Speech by the Governor of the Bank of England

Review of monetary developments

Given at the Lord Mayor's dinner to the bankers and merchants of the City of London on 16 October 1980.

This evening, My Lord Mayor, is by tradition an occasion for taking stock of economic and monetary policy. Tonight provides a timely occasion. We have reached an important stage in the development of the economy; we can discern some benefits beginning to emerge from the policies which have been pursued, and can also weigh up more clearly some problems and risks ahead. On the financial side, the sudden spurt in monetary growth following the end of the corset caused some confusion and uncertainty. The Bank for its part therefore has, as I am aware, received a good deal of advice—from opposite sides, both for being lax and not controlling money; and for having too tight a policy, with interest rates too high; and as regards its methods of control. Such matters as these cannot be put into perspective every day, and I particularly welcome the opportunity which this occasion affords to say something about them.

Although I shall look chiefly at developments over the past year, it will not, I think, surprise you if I emphasise the Bank's central conviction, consistent under successive governments, that the economic system can only work well against a background of financial stability. These words, taken from the first Mais lecture of two years ago,[1] mean, as I then indicated, that our first order of business must be to maintain confidence in the framework of the system. This involves the containment and defeat of inflation and a financial discipline which reflects over time a reducing growth in the rate of expansion of money. The task is made easier or more difficult, and its pain lighter or heavier, by the extent to which the actions of the economic agents in society—government and public authorities and corporations, employers and wage earners—are consonant with the guidelines set for its accomplishment.

But let me turn first to the economy as a whole. There are severe problems and difficulties, but it is right also to recognise that some positive results are beginning to come through.

Over decades our productivity performance has been poor. It has long been plain that if we had been less resistant to change, average output per man, and hence the average standard of living, could have been far higher. It is encouraging, therefore, to hear reports that attitudes may be changing. The Bank's wide contacts with industry suggest that managers are more alert to the need to manage, and that workpeople are more concerned with the success of the firms in which they work. Improved methods, it is said, are being introduced and accepted more quickly, because it is realised that they are essential to survival. If this sense of reality can be preserved when trade revives it could provide the basis for a new and enhanced prosperity.

The prime object of policy is the defeat of inflation; and we must be greatly encouraged by the signs that inflation is now yielding ground. Retail and wholesale prices have been rising progressively less rapidly—as have also the prices of commercial property, houses and land, typically the harbour of funds seeking to escape inflation.

The immediate course of inflation depends importantly on what wage settlements will be. Here, too, there are hopeful reports. It seems likely—particularly if settlements in the public sector are kept moderate—that wage increases in industry will be at much more realistic levels than last year.

That would be a heartening change. If we are to achieve price stability in the years ahead, wage increases will have to be earned—earned, that is, by productivity increases; and we will once again have to get used to low single-figure settlements, as in many other countries.

But, as I am well aware, for many firms this is an anxious time. Demand has shrunk, and low profits are being further squeezed. Firms are being forced to undertake severe retrenchments—some perhaps overdue—of stocks, of overheads, of labour, and now increasingly, of investment. Many firms, moreover, are understandably concerned about their ability to hang on in markets at home and overseas in which they are trading at a loss. The force of the recession still seems to have some way to go. When it ends, many companies will be in a better condition to grasp the opportunities that an upturn presents; but, the longer the recession lasts, the more will others find their situation becoming difficult.

One of my important tasks tonight, My Lord Mayor, to which I must now come, is to discuss the behaviour of the monetary aggregates. As we all know, our target aggregate, sterling M_3, showed a rapid increase in the summer. It is therefore important to determine the nature of that acceleration.

It is, first, clear that the corset seriously distorted the monetary statistics, both in the two years while it was in

(1) Reproduced in the March 1978 *Bulletin*, page 31.

effect, and after its removal in June. The effect was not unexpected: the uncertainty related to its extent.

One general lesson from this experience with the corset and from our earlier experience with quantitative lending ceilings is that we need to be deeply sceptical of the value of direct controls of this kind.

It also seems clear that, making all due allowance for the effects of the corset, the true underlying rate of growth of sterling M_3 accelerated sharply in the late spring and summer to well outside the target range. This followed a period of some months in which monetary growth had moderated.

These swings in the rate of monetary growth reflected quite largely the fluctuations in the scale of public borrowing. At the turn of the year the public sector borrowing requirement was relatively low, while heavy funding continued. In the spring and summer there was a resurgence in public borrowing—which perhaps approached a rate of about £7½ billion in the first six months of the financial year. This resurgence was no doubt in considerable degree temporary, but it was much larger than expected. It was in consequence more than could then be financed outside the banking system from the capital market, even though sales of gilt-edged stock were made to domestic non-bank investors in that period of over £4½ billion.

