Responsibilities of the private and public sectors

In discussing the respective roles of the public and private sectors, the ***Deputy Governor*** *makes two points:* (1)

- *There are a number of respects in which pure* laissez-faire *can no longer form an appropriate model for the private sector which must find a way, consonant with maintaining healthy competition, of assuming responsibility for solving problems in circumstances when, for each enterprise, immediate short-run interests might point in the opposite direction.*
- *If we are to look to industry, commerce and the financial services to take on these responsibilities it is essential that the private sector is allowed to be strong and unfettered enough to cope. Here, the authorities have responsibilities too.*

Three areas of particular concern to the Bank are used to illustrate these points, namely the problems of international sovereign debt, regulation of the securities market and the difficulties at Johnson Matthey Bankers.

I should like to draw back a little from the immediate problems of industry, and reflect on some general questions of relative responsibility between the public and private sectors.

Before an audience such as this, there is little need to draw attention to the importance of private enterprise and initiative or to the dangers of relying too heavily on government for a resolution of our economic and social difficulties. You have lived through—as we all have—the chastening experience of governments throwing money at all manner of problems. First it was helping lame ducks over the stile—a curious enterprise even in principle it seems to me, which ended all too often in the duck not merely not walking too well but, rather more important, being unable to swim. Then it was picking winners—a notoriously difficult business at which the government has, unsurprisingly, proved no better than the rest of us.

But quite apart from recent national experience, anyone with the least historical sense would hesitate to lecture the inhabitants of Manchester on the responsibilities and potentialities of private enterprise. We have all learned these truths from the Manchester School; and the combination of rational analysis and passionate advocacy which characterised Cobden, Bright and a host of others has changed the nature of our thinking and politics. Manchester has long been in the lead in warning us of the dangers of government interference and the inherent strengths of private initiative if left alone.

But the world has become immensely more complicated than it was when the doctrines of *laissez-faire* were first enunciated. The importance of relying, wherever possible, on the private sector remains undiminished. There are, however, practical implications of doing this, that have perhaps not been given the attention they deserve, but which have impressed themselves forcibly on us at the Bank of England in recent years. In a nutshell, there are two points I wish to make. First, as I have just indicated, there are a number of respects in which simple *laissez-faire* can no longer form an appropriate model for the private sector. In many fields, private industries have to find a way, consonant with the maintenance of healthy competition, of assuming joint and shared responsibility for solving problems in circumstances when for each enterprise the pursuit of immediate short-run interest might point in the opposite direction. And second, if we are to look to industry, commerce and the financial services to take on these responsibilities, thus avoiding bureaucratic intervention and the expenditure of public money, it is essential that the private sector is allowed to be strong enough and unfettered enough to cope. I shall explain what I have in mind with respect to three very different areas, all of particular concern to the Bank of England.

International sovereign debt

First, there are the problems related to international sovereign debt. At least with hindsight, and in the context of a greatly changed world economic environment, it is clear that many governments borrowed too much from the world's banking systems (or that the banks lent too much to the governments—there can be endless argument over where the primary responsibility lies). The problem erupted in the summer of 1982, since when it has been handled in a pragmatic way by a combination of private and public sector efforts—adjustment by debtor

(1) In a speech to the Manchester Chamber of Commerce and Industry, on 23 October.

governments, monitoring and official assistance by the IMF, encouragement and help by a number of governments from the developed world, and agreements by the major banks to reschedule existing debts and provide new funds in ways and on a scale which could only be achieved collectively.

The success of these collective efforts has so far been quite marked, even if undramatic. None of the dire catastrophic outcomes predicted by the many who have urged more radical—and by the same token more interventionist—strategies have come to pass. One by one the major debtors have implemented policies of domestic adjustment and the world's banks have continued to provide the necessary reschedulings of old money and the requisite volumes of new money.

There is, however, no cause for complacency. We still have a long and narrow path to tread, and all the patient effort put in so far can still be rendered useless if we slip off it. We need to continue to rely on positive developments in world activity, interest rates and commodity prices; on the continued successful determination of governments in debtor countries to implement tough, but necessary, domestic policies. And we need to rely on the continued willingness of the world's banks to act collectively in a way that none of them might individually choose to act. An essential element in achieving this of course is for each participating bank to feel that others are not having a free ride at its expense. Hence the painful time-consuming process of ensuring that the burdens of the actions taken are broadly shared. This task has in each case been undertaken by the banks themselves, as is absolutely right: it is a collective exercise by the private sector, in its own long-run, as opposed to short-run, interest.

But the official side has its responsibilities too. We certainly have thought it right to help, at the right moment and in the right way, the banks' endeavours by such encouragement as we can give. As time has gone on, however, our responsibilities have become more complicated. Increasingly, as supervisors of the banking system, we have had to be concerned that banks' balance sheet strength is maintained, and that capital ratios are not put under too great a strain. More positively, we are ready to respond in support of banks' own initiatives to strengthen themselves, especially by generating new capital resources and by making adequate provisions against the risk that loans to these countries might become bad or doubtful.

