Ref. C.T.
I.E.65

S.R.31
I.G.8
C.C.P.361
C.C.P.332.1

Chapter III

Bank Rate and Market Rates

Bank Rate

The history of Bank Rate during the war may start from the end of 1938, at a time when considerable pressure on the exchanges was being experienced and more anticipated. Exchanges are dealt with in Part II of the History and will not be referred to here except generally. The 2% Bank Rate had remained unchanged since 30th June 1932, and the Government was still wedded to a policy of cheap money.

On 24th November 1938 the Governor wrote to Sir Richard Hopkins in connection with a proposal concerned with forward dealings in dollars and their possible effect on rates. "....Some precautions seem essential. We shall therefore begin in the next few days (subject to an understanding with certain banks) to reduce or eliminate forward dealing in dollars and in consequence to bring in dollars from forced covering. The gradual effect may be to shorten the supply of cash in this market and so to raise interest and discount rates and perhaps to lower gilt-edged stocks."

In reply Sir Richard wrote on the following day: "...I do not understand that it is in your opinion desirable to raise interest and discount rates and perhaps to lower gilt-edged stocks. Certainly no proposal could be more unwelcome to the Government at a moment when budgetary difficulties are very great and when trade and industry, as we are informed in reliable quarters, are showing for the first time a strong disposition to throw off the effects of the September crisis. Your meaning I take it is rather that you wish to carry out certain technical operations in defence of the exchange while you fear that as an unintended result of those operations there may be a tightening up of interest and discount rates."

The Bank replied on the same day that Sir Richard's assumption was correct. The secondary and unintended effect upon Money Rates and gilt-edged prices would in any event be quite temporary, and due merely to the fact that the end of the year was approaching.

It was

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It was by now clear that the Continent doubted the safety and security of the U.K.as a refuge for capital, and the Governor, at a meeting in Basle of the B.I.S., found that the French, Dutch, Belgian and Swiss representatives were all much perturbed about the sterling-dollar rate and feared that any further considerable depreciation of sterling would involve a change of policy in Holland, Belgium and Switzerland, and perhaps France.

On 29th December 1938 the Governor wrote to the Chancellor:

"....with the approach of the New Year the expected pressure upon sterling begins to develop and within a few days the exchange rate will cease to benefit from the temporary shortness of money. For the last two months you at the Treasury and we here have been discussing and considering this position and you decided to take no action to improve or to hold the international level of sterling; unless it be through some tightening by the Kennet Committee. Andthus, while the position of France is improving owing to the settlement of her internal political difficulties and while the position of Holland and Switzerland is so satisfactory that they are seeking to lend money abroad, the position of our exchange is expected to deteriorate rapidly. If this should happen, we must expect other currency relationships to be readjusted at a later stage, to the disadvantage of sterling.

Even though you have so far decided to take no action to hinder such deterioration, it might be convenient for you to consider what is to be done if and when difficulties of great or small degree break upon us. You might, for instance, care to consider whether some arrangements for the support of sterling could be made, either within the tripartite Agreement or as in 1931. On the other hand we here may consider, mainly for its psychological effect, an increase in Bank Rate. But in any case I feel strongly that we should be so far prepared for what may happen that our action when the time comes will have been generally decided in advance and will only need to be fitted to the particular happening."

The Minutes

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The Minutes of the Committee of Treasury on 3rd and 4th January 1939 read as follows:

"3rd January 1939 With reference to the Minutes of the 21st December 1938 and earlier, the Governor reviewed the representations which he had made to the Chancellor during the past two months as to the serious dangers attending the sterling exchange position. No action having been taken in Whitehall, he had on the 29th December written a letter to the Chancellor which he laid before the Committee.

Intimation had now been received from Holland, Belgium and Switzerland that, in the event of any further considerable fall in the sterling rate, they might find it necessary to take measures for self-protection: in France too a change of policy might prove necessary which would be unwelcome to us.

The Committee agreed, after discussion, that the Governor might inform the Chancellor that, owing to the serious prospect of the Exchanges, the Bank were disposed to raise the Bank Rate to, say, 4% within a week or two if such a course were not in conflict with the policy of His Majesty's Government.

