The financial scene in the 1970s

Lecture by the Deputy Governor[1]

The Deputy Governor comments on the broad financial changes which have accompanied the shocks to the economy in the 1970s. Growing sectoral imbalances have increased the need for intermediation: personal savings have risen, the public sector has gone into large deficit, and companies have been squeezed by slow growth and rising costs.

Mr McMahon comments on the form savings took, the role of the institutions and banks and government finance—and traces the effect of inflation and increased uncertainty, interacting at times with the tax system. Monetary control may have become more difficult: 'borrowing from banks may have become less responsive to . . . interest rates and . . . to depend more on the relatively slow adjustment of the industrial sector's deficit'—'it has proved all the more necessary . . . to sell large amounts of debt' to achieve monetary targets.

Introduction

It is well known that the economic environment deteriorated—both in the United Kingdom and in the world as a whole—in the 1970s. Underlying rates of growth slowed down; there were the successive oil price shocks; and national inflation rates became almost universally high and volatile. These unwelcome developments were accompanied by some striking changes in the financial scene. The dispersion of financial balances grew—both deficits and surpluses became larger, in absolute terms and as a proportion of GDP. There were major shifts in the pattern of balances as between countries or sectors. And there were important changes in the channels of intermediation: most notably, both domestically and internationally, a marked shift of certain types of business towards the banking system.

I do not intend tonight to say much about the international scene. But I would remark in passing that the world as a whole has provided some rather suggestive analogies to developments in the United Kingdom. In both cases, financial surpluses have been concentrated in a sector with a high preference for investing in liquid assets—OPEC on the one hand and the personal sector here. And the continuing deficits of oil-importing countries may be thought to have had a parallel in the deficits of the UK company sector; certainly in both cases the banking system has had to shoulder the main burden of the consequential intermediation. One should not press these analogies too far—for example, the shift in purchasing power towards OPEC may prove more durable than the shift from profits to wages in the United Kingdom—but one might speculate that in both cases one has seen the operation of quasi-monopoly power succeeding in altering terms of trade.

My aims this evening are twofold. First, to review financial developments in the United Kingdom over the past decade and the extent to which they have been affected by the tax system and other government policies; and, secondly, to consider the implications of recent developments for monetary and financial policy.

Financial developments in the 1970s

Distribution of surpluses and deficits

I start then with a review of the financial developments themselves. It is striking to recall just how large the shifts in sectoral financial balances have been. Taking the personal sector, for example, the surplus in the 1960s and early 1970s averaged round 2% of GDP, whereas from 1973 onwards the average has been over 5%. This shift in the personal sector was necessarily matched by bigger deficits elsewhere—especially for the public sector and for industrial companies.

The public sector deficit was expanded deliberately in the mid-1970s to offset the contractionary effect of the first jump in oil prices. It has since declined somewhat from its peak as a proportion of GDP, but it remains large in nominal terms. The financial position of industrial companies, on the other hand, worsened in the late part of the decade, as companies were squeezed by a combination of slow economic growth, weak demand, and rising labour, energy and other costs.

These large imbalances between the three main domestic sectors of the economy seem likely to remain crucial influences, both on the development of the financial system, and on the authorities in framing policies towards it. I have

(1) The Ernest Sykes Memorial Lecture given at the Institute of Bankers on 13 January 1981.

deliberately left to one side discussion of the United Kingdom's external financial balance—that is, the current account. It, too, fluctuated more sharply during the 1970s, especially in the aftermath of the first hike in oil prices, but the question of its financing raises rather different and separate issues which I do not propose to enter into this evening.

Neither can I seek to give detailed explanations for the shifts in each domestic sector's financial position. I should, however, like to make one general point, perhaps particularly well illustrated by the rise in the personal savings ratio. It is salutary to remember that the reaction of individuals to inflation and uncertainty was not predicted, and still cannot claim to be fully understood. One explanation ascribes the increased flow of new saving to an attempt on the part of individuals to make good the erosion, by inflation, of the real value of their financial assets. But while experience in some European countries ran parallel to that in the United Kingdom, consumers in the United States responded to an admittedly less marked acceleration in inflation by maintaining their expenditure. It remains to be seen how far this different response represents behavioural differences on the two sides of the Atlantic, or how far it results merely from different inflationary experience, or a different structure of personal sector finance.

