Speeches by the Governor of the Bank of England

Given at the annual banquet of the Overseas Bankers Club on 4 February 1980.

Let me sketch with a few touches the picture which the world, at the start of the 1980s, presents to the eye of a central banker, before going on to treat more selectively of some features which are of most direct concern to members of this Club. It is a picture of a world shot with anxiety and uncertainty. We are familiar enough with many of the dangers and difficulties, but the events of recent months have extended their scale as political tensions and economic uncertainties have met in malign combination. This has shown itself with a vengeance in the soaring, and now gyrating, price of gold, but it has also begun to percolate into other parts of the financial arena, generating nervousness and some strain in contractual relationships. Thus governments, international institutions and central banks, as well as the world's commercial banking system, now find themselves facing yet harder challenges.

The world economy, still convalescent since 1974, has begun to show signs of relapse. Output and world trade, it is true, were reasonably buoyant last year; but at the same time inflation, only then subsiding but obdurate still, began to break loose again. It is true also that the onset of a world recession, confidently foreseen, has been delayed. But a reason for delay appears to be the ominous one that inflation psychology has till now buoyed up spending.

Closely associated with these developments is, of course, the rapid and continuing increase in the price of oil, which has contributed to the widening current account deficits of the oil-importing world. It is this aspect—and in particular the recycling of the oil-exporting countries' surplus to the deficit countries—that is perhaps of most direct concern to us here tonight and to which I would now like to turn. My starting point is the analogy to be drawn between today and 1974—for I want to avoid any false lessons from a sense of *déjà vu*. The similarities are striking, but there are also important differences; and among both the similarities and the differences, while some are a source of reassurance, some give cause for concern. Take first the scale of the present recycling problem. Not only is it greater in nominal terms but, more worryingly, it is likely to be more persistent than before. In 1974 the current surplus of the oil exporters was \$60 billion, but by 1975 the surplus had been halved. In 1979 the oil exporters' current surplus was again of the order of \$60 billion; but this year, so far from falling by 50%, the general expectation is that it is likely to rise by around 50%.

The sums involved are very large indeed—even if looked at in real terms—and it is difficult to be optimistic about the outlook for 1981 and beyond. The imbalance in the world economy may be less pronounced next year but could well remain uncomfortably large for some time. Particularly now that some producers are disinclined to extract at full capacity, the real price of oil may not fall as it did after 1974, and some oil exporters are more sensitive to the political and economic problems of accommodating rapidly increased rates of spending.

In some ways, the world can now cope better with such difficulties than in 1974. Not least among such more favourable factors is the experience governments have gained since then. There is much wider recognition of the need for policy measures to achieve a greater degree of economic adjustment, both through increased energy efficiency and through combating inflation. Of course, the re-emergence of an OPEC surplus entails a corresponding increase in the deficits of the oil-importing world, but it will be important, particularly for countries already in an exposed position, to rein in that increase. Several countries, including the United Kingdom, have acted firmly in these respects. It may well be right for more countries to follow suit, to adjust rather than find adjustment thrust upon them.

The last six years have clearly demonstrated that international financial markets are resilient and constructive. International banking activity has grown fourfold since the end of 1973 and with it has increased the ability of the banking system as a whole to take deposits and to lend on a large scale.

Accompanying and underpinning this growth has been a considerable prudential tightening by the banks themselves and by the authorities in major financial centres. We, and our colleagues in other centres, believe in continuing this process and further improvements are now in train. Reinforcing the soundness of the international banking system in this way will help to provide a secure basis for sustainable growth in its financing capacity.

There are, however, several features of the present situation which work against us. I have stressed the need, and the greater recognition of the need, for current account adjustment, especially by countries with a relatively weak external position. But however vigorous the adjustment effort, payments imbalances cannot be quickly reduced. Many countries will still need finance on a considerable scale.

These countries will tend to be ones that have already accumulated a very heavy burden of outstanding debt. Well before the end of the 1970s the debt service commitments of the non-oil developing countries were growing more rapidly than their exports. Now, with maturities closely bunched, world trade slowing down and interest rates high, the debt service ratios for many must be rising—and will go on rising—uncomfortably fast.

The financial needs of these countries cannot be met without further heavy recourse to the international markets. For there may be greater reluctance than in 1974 to draw upon foreign exchange reserves—much of which reflect market borrowing and which in many cases are not large in relation to import needs. Moreover, the finance available from official international and multilateral sources, although greater than in 1974, is still modest in relation to current and prospective needs.

The growing burden of market debt which these countries have already incurred is mirrored in the balance sheets of the banks. The greatly increased international exposure of the banks, recent political developments and the more cautious attitude on the part of monetary authorities across the world towards expansion in the euro-markets may together temper the banks' willingness to lend.