4th January 1939 The Deputy Governor acquainted the Committee of the following matters -

....

With reference to the Minute of the 3rd January, the Governor and Deputy Governor had a long discussion with the Chancellor the same afternoon regarding the sterling exchange position.

The Governor had raised with the Chancellor, on the basis of mutual co-operation, the question of the possible advantages of a rise in the Bank Rate in the near future as the traditional method of protecting our exchange position. It had been agreed that further consideration of this suggestion should be deferred until the Chancellor had had an opportunity of discussing the question with the Prime Minister and the outcome of the Rome* visit could be assessed by His Majesty's Government."

On

*Visit of the Prime Minister to Mussolini.

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On 6th January the Exchange Equalisation Account was strengthened by the transfer of £200 million gold (market value £350 million) from the Issue Department. This meant in effect a return to the E.E.A. of all the gold which had, at various times, been passed from the Account to the Issue Department. The increase in the fiduciary issue was merely the counterpart of this redistribution of resources. This, with a request to the London Market to refrain from transactions in forward gold and not to facilitate advances against gold, and a request to the banks to scrutinise foreign exchange operations with a view to eliminating undesirable transactions, had some effect. Foreign Central Banks cooperated, but remained apprehensive.

On 11th January the Governor informed the Committee of Treasury that at the January meeting of the Board of the B.I.S.:

> "There was a general desire to co-operate in order to maintain the exchanges but the opinion was expressed in several quarters that, failing a lessening of the international tension, no improvement could be looked for in the sterling position except possibly through some abandonment for technical reasons of the policy of so-called 'cheap money'."

Nothing further appears to have happened in connection with Bank Rate until the approach of war. On 24th August 1939:

> "The Governor acquainted the Committee that he and the Deputy Governor had had long conversations in Whitehall on the previous evening regarding the financial and Exchange situation and the advisability of a change in Bank Rate. He had recently urged more than once that as a precaution the Bank Rate should be raised, but his advice had not been accepted. In view of the critical position which had now developed, making necessary far-reaching emergency measures, the Chancellor was in agreement that Bank Rate be raised to 4 per cent. Although the time was past when a rise in the rate would have done most good, there was no doubt that it was an essential action in the present

circumstances

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circumstances.*

It was agreed to recommend to the Court of Directors that the Bank Rate be raised from 2 per cent. to 4 per cent."

The change was made on the same day, and the rate was reduced to 3% on 28th September.** On 18th October the Committee of Treasury agreed ".... that no alteration be recommended in the Bank Rate which, as in recent weeks, was in accordance with the wishes of H.M.Treasury. In this connection a full discussion took place on the relations of the Bank with the Treasury and with the Clearing Banks in this and kindred matters."

On 26th October the rate returned to 2 per cent ".....in accordance with the wishes of H.M.Treasury". (C.T.25.10.1939.)

The Bank Rate came under discussion in the House of Commons on 7th November 1939 when Mr.Stokes*** asked the Chancellor to inform the House of the identity of the persons who were consulted when the question of changing or maintaining the Bank Rate was under discussion; whether he was satisfied that no individual concerned might be presumed to have a direct pecuniary interest in the matter, and whether he would endeavour to see that Parliament was consulted before changes were made. The Chancellor, of course, repudiated emphatically the insinuation made in the second part of the question. On the following day these proceedings in the House were discussed by the Committee of Treasury, who

> "................. in view of their importance to the Bank and in the interests of historical accuracy, decided to record first that, since the beginning of the year, the question of maintaining or changing the Bank Rate had only been before the Committee

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*The Governor's statement to the Court (of that day) was on the same lines:

> In recommending an increase in the Bank Rate from 2% to 4%, the Governor said that the step was taken at the request of the Chancellor and with the agreement of the Committee of Treasury. He himself regretted that action had been so long delayed but, up till now, the Chancellor would not agree to any increase in spite of the advice which the Bank had repeatedly given him during the past few months. (Secretary's Office record.)