Regulation of the securities industry

I should like to turn now to a second and topical area in which we believe that the private sector acting collectively will produce a better answer than pure *laissez-faire* on the one hand or bureaucratic official intervention on the other. I refer to the regulation of the securities industry. There have always been those who have urged a minimalist approach to prudential regulation, combined simply of appropriate legal sanctions against fraud and an otherwise general policy of *caveat emptor.*

However satisfactory this may or may not have been in the simpler financial services world of the past, it is, I believe, fundamentally inadequate for the world we are now entering, a world in which many long-established restrictions and barriers are being dismantled. As these changes in financial markets proceed, giving market considerations greater weight in determining the types of activity undertaken within a given institution, so the problems and dangers of conflicts of interest multiply and the risks of imprudent behaviour increase. The ordinary outside investor can see less clearly what is going on; and institutions are contemplating new areas of activity. On both counts new and strengthened codes of practice are required. But it would be a sad and ironic consequence of the greater freedom conferred by this shake-up of attitudes towards what individual institutions can or cannot do, if it led simply to the creation of an official intrusive regulatory body which imposed its own toll on efficiency.

At the Bank of England we have always believed in what is often called self-regulation, but for which a more accurate name is probably practitioner-based regulation. We believe that this produces both a more efficient solution and a higher standard of behaviour because it places the responsibility for the health and standing of their markets on the market participants themselves, who have a major interest in seeing that their markets should work well. The greater the reliance on mechanical and legalistic rules imposed by an official agency, the less responsibility the practitioners have, and the more indeed they are encouraged simply to look for loopholes and generally aim to sail as close to the wind as possible providing they are not in breach of the letter of the law.

Thus we welcome, as the Governor made clear in his Mansion House speech,[1] the new arrangements for a securities and investment body as envisaged by Mr Fletcher last week. Though many details are still to be worked out, the essential feature is agreed, that the new regulatory body will not be a statutory agency like the Securities and Exchange Commission in the United States. It will have powers conferred on it by statute and there will be lay members serving on it, but it will be a securities industry body, run and paid for by practitioners.

This last point is important. Regulation in the complex modern world of financial services is expensive. Since it is overwhelmingly in the interests of the securities industry itself that it should be well-regulated—and seen to be so—it is reasonable that the industry should bear the costs. But the corollary is equally important. If the industry is voluntarily to set up, run and pay for its own regulatory agencies, it must be assured that government will genuinely stand back. Some ultimate statutory base there must be, some degree of broad responsibility to Parliament by the Secretary of State, and some

(1) See page 472.

arrangements for appeal. But beyond that, I am sure that the counterpart to a willingness by the securities industry to undertake the heavy burdens and responsibilities of regulating itself, is that the government must not intrude itself on the detail.

The risk of contagion from a bank failure

I come now to my third—equally topical—area of where the relative responsibilities of the public and private sectors need careful consideration. This is the handling of a threat to the system as a whole from a failure of a particular participant. This is a problem almost unique to the financial system, and within this, of particular importance to the banking system. The ease and speed with which holders of liquid assets can move them from one institution to another has no close parallel in industry more generally. This has always been so but has perhaps been exacerbated by the developments of information technology and by the growth in interdependence of financial institutions throughout the world which has been a feature of the last two decades.

As a result, the failure of certain individual banks or financial institutions can give rise to rumours or fears about other institutions and hence put great and immediate pressure on such institutions which can, if unchecked, do them irreversible damage before the full facts can be established. It is important to emphasise that not all banks or financial institutions play a part important enough in the United Kingdom or the world for their failure to comprise a potential systemic threat. Many do not. But some do; and Johnson Matthey Bankers, through its membership of the London gold market and the extent of its bullion business throughout the world is such a bank. The problems in Johnson Matthey Bankers in fact had nothing to do with its gold business, but long before it would have been possible to convince world markets of this, incalculable damage would probably have been done to other banks operating in the same field and, through further extension of contagious mistrust, quite possibly to other banks still who, though they were not in the bullion business, might have been thought to be heavily exposed to the banks already under threat.

It was for these reasons that we believed it essential that Johnson Matthey Bankers should not be allowed to close its doors. Hindsight has in no way shaken our conviction; and I believe that in fact our view is very widely shared in the financial markets.

This is not the place for a discussion of any implications this episode may have for the Bank of England's supervisory arrangements. Nor do I wish to go into the details of the rescue arrangements which of course were dominated by what was practicable in the circumstances—like all such arrangements which have to be devised under great pressure of time and which require contributions of varying kinds from many different parties, all of which have differing degrees of involvement and varying kinds of long-term interest in the solution. All I wish to emphasise here is that we considered it desirable in this rescue operation to call upon the major banks to help share some of the risks involved, rather than have recourse to public funds. Many of the banks concerned had of course no direct involvement with JMB or its problems. But all of them, I am glad to say, recognise their long-run interest in the containment of a potential systemic threat and we have been encouraged by this awareness and by their acceptance of the responsibilities it entails.

However, as with arrangements to cope with the international debt crisis to which I referred earlier, the banking system is necessarily constrained in what it can do, even in its own collective long-run self-interest, by the weakening of many balance sheets that has occurred in the recent period. If we are able to look to, and call upon, the banking system to help sustain the present predominantly free-enterprise economy, we have to ensure that the banking system is strong enough to play that role.

Conclusion

All of the topics I have touched on illustrate, I hope, the way in which the financial institutions are taking increased responsibility for maintaining the health of the markets in which they operate. This is most desirable, but the costs of so doing should be recognised. If the private financial sector does not take responsibility, the costs of its failure to do so will, one way or another, fall on the economy as a whole and ultimately on the taxpayer. That would be welcome neither to the taxpayer nor to the financial sector.