As I have just suggested, this explanation of individuals' behaviour can be regarded as an example of a more general point. The financial balances we usually talk about are calculated according to the normal accounting conventions; but in one important respect they can be misleading. They depend, of course, on the measure of each sector's income, which includes, as well as payment for productive services provided, 'investment income'. The problem is that this investment income is assessed in terms only of the *flow* of interest, dividends, etc., and takes no account of changes in the real value of the assets generating the flow. Including one without the other leads to significant distortions, especially during periods of rapid inflation when nominal interest rates tend to rise and when the higher interest flows from, for example, bank loans and deposits compensate for the declining real value of the assets.

If rough allowance is made for these gains and losses on monetary assets, the picture is strikingly different. All or most of the personal sector surplus is wiped out; the deficit for financial companies is greatly increased; but on the other hand there is a surplus in most recent years, not a deficit, for the general government sector; and, except in the particularly difficult period of 1974–75, a surplus also for industrial companies. How far behaviour has been influenced by an implicit view of these adjusted financial balances is difficult to say. Inflation gains and losses have certainly not been matched one-for-one in new saving. But, as I have mentioned, the 'real asset' effect helps to explain household behaviour. The fact that the real value of companies' debt was eroded may also give a clue to the capacity of industrial companies to withstand a run of substantial deficits and to continue borrowing. And the financing of recent heavy public sector deficits also appears in a somewhat different light.

The investment of surpluses and the financing of deficits
Let me turn now from the distribution of financial surpluses to the ways in which they were invested. It is striking that a large part of the personal sector's increased saving went into liquid assets. Besides a desire to maintain the real value of transactions balances, another factor was no doubt an unwillingness, in a period of increased uncertainty, to commit funds to longer-term financial assets. A shift in income distribution in favour of wage earners may also have played a part, since bank accounts and building society deposits are the most accessible and familiar ways of saving for this group.

In fact, the prime beneficiaries were the building societies, which generally enjoyed a competitive edge over their rivals. The reasons for their success are not altogether clear, and it may prove in part transitory. But one factor was no doubt a favourable tax treatment; and, in addition, they exploited their ability, as non-profit-making specialists, to operate on relatively narrow margins and they were more effective than some of their competitors in providing ready access to their services. During the 1970s, personal sector deposits with building societies more than quadrupled, rising from £10 billion to over £40 billion; in the same period, deposits with banks rose only threefold, from about the same initial level of £10 billion to just over £30 billion. In the past two years, however, when effective interest-rate differentials have been narrow or non-existent, the inflow into bank deposit accounts has revived, and personal deposits with banks have been growing faster than those with building societies.

The move by persons towards greater holdings of liquid assets was accompanied by a continuing decline in their direct holdings of companies' equity and debt, and a switch to indirect holdings through life assurance and pension funds. The combined annual inflows to these types of institution rose no less than sixfold—from £1½ billion in 1969 to £9 billion in 1979. Individuals were no doubt increasingly wary of trying to manage their own portfolios in conditions of greater uncertainty; but the tax advantages enjoyed by contractual savings institutions were certainly also important.

In fact, there are a number of ways in which the tax system may have influenced the pattern of intermediation; and influenced it so as to have important economic consequences. I have already noted the tendency for savings to be pushed towards the institutions and for individuals to be discouraged from investing in new business ventures. In addition, the tax relief available on mortgage interest combined with inflation to make borrowing for house purchase a cheap and almost risk-free method of financing an appreciating asset with a depreciating debt. And the shift to contractual saving may itself have had further consequences for the provision of risk capital. Thus it has

been argued that the long-term institutions find it unrewarding to spend time assessing new or small firms as credit risks, preferring instead to channel large blocks of funds into well-recognised companies.

There have, however, been developments working in the opposite direction. For example, the measures announced in the last Budget make it easier for small firms to raise equity or other long-term finance. And there are signs that some financial institutions are expanding their business in this area. The clearing banks now operate or participate in schemes to provide medium-term and long-term finance, and even equity capital, to small firms. Some insurance companies and pension funds are also becoming similarly involved.

Nevertheless it is fair to observe that, as is often the case, tax incentives originally designed for the best of motives—such as the encouragement of provision for retirement—have created or magnified distortions in the process of saving and investment which are later found to require corrective measures.

Quite apart from these particular factors, the mid and late-1970s were an especially difficult period for companies seeking to raise finance. Rapid inflation was followed without much delay by historically high nominal interest rates, both short and long. These rates reflected an economic environment in which official monetary policy was increasingly directed towards a counter-inflationary restraint on the money supply. While going at least some way towards compensating savers for the effects of inflation, high interest rates at the same time added greatly to the nominal interest burden on industry. At the same time, financial markets tended to become more erratic and volatile, with steep fluctuations in the prices both of ordinary shares and of fixed-interest securities. In consequence, the volume of long-term savings channelled into industry varied widely and was, indeed, subject to periodic interruption.