**On 11th September a ~~[illegible]~~ Minute of the Committee of Treasury says: "While it was formally agreed that no alteration be recommended in the Bank Rate, the Committee recognised that during the continuance of air attacks some of their decisions might have to be provisional or action thereon delayed."

***Labour (Ipswich).

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Committee, or indeed before the Court, on the understanding that no decision should be reached that would not meet with the agreement of H.M.Treasury; and second that, every time the question of a change had arisen since the outbreak of war, the Committee had accepted and recommended to the Court whatever course was said by the Governors to be the expressed wish of the Chancellor or of the Treasury."

On 9th November there were further references in the House. Mr.Dalton* stated that "..... as between the Treasury and the Bank of England ..... the relationship has been completely revolutionised, and that the Governor of the Bank of England is to a much greater extent than is openly admitted or legally recognised to-day the agent and servant of the Treasury rather than an independent financial dictator, as has been the case in the past. ..... The Government has enormous powers so far as the settlement of rates of interest and other terms of borrowing are concerned."

Mr.John Wilmot** spoke in the same sense, and added:

"The Bank Rate has already been reduced by 1 per cent., and many people believe that it should never have been raised. The Chancellor of the Exchequer seems to disown any share of the credit for its reduction but I find it very difficult to believe that the Government itself is not at this time really in command of the mechanism to fix the Bank Rate. I would suggest that these controls should now be used to reduce the Bank Rate to 1 per cent....."

The Committee of Treasury took note of these speeches on 15th November.

On 21st November Mr.Stokes again asked the Chancellor what control he had over the fixing of the Bank Rate, or whether in fact the effective control of the Bank Rate was not in the hands of the Treasury Committee of the Bank. He asked for the names of the members

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* Labour (Bishop Auckland)
** Labour (Kennington)

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members of that Committee, which the Chancellor refused to give. On 29th November the Governor informed the Committee that he would ask Mr.Stokes to call, and on 13th December reported a long talk with him. He had not given him the names of the Committee of Treasury "on the grounds first that the Chancellor had declined to do so and secondly that authority was exercised in the Bank only by the Court of Directors or by the Governors."

It appears that in December Lord Kindersley discussed with the Governor the possibility of a reduction in the Bank Rate to 1%. He favoured this rate on the grounds that there would be a large saving on the interest on Treasury Bills and on other short borrowing, an ability to continue borrowing cheaply for longer periods, and incidentally the advantage of giving definite proof that the banks and the money market were ready and anxious to help to finance the war on the cheapest possible basis.

On 30th May Mr.Stokes asked the Chancellor "Whether he now controls the fixing of the Bank Rate", and on 4th June the Chancellor told him that he had power to give directions in this matter.

When

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When asked by another member whether he could not exercise his authority, the Chancellor replied that he could do so "but I am not satisfied that the situation requires it."

Lord Kindersley once more raised the question of a 1% Bank Rate in a letter dated 3rd August:

> ".......I have never changed my view that it was desirable, but lately several advantages that would not have accrued at that date* will do so to-day.
>
> (1) There is of course no doubt that the 3% and 3½% Government loans are great competitors to the 2½% loan. A fall in the Bank rate would presumably lead to a rise in these stocks, whereas the 2½% being on tap would not rise but would look attractive.
>
> (2) The reduction would presumably lead to a fall in the banks' charges for industrial and other loans and in view of E.P.T. incidence the advantage of this reduction would find its way largely into the Government coffers.
>
> (3) The rise in gilt edged resulting from a reduction in Bank rate should, I think, stimulate the Equity Market and indirectly through improved sentiment would help subscriptions to War Bonds."

The Governor laid the letter before the Committee of Treasury and expressed the opinion that Lord Kindersley was so preoccupied with the National Savings Movement that his view of the market and rate structure as a whole was somewhat obscured.

Among advocates for a reduction Mr.Stokes remained the most tenacious. He put the question to the Chancellor on three occasions: 21st January 1941, 1st July 1941 and 24th November 1942. On

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*December 1939.