The banks may also find it more difficult to bear the brunt of the recycling burden because of the risk that, as their international business grows, their internal ratios of own funds to deposit liabilities and to total lending may come under strain. Competition has kept lending margins so narrow for the last couple of years at least that the scope for generating internal capital must have been very limited. Given the present state of equity and bond markets, such capital constraints could become increasingly serious.

How then should we react to the issues and problems I have outlined? You will not expect me, and I do not expect you, to be intimidated by their scale. It is in the interests of all of us that the recycling operation should be carried through smoothly and efficiently; and it is impossible to envisage a successful operation without a major contribution from international banking flows.

To that end, it is necessary to identify what could help, and what impede, that contribution. Let me therefore set out briefly a number of points which should, I think, engage our attention.

Evidently it will be helpful if the returns to the banks are commensurate with the risks they assume. I have for some time been convinced that spreads and margins on international lending had fallen too low; and more especially that the differentials between the best risks and less good risks had narrowed too much. There are now indications that spreads may be edging up for lending which is considered to be more risky. This is a development to be welcomed, both in itself as a more realistic assessment of risk and because it may encourage a further increase in total lending by drawing on a wider circle of banks.

A good deal of thought needs to be given to the machinery of international lending. The syndicated medium-term credit has proved to be an effective way of mobilising bank funds. Recent events have put a good deal of strain on syndication procedures, and at the very least some changes in loan agreement documents are likely to be necessary. I do not underestimate the ingenuity of the international banking community. But I would say that there is some urgency in adapting and improving techniques so that the capacity for moving a considerable volume of funds internationally is not impaired.

In the difficult and challenging situation we have to foresee, it will remain essential that international banking operations do not transgress the bounds of prudence. The primary responsibility for the prudent conduct of their business must lie with the banks; but all have a part to play. Some borrowers will have to be more willing to supply both the information which the lenders need, and evidence of an intention to use the borrowed funds to assist, rather than merely to postpone, adjustment. Supervisory authorities individually, and increasingly in concert, have a rôle in facilitating information flows, and in setting and monitoring standards. You may be assured that the Bank of England will play its full part in this.

I would also stress that banking relationships, whether with borrowers and lenders or between bank and bank, rest on a foundation of confidence. Recent, and essentially political, events have shaken confidence. Fortunately the banking industry is highly resilient; but further sapping of confidence could become incompatible with an enhanced recycling rôle.

Thus far, I have spoken largely about the contribution which the banking system will have to make to the recycling process. That contribution is essential; but it needs to be complemented and supported by flows of funds through other channels. There is considerable scope for increased flows of international private investment. The conditions which will encourage banking flows should also encourage investment flows. There is also scope for increased flows direct from OPEC countries to deficit countries.

There is opportunity also for a larger rôle for the official institutions—and in particular the International Monetary Fund (IMF)—in the recycling process. While it seems that the Fund is likely to have resources sufficient to meet calls on it over the next year or so, the traditional means of providing such resources may need to be supplemented in the longer run. We also have to keep under scrutiny the basis for the distribution of the Fund's resources to borrowers, in particular the relationship between countries' quotas and what they can borrow. However, in line with what I have already said this evening about the need for adjustment, we shall have to continue to ensure that borrowings, on whatever scale, are made under the appropriate conditionality. Such an approach should make it easier for co-operation on recycling to flourish between the IMF and the private banking system.

Last summer, in another forum, I suggested that what we have at present is best described not as an international monetary system, but rather as a set of international arrangements. Since I made those remarks the outlook for the world economy, as I have suggested this evening, has darkened. On that earlier occasion, however, I also drew comfort from the greatly improved network of information, consultation and collaboration between the major powers. I did not look upon these arrangements then, nor do I look upon them now, as a steering mechanism to be used only in conditions of fair weather. Their present informal nature should not be taken to imply that they are incapable of withstanding the stresses to which I have referred. I would suggest rather that we take encouragement from the high degree of unanimity in the remarks made by representatives of the world's monetary authorities during the last few weeks on the kinds of policies to be pursued in the difficult period ahead. This is a public manifestation of consultation and collaboration at work. If this community of view is sustained, as I feel sure it will be, the foundations of the international economy will remain secure.

Given at the annual banquet of the Bristol Chamber of Commerce, Industry and Shipping on 13 February 1980.

Last week I spoke of the international outlook and of the heavy tasks which fall to the international institutions—the International Monetary Fund and the World Bank—and to the world's commercial banking system in recycling the immense financial flows accruing to OPEC from recent rises in oil prices.