Within the total, there was a clear difference between the position for equity issues and for industrial bond issues. In late 1973 and 1974 there was no significant volume of new equity issues. Subsequently, the market recovered and a good deal of new equity was raised, mainly in the form of rights issues. Despite these interruptions, it is questionable how far the supply of savings through the equity market was seriously defective in the aggregate over the decade as a whole. For much of the period—even with the low level of industrial profitability and tight official restraint of dividends—structurally sound companies seem, in the main, to have been able to raise new equity where this was needed to preserve a desired balance sheet structure.

This was certainly not true of the fixed-interest market, however. The high nominal interest rates and the volatility of inflationary expectations made companies reluctant to issue the long-term fixed-interest debt that is attractive to the life funds and pension funds. Companies, with some justification, judged that considerations of cash flow—and future general uncertainties—precluded their financing new investment by borrowing long term at very high fixed rates of interest. In this context, the possibility that the rate of inflation might fall represented a deterrent. Consequently, issues of debentures and loan stocks, previously a familiar method of industrial financing, ceased altogether: after 1974, except for companies which could raise funds abroad, equity issues and bank borrowing become almost the only methods remaining.

Various attempts were made to fill the gap. As an example, the Bank of England and the clearing banks subscribed additional capital to Finance for Industry Limited (FFI), while the life assurance and pension funds undertook to acquire loan stock to be issued by that institution. By this means, and with additional interim support from the banks and the money market, FFI was able to offer medium-term loans to industry at both fixed and variable rates of interest.

But the main new domestic source of medium-term finance was the banking system itself. Historically, British banks had been under no great pressure to provide medium-term credit; apart from the hardcore element in overdrafts, medium-term lending tended to be confined to export and shipbuilding finance with government guarantees or special arrangements for official refinancing. The circumstances of the middle 1970s created a need for medium-term finance in the 5–10 year range; and it may be fair to suggest that the influx of foreign, and in particular US, banks into London provided examples of new techniques, encouraging the banks to respond by increasing the amount of their medium-term lending to customers. As in the international markets, the development of medium-term lending at variable rates, linked to a specific short-term rate, has been one way of bringing borrower and lender together on terms which both find acceptable.

Leasing provided another, relatively new, form of medium-term finance for industrial investment—again, in large part though not exclusively, supplied by banks and other deposit-takers. The main impetus for the growth of leasing came from the decline in industrial profitability and from tax changes—the replacement of investment grants by investment allowances and the introduction of stock relief. The coexistence of a large number of industrial companies with investment requirements in excess of their taxable profits on the one hand and, on the other, of financial institutions in the reverse position led to the development of a market in taxable capacity. The cash flow benefits of the investment allowances which the lessors in this market were able to pass on to the lessees were particularly attractive in a period of high borrowing costs.

I turn now to the financing of the public sector deficit, which has followed a different pattern from that of industrial financing. In the interest of restricting the growth of the money supply—and in strong contrast to developments in the corporate debenture market—the Government has relied upon heavy sales of long-term fixed-interest securities to the non-bank public, rather than on bank finance, to fund its borrowing requirement. In the last five years, sales of gilt-edged have absorbed about half

the total cash flow of the long-term investment institutions. This compares with proportions which ranged from a sixth to a quarter in the late 1960s and early 1970s; and is larger than the institutions channelled into all fixed-interest securities—both public and private—in the earlier period.

There is an interesting contrast here with experience in the United States. There, for most of the 1970s, insurance companies and pension funds invested much more heavily in corporate bonds than they did in government securities. But the government borrowing requirement was proportionately lower than here; and interest rates were lower and more stable—reflecting lower actual and expected rates of inflation. These factors no doubt largely explain why corporate borrowers continued to raise money in the long-term capital market, when they deserted it in this country. More recent experience, however, has shown that the American bond market is also vulnerable to conditions of high inflation and fluctuating interest rates. It is possible, too, that in this country the extent of government involvement in the market for long-term bonds has influenced companies' ability to secure long-term funding for themselves.

Perhaps I could try to sum up where we have got to so far. We have seen that economic developments over the past decade, especially the upsurge in inflation and changes in the distribution of income, have meant large shifts in the pattern of financial balances both internationally and in the United Kingdom. At the same time, inflation and increased uncertainty, interacting sometimes with the tax system, had a marked effect on the way these balances were financed. Building societies' borrowing and lending grew rapidly; the long-term bond market was increasingly dominated by gilt-edged stock; and industrial finance, both short and medium-term, came to depend very largely on the banks.