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On the second occasion the Chancellor was invited to agree that it would be to the Treasury's advantage if the "discount syndicate were demolished and a free market allowed". Giving a negative answer each time, the Chancellor added on 1st July 1941 "...it would be very dangerous for me to agree with Mr.Stokes".

Bank Rate remained unchanged from 26th October 1939.

Market Rates

During 1919 the Clearing Bankers had come to an arrangement for uniformity in their Short Loan Rates, and short loans to bill brokers were made at rates which were, in effect, 1½% below the ruling Bank Rate. This margin continued until 1925 when, on changes in the Bank Rate, it was narrowed to 1¼% and finally to 1%.

The margin remained at 1% until 1934, except for a few weeks in 1931 when Money Rates rose somewhat before Bank Rate and the margin was narrowed to ½%. On the 30th June 1932 the Bank Rate was reduced to 2%. The Clearing Bankers' Short Loan Rate was 1%, but very considerable amounts of foreign and colonial money were seeking employment in this market and the Discount Market were able to obtain short loans from sources other than Clearing Bankers at ½% and even under. The Discount Market's raison d'être was of course the selling of bills to banks and taking their short money at call; but they were then making considerable profits on running short Government Bonds. They were therefore in a position to attempt to satisfy the banks' keen demand for bills by tendering for them at rates which showed no profit either on the jobbing or the running. In November 1934, for example, the rate ranged between 6s.7½d and 4s.9½d; and the Clearing Banks, who were feeling the effects of competition in the Short Loan Market, reduced their Short Loan Rate to ½%. But as they remained competitors in tendering for Treasury Bills this move did not remedy an entirely unsatisfactory state of affairs in which Treasury Bills were being dealt in at rates below the Money Rate: on the 25th January 1935 the rate was3s.11d.*

In

*Pressure of foreign funds may have been a contributory factor in these periods.

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In February 1935 the Clearing Banks decided not to tender for Treasury Bills and not to buy them at less than the Money Rate - a decision which restored the normal relation between Money and Bill Rates.

In 1938/39 several factors were responsible for low rates. A large volume of money was available for all purposes. Monetary conditions had been kept easy ever since there were signs of a trade recession. There had been an expansion of the Cash Base (Bankers' Balances at the Bank of England averaged £9/10 million higher in 1938 than they had been in the three previous years). Private savings in 1938 were about £500 million. Foreign liquid funds* were £614 million gross and £328 million net (November 1938), an increase in the net figure of £111 million since 1931; while there had also been a considerable contraction in overseas lending. Private purchases of dollar securities declined in 1938.

Industry was refraining from new outlay and accumulating balances; building was less active; there had been a fall in wholesale prices.

In all these circumstances bankers were finding it difficult to earn profits. Their advances were nearer 40% of their assets than the customary 50%; and a corresponding increase in Treasury Bills was not available. Excluding in both cases Exchange Equalisation Account assets between March 1932 and March 1938 the total issue of Treasury Bills had risen by £88 million only, while the total National Debt had increased by £500 million.

In general, however, it was a part of the Bank's policy that the amount of Treasury Bills should remain low, so that there should be no difficulty in dealing with any emergency which might arise.

Loans for short periods and day-to-day money had been at ½% almost

*Returns from about 130 banks, etc.

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almost continuously since November 1934. When the Bank Rate was raised to 4% on 24th August 1939 the Short Loan and Call Money Rate became 3%: the margin between Bank Rate and the Short Loan Rate had narrowed to 1%: when Bank Rate returned to 2% in October 1939 the Short Money Rate became 1%. The Treasury Bill Rate, which naturally followed the Short Money Rate and Bank Rate upward, adjusted itself to the new Money Rate in October and remained around 1%. The maintenance of Money Rates at above their pre-war level, in spite of the reduction of the Bank Rate to its pre-war figure, was a subject of interest in the House of Commons. The Chancellor told questioners that the rate to be charged for Call Money was one to be decided by the banks themselves in the light of current monetary and commercial conditions; and this answer may be taken as a reflection of the Governor's views. According to the recollection of certain officials of the Bank, he had felt that well before the war there were indications that the rate structure then existing was not altogether a healthy one, and the facts seem to bear out this contention. Light is thrown on the determination of money rates by a note made on 20th December 1939 after a meeting of the Committee of Treasury.