Tonight I want to speak rather of domestic concerns, and in particular of my monetary responsibilities, the exercise of which closely affects you all. Almost all of you have, I am sure, reason to be concerned, whether personally or in your business affairs, about the present level of interest rates. These are inextricably intertwined with inflation, which is where I begin.

Our experience in this country, as in many others, has been distinctly disappointing. The 1970s have ended with a great resurgence of inflationary pressures. I think all of us would now agree that this threatens the future growth of output and employment.

The fact is that modern economies will not function well if people cannot rely on the future value of money. As I have said elsewhere, inflation impedes economic expansion by inducing caution among consumers, and by making business, and in particular investment, so much less predictable. If we could reduce inflation, this would itself generate a faster expansion in the private economy. The expansion we sacrifice in order to deal with inflation is less than might appear.

A firm monetary policy has a central rôle in combating inflation, since in the long run the inflationary process cannot be sustained without an accommodating growth of money and credit.

It is for this reason that I conceive it to be the duty of the Bank of England, as the nation's central bank, to seek, through the ups and downs of economic and political change, to put its weight consistently behind policies designed to promote a framework of monetary stability. For we believe, as a settled conviction from experience, that it is within such a framework that the wider aims of policy have their best—perhaps only—chance of success.

It is not to be supposed that this task of promoting monetary stability can always be accomplished without actions which themselves seem, and indeed are, harsh and disagreeable. I know that the present level of interest rates is bitter medicine. It is bound to hurt many businesses, and many of us as private borrowers. It is most hurtful to people who are committed to borrowing that they would not have undertaken had they known how high interest rates would rise. But we sometimes tend to forget that if there is a borrower, there must also be a lender. As my Canadian colleague has put it, it takes two to tango; and one needs to look at the situation from the lender's side too. People naturally think of lenders as being banks or other financial institutions, but these are better seen as intermediaries. The true lenders are the savers—those who hold deposits with banks or life assurance policies, contribute to pension funds or own bonds, and who among you are not also included in that list? To savers, interest rates do not look all that high, since they are aware that the interest rate they receive is in effect reduced by the declining purchasing power of money.

You may still ask: is our monetary policy too strict? I do not believe so. Perhaps I may usefully remind you that it has more than an accidental resemblance to the policy pursued under previous Administrations. Even before formal monetary targets were adopted, our aim was to control the growth of the monetary aggregates. We now have a target range for the growth of the money supply of between 7% and 11% a year. The effort to keep to these limits has required high interest rates. But, given the pressing need to reduce inflation, does anyone seriously argue that we should relax our efforts? We must indeed hope, over time, to see targeted rates of money supply growth brought down—partly to promote, and partly in consequence of, lower inflation, and we must move in that direction as we judge it right and feasible.

The present monetary target runs to next October. So far we have encountered some difficulties in keeping on course, not recently because we have failed to sell government debt to the public—in the last three months we have been well ahead of public sector borrowing needs—but because of continuing large increases in bank lending to the private sector. Cash flow pressures on industry have been mounting. It seems clear that generally stocks are at high levels, though over the next year or so they may be substantially reduced.

Another major source of financial pressure has been rising labour costs. In recent months there have, I believe, been some signs of greater realism in wage settlements which in many cases have included provision for real productivity improvements. Even so, the overall results this time round leave much ground for anxiety.

It is in just such circumstances as we have now, in which upward pressure on pay and prices has built up strongly, that we can least afford to allow monetary developments to accommodate the inflation we need to master.

We cannot risk greater inflation by printing more money. Nor could we realistically hope to control the volume of money by rationing credit. There would be too many ways round such a control, and it would create other very severe problems.

I would not want to leave you with the impression that monetary policy alone has the answers: it has not. It is central to the fight against inflation and provides the climate in which other policies can work successfully. But it is not itself the sole key to the invigoration of our existing industries or the birth of new industry—something which we must also accomplish.

In recent years manufacturing industry, by and large, has failed to repond to rising demand, which has been met from imports. High labour costs and low profits have led to reduced competitiveness and low investment; and resistance to change has reinforced inflationary pressures.

Let me speak out against a certain—I would not say pessimism, but rather—fatalism. There is nothing inevitable about our economic performance or decline. Many observers outside this country, untouched by our fashionable gloom, see us as uniquely promising among the industrial countries—no doubt in part because of our energy resources, an immeasurable advantage. Again, have we ourselves sufficiently recognised the immense productivity gain we would have, if we did no more than match our neighbours' performance?

If we could bring about such a change in performance—the only real basis for improved living standards—then our success will be assured. It will not be done by edict from Government or central bank, the Confederation of British Industry or the Trades Union Congress; but only by a change in attitude towards performance—in homes, in schools and in myriad scattered workplaces throughout the country.