The implications for monetary and financial policy

Let me turn now from this description of financial developments to my second main theme, the effects of these developments on monetary and financial policy. Here the changed structure of industrial finance has been crucial. To the extent that industrial financing has been diverted towards the banks by lack of suitable alternative instruments, borrowing from banks may have become less responsive to changes in the structure of interest rates, and may have come to depend more on the relatively slow adjustment of the industrial sector's deficit. It has therefore proved all the more necessary, in the attempt to achieve monetary targets, to sell large amounts of debt. In the main, this has meant selling gilt-edged to the long-term financial institutions. These developments have, in combination, made it difficult to reconcile the requirements of monetary control with tolerable borrowing costs for industry; and have also put the liquidity of the banking system under strain.

The recent decision by the Government to increase its target for sales of index-linked and other national savings instruments is intended to help in meeting this set of problems. The aim is to reduce the Government's dependence on gilt-edged sales, and thus help reduce the pressure on long-term interest rates. In due course this may encourage companies to fund some of their bank borrowing with long-term debt issues. If this occurs, the institutions will have the opportunity to substitute acquisition of such debt for purchases of gilt-edged; and if bank lending to the private sector is reduced by this means, there will be less need to overfinance the public sector deficit and correspondingly less strain on banks' liquidity.

This strategy has the merit of directly tapping the funds of the sector with the largest accumulation of monetary and near-monetary assets—the personal sector. It necessarily draws the Government more deeply into direct competition with the banks and the building societies at a time when competition within and between those two groups of institutions is already becoming more intense. Several of the clearing banks are promoting schemes offering higher rates of interest on sums of a given minimum amount committed for longer periods than the traditional deposit account. The banks have also been developing schemes for making loans available for house purchase in larger amounts and on more competitive terms than in the past.

The building societies, for their part, though still operating within the framework of a recommended rate structure set by the Building Societies Association, have individually been offering a variety of options for saving accounts, with varying terms and degrees of liquidity. On the mortgage side, too, the recommended rate has become a base rate on top of which differentials are set for loans over a certain size; and these again vary from society to society. The rate structure operated by societies is thus clearly in process of transformation into a looser form.

In one sense, greater competition in housing finance may be thought to give the authorities some cause for concern. The demand for mortgages is, in any case, likely to be substantially encouraged by the tax relief available on mortgage interest; and there is a question whether funds might not be attracted into housing finance on an altogether disproportionate scale, which might provoke an inflation of house prices. How real is this fear? In present conditions, with house prices on a plateau, the danger certainly does not seem an immediate one. And, more generally, it has to be remembered that however good houses are as an investment proposition, the eagerness of householders to invest is heavily circumscribed by their ability to service the mortgage payments, particularly in the early years of the mortgage agreement. It is doubtless for this reason that house prices have over a long period shown a fairly stable relation to average earnings. It may therefore be that even a vigorous entry by the banks into this market will not affect the more basic factors of supply and demand.

In the past, governments have from time to time sought to meet these possible dangers by restricting competition, either directly by guidelines on lending, or indirectly by

encouraging the building societies to hold down their interest rates and thus to ration funds. The habitual stickiness of building societies' interest rates has also had a braking effect on the housing market at times when interest rates generally were rising.

This stickiness has had the opposite effect when interest rates have been falling—attracting large inflows of funds into mortgages, which have then often been largely dissipated in higher house prices. This has undoubtedly added to instability in the housing market, has at times inhibited the full use of interest rates as an instrument of monetary policy, and has suppressed some of the benefits in efficiency and innovation which might be expected to flow from greater freedom of competition.

It is arguable, therefore, that the authorities should face the consequences of competition by adapting to it. This, indeed, is the logic of present efforts to compete for funds in the same market for personal savings. Success in those efforts will itself reduce the likelihood of an excessive expansion of funds into housing. Moreover, if building societies move, whether collectively or individually, to a system which adjusts more promptly and fully to movements in market interest rates than in the past, this should facilitate a steadier flow of funds into housing finance.