"....... The Governor referred to the agitation in the Press and Parliament for the reduction of the banks' 1% call rate. He had informed the Chancellor that there appeared to be no case for his intervention. New expenses had been incurred for which the banks were entitled to recompense themselves and the level of the call rate was properly a matter between themselves and their customers. In any case, the fixed rate of ½% to which reference was now being made had been arranged in order to prevent a further fall in rates rather than a rise; and it had undoubtedly led to trouble in that the difficulty of making money had led to call money being improperly employed.

The Committee agreed with this view."

On 10th January 1940 the Governor again returned to the subject in Committee of Treasury:

"Attacks

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"Attacks were being made, in the Press and elsewhere, upon the maintenance of the Clearing Banks' money Rate at 1%, as laid down in their schedule of rates dated 4th October 1939. After reviewing the relation between the Bank Rate and Market rates for money and Treasury Bills in recent years, he did not at present think it advisable that either the Bank or H.M.Government should intervene."

As an illustration of the misuse of funds during the cheap money conditions of the pre-war period, one instance may be given.

Many local authorities had been issuing Bills, the proceeds of which in some instances had been used to finance capital expenditure. Consequently in the autumn of 1938 Clearing Banks decided not to accept Municipal Bills as security for the market unless they could be re-discounted at the Bank of England. This restricted first-class Municipal Bills to those of four or five authorities for whom the Bank acted as issuing agent, and a considerable difference in rates arose, not reflecting the respective merits of the Bills.

On 9th November 1938 the Governor informed the Committee of Treasury that he hoped to arrange with the bankers to take the Bills of their own clients at rates approximating to current market rates. Failing this, if the Chancellor required, the Bank would have to regulate Municipal issues. The bankers did not agree to the proposal. In December, therefore, the Bank of England told the Discount Market that they would accept Bills issued under certain conditions which ensured that the money would be used for temporary purposes only.

Early in June 1940 the Governor, in connection with the National Savings Campaign, enquired of the Chief Cashier whether the Bankers could not be asked to pay no interest at all on deposits, or rather on new deposits, assuming the new proposal concerned with T.D.R.'s was accepted. The Chief Cashier (12th June) thought this idea might be welcomed by the banks; if not, the customary ½% might be regarded as the maximum instead of the minimum Deposit Rate.

But

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But the Discount Market would also have to be brought into line; their published rate was ¾%.

By 17th June the more drastic suggestion of no interest seems to have been given up:* a brief note concerning T.D.R.'s given to the Chairman** of the Clearing Banks' Committee ends with "No deposits to be taken or renewed by the Banks at a rate above ½% per annum" (with a pencil addition by the Governor reading "and no increased deposits by the Discount Market"). On the same day the Chief Executive Officers of the Big Five, who had evidently seen the Bank of England memorandum and who seemed to assume that the Deposit Rate proposal would mean a "Treasury direction", submitted various changes in the existing rate structure, which they "ventured to suggest" it would be preferable that the Clearing Banks should be allowed to make themselves. The changes proposed (for old and new funds) were a reduction of ½% (to ½% or ¾%) on "competitive Special Deposit Money" and a general maximum of 1% on "old Country deposits".

In short, the Bankers suggested a range of rates from ½% to 1%. Thus 1% became the maximum Deposit Rate, but applicable only to a proportion of the total deposits. This compromise was accepted by the Bank, who also conceded existing higher rates on small quasi "Savings Banks" deposits. 2½% was to be paid on the first £100 of money lodged in "Home Safe Accounts", while 1½% on sums up to £500 was soon conceded in the case of the Scottish banks.***

On 19th June Mr.Campbell told the Committee of London Clearing Bankers that the Governor would deal separately with the Discount Houses (who were also required to reduce their maximum rate to 1%) and would not want them brought into the discussion; that while any reduction should be regarded as the wish of the Treasury, the Governor was anxious to avoid anything like an order or instruction from the Treasury. Mr.Campbell further reported that

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*Possibly on the ground that payment of <u>some</u> interest on Deposit Accounts is an inducement not to spend and hence of assistance against inflation.