In face of such swings in the borrowing requirement, the difficulties for short-term control of sterling M_3 are, I submit, bound to be increased.

At the same time, net external outflows from the private sector, which exercise a contractionary effect on monetary growth, diminished as the current account went into surplus.

There was, in addition, one other powerful force, arising from the condition of the economy—persistently strong demand for bank credit from the private sector. The bulk of this borrowing has been by industrial and commercial companies and, increasingly since the recession really began to bite in April, a proportion of it has been undertaken to maintain the substance of businesses intact.

The large financial deficit of companies has gone along with a large surplus of the personal sector. Given that companies effectively lacked an alternative channel of finance, via the capital market, the marrying of these large negative and positive imbalances has fallen to a very considerable extent on intermediation through the banking system. The aggregate that is the target of policy, sterling M_3, was correspondingly inflated in a way that may well misrepresent the degree of stringency with which monetary policy is affecting the economy.

Assessment of what has happened must also take into account the likelihood that these pressures on sterling M_3 may now begin to ease. Inflation is past its peak. There are some tentative signs that private sector demand on the banks may be beginning to slow down. Public borrowing should also fall off: its enormous scale in the first half of the financial year must be judged to have been of a pseudo-seasonal character, which in some degree will correct itself. Taken together, such changes would at least hold out the prospect that the recent inflation of the sterling M_3 statistic may not persist. This suggests that over the whole of the target period to next April the rise in sterling M_3, after proper allowance for the distortions of the corset, may turn out to be much less than has been generally supposed.

The recent experience illustrates the strength of the forces of monetary creation with which we are contending in our monetary aims, forces which derive their current power from the pressures and distortions prevalent in the economy. It is of course possible to imagine a tighter or more rigid control of the creation of money achieved on a more continuous and shorter-term basis. Temporary pressures and distortions would then be turned back more abruptly on the real economy instead of being reflected in temporary variations in monetary growth.

In reflecting on this whole experience my final observation is to emphasise the sheer erratic variability—words again from the Mais lecture—of the counterparts contained in sterling M_3. The lesson, perhaps, is the need to avoid attaching undue importance to short-term developments in any single monetary aggregate; it is sounder to take into account, as we in fact do, the underlying developments both in the aggregates as a whole and in the real economy. Taken overall, this evidence suggests that policy has been restrictive rather than otherwise.

The tenor of these remarks is to suggest that monetary control, as any central bank practitioner will confirm, is not a simple matter.

That said, it is of course right that we should at all times be active in the search for improved methods of monetary control. This subject has been under intensive official consideration, and we have recently had the benefit of advice both from experts in the City and our own universities, and from central banks and universities in other countries. It will be a little time yet before the conclusions to be distilled from these extensive consultations can be put forward.

Meanwhile, some important changes are already in train. The abolition of the corset means that we shall soon have a system in which the distortions it caused will be a thing of the past. Furthermore, it has already been agreed that there will be an important extension to the availability of index-linked national savings. This move, which could doubtless be extended, and the projected sale of British National Oil Corporation bonds, should materially ease a situation that has complicated monetary control. The Bank welcomes these developments: they should enable an increasing proportion of the public sector's needs for finance to be met directly from personal savings and should constitute a helpful step on the road to opening the capital markets again to corporate borrowers.

These are adjustments and modifications to our present system of control. Proposals have been made that we should move to a rather different system, a monetary base method of control. It is an attraction of such a system that the monetary base—held by the banking system as the basis for its operations—is more directly controllable by the monetary authorities than are the monetary aggregates, particularly the wider aggregates such as sterling M_3. I will not embark on a discussion of the exact way in which changes in monetary base might be related to the behaviour of the wider aggregates, for the hour is late and the subject complex. But two things are, I think, clear. It would create a rather different environment for many of our financial institutions, and it would require a perhaps not inconsiderable period for experience to be gained as to the response of the system under the new conditions.

It would be premature to attempt to come to a definitive view on these questions. For some time to come we shall, in any event, continue to face the sort of tensions besetting monetary policy which I have set before you, and which are the background to monetary management.

My Lord Mayor, I have concentrated largely on monetary policy. That is appropriate not only by reason of my responsibilities, but also by reason of the crucial role which monetary policy has to play in our efforts to provide a sound and stable financial framework for the economy. A central bank makes its particular contribution by pursuing a steady and determined path towards that goal. I do not think you will suppose that we shall shrink from that responsibility.