It could be argued that a more competitive system of housing finance would mean higher mortgage rates on average than would have been the case under the system which prevailed in the 1970s. But while greater competition for funds may put some upward pressure on interest rates, competition to lend may exert some countervailing downward pressure. We may have seen something of this in recent months with the reductions in rates made both by the building societies and by the banks in the aftermath of the reduction in minimum lending rate. In any case, higher interest rates should not necessarily be cause for alarm. They would have some dampening effect on mortgage demand and on house prices, as has been shown in the past year. But experience with a 15% mortgage rate has also probably modified house-owners' perceptions of what is an acceptable level of nominal, pre-tax mortgage rates.

Greater competition for personal savings could, in one sense, be helpful for control of the money supply in that such competition is likely to be conducted partly in instruments at the further end of the liquidity spectrum from money. The promotion of building society term shares, the search by banks for similar longer-term savings accounts, and the drive to sell national savings certificates are examples. At the same time, however, there may be developments, as in the United States, which go in the opposite direction, enabling time and savings accounts to be used more easily for transactions purposes. All these developments will need to be taken into account by the monetary authorities in defining their objectives in controlling monetary aggregates.

Prudential problems

I cannot close this review of financial developments without referring, however briefly, to the prudential problems they have created for the banking system. One important issue is the continuing need to raise new capital if the banks' capital base is not to be eroded in terms of their overall balance sheet. This problem has been compounded by, indeed has partly arisen from, the failure both of traditional accountancy methods, and also of the tax system, to recognise the decline in real value of net monetary assets. Part of the solution may therefore lie in the application of the new methods of inflation accounting, and possibly also corresponding changes in taxation. Two further considerations suggest themselves. First, the relatively healthy performance of bank profits over the last decade has in some measure compensated for the riskier environment in which the banks have operated and has worked towards preventing impairment of the banks' capital base. Secondly, the raising by the banks of new capital, either in the equity or in the long-term debenture markets, can be seen as a helpful development in terms both of prudential and of monetary control.

Over the last decade the banks, by lending on longer terms while accepting short-term deposits, have substantially increased the maturity transformation which they provide to the capital market. While welcome in filling a gap in industrial financing, this has obvious prudential implications. For this reason the techniques of banking supervision have been directed increasingly to the refinement of the measurement and assessment of liquidity. Liquidity has to be looked at not only from the viewpoint of the individual bank, but also in terms of the system as a whole. While an individual bank's maturity transformation may appear quite modest, the overall transformation between the initial placing of funds and their ultimate employment in non-bank lending can be much greater. Appropriate means of monitoring this overall position, and ways of assessing liquidity which can be applied to banks' wholesale as well as retail business, are at present being discussed both domestically and internationally. To the extent that economic recession increases banks' exposure to poor credit risks, the need to resolve these problems becomes that much more acute.

Conclusion

I have tonight sought to review a number of important developments which are necessarily of very varying character. In conclusion, I would like to highlight a few broad lessons which, I suggest, can be drawn from the experience of the 1970s as I have described it this evening. Economic developments generally have put the process of financial intermediation under unusual stress in this period. This has required a measure of structural adaptation. In the main, the adaptation has proceeded remarkably smoothly. The success of the euromarkets in handling much of the burden of recycling has its counterpart on the domestic scene in the role which the banks have come to play in the provision of corporate finance. The changed role of the

financial intermediaries has, however, posed problems for monetary policy; and has required a fresh look at the techniques of prudential supervision. At the same time, and very largely because of inflation, some features of the tax system have come to seem less satisfactory and to be promoting changes in behaviour which are no longer consistent with the original objectives.

In terms of monetary control, structural shifts in the pattern of intermediation have led to a quest for new instruments to supplement or replace the conventional techniques of open-market operations and the manipulation of short-term interest rates. They have also stimulated discussion on the appropriate objectives and targets of monetary policy. The debate on both these issues seems certain to continue. On the supervisory side, there has, as always, been the problem of balancing competition and adaptation to innovation against the need for stability in the financial system as a whole. This is a problem likely to persist both for the supervisory authorities and for financial intermediaries themselves.

Perhaps one important message in all of this is that the economic environment of the last decade has put policy making under particular strain. Even when the institutional framework is changing only gradually, it is hard enough to pursue a consistent line in an economy such as the United Kingdom whose performance is relatively weak. The task becomes in significant degree more difficult when the economic structure itself is undergoing rapid and unpredictable change. Policy will always need to take account of short-term pressures, especially when—as in recent years—these are acute. This is not to say that policymakers are unaware of the structural changes which may be going on around them. While there will always be difficulties in taking full account of such changes, or even recognising properly their nature and scope, the authorities must seek to keep the longer-term perspective in mind and, no less than the markets themselves, be ready to adapt.