responsibility, deriving from statute, to monitor the capital and liquidity adequacy and other prudential aspects of banks' businesses. The Bank certainly should, and indeed under the Act must, be in a position to explain the basis on which it sets about fulfilling that responsibility. But I would emphasise that it remains the Bank's purpose to discharge that responsibility without unreasonable interference in the activities of the institutions concerned.

The Bank stands, as it has always stood, for the maintenance of sound and responsible financial business in the City. Within the limits imposed by this precept, we are in no way in the business of constraining innovation and enterprise in the banking community—without such enterprise and innovation, the City would not be what it is now. We have always believed that the broad, strategic interests of supervisors and supervised in banking business are as one and that, even at the tactical level, real conflict should be rather rare. I am confident that my colleagues will continue to carry out the Bank's responsibilities in this area with the professionalism which the banking community has the right to expect and with the sensitivity to what goes on in the market place that is the hallmark of effective central banking.

Nevertheless, I accept that 1980 may be in some respects quite a difficult year of adjustment for us all. It will require co-operation, patience and a willingness to talk the issues through. For the introduction of such a substantial piece of legislation as the Banking Act must inevitably cause some disturbance to the existing order. But I hope that at the end of the day it will be readily recognised that the Bank has maintained its flexible and participative approach to supervision whilst working within the new statutory framework. The Bank and the banking community together need both to enhance our system of prudential supervision and to preserve the pre-eminent position of London as a financial centre. That is a prize not only well worth winning but one we have to win. It will certainly not be lost for any lack of will on the part of the institution for which I speak.