**Mr.Colin Campbell.

***The unique Birmingham Municipal Bank contined to pay 3%.

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"with regard to the point that the rate agreed upon should apply to every Bank in the United Kingdom, the Governor proposes in the meantime to confine himself to the Deposit Banks, including the Scottish Banks.........

He agrees that the rate for old Country Deposits, which was formerly fixed at 2½%, should now be maximum 1%.

I suggested to the Governor that the probable effect of a reduction in Deposit Rate to ½% would inevitably lead to a reduction in the Treasury Bill Rate below 1%. This he is not prepared to admit at the moment and he stated that he is anxious to maintain the existing rate of 1%......."*

The changes made in June 1940 did not dispose of the issue of the short-term rate structure in war-time. In the following month the arrival at the Treasury of two memoranda brought up the question again, for although these were anonymous the Treasury evidently felt that they needed some form of answer. Extracts from these memoranda follow:

First Memorandum

"..............

There are four changes which the City expects now and which we think desirable:

(1) A request to the Discount Market and Banks to reduce their short loan and/or Treasury Bill rates to half the present level.

(2) A request to the Banks to abolish interest on bank deposits.

(3) A reduction in the long term rate of interest, i.e.the issue of new war loans at lower rather than higher rates.

(4) Direct requests to all financial institutions to take up "quotas" of new war loans when issued.

Clearly

*At a meeting of the Chief Executive Officers of the Clearing Banks on 26th June 1940 -

"The Chief Cashier declared, on behalf of the Governor, that it was not desired that there should be any change in money market rates or in the rating structure of the Clearing Banks such as might occasion any change in the current rate for discount of Treasury Bills."

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Clearly, in such a crisis as the present, financial reforms are of minor importance and those named are merely directed towards lowering the rate of interest. They can, however, be effected at this time practically without effort. They would save in the end many millions and they could be a prelude to a real review of new methods. There is no doubt that measures like these could easily have been carried at the outbreak of war and that now the Government can do absolutely as it likes with the City. It is to be hoped, therefore, that the Government will not be persuaded into thinking that this or that financial reform is impossible.

..........."

Second Memorandum

"...........

I can only repeat what I have said before. If the time for a new loan is approaching, and I think it is, the Treasury should announce forthwith that Treasury Bills will in future be issued to those who tender for them at the rate of one half per cent per annum. There is nothing new in a fixed rate; the rate has been fixed for weeks by common consent, and for weeks, if not months, the Treasury has been expected to demand a reduction of one half (to ½). Only the Bank of England thinks a short term rate of 1% is safe but ½ is dangerous and would lead to speculation! The banks etc. are absolutely dependent on Treasury Bills for the short term investment of their funds.

At the same time the Treasury should tell the banks, not merely intimate to them, that in the interests of cheap war finance it is desirable to abolish all interest on bank deposits.

Next the Government should announce that investors must not expect any rise in the rate of interest on war loans: on the contrary, they must expect a progressive reduction........."

A justification of the Government's policy was drafted at the Treasury. There was little difficulty in defending the

Government

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Government in the matter of low rates on medium or long-term loans, as they were already being established. In forwarding the draft for the Bank's comments, Sir Richard Hopkins said that he hoped "a means might be found to make a passage on the Treasury Bill Rate more specific".

"...........

The rate at which the banks are willing to lend money for short periods is frequently referred to as governing the rate for Treasury Bills. It is an important factor; but there are others, such as the volume of bills outstanding and the general economic and political conditions of the moment. Moreover, at a time when the short-money market has to be carefully watched from the point of view of checking tendencies to inflation any reduction of the banks' lending rate must be weighed with particular care. [Again, we do not want to put the Discount Market out of business, but if the rate for short money is cut too fine the margins on which the Market subsists may be almost obliterated: that position was rapidly approaching before the war when short money rates and Treasury Bill rates were in the neighbourhood of one-half per cent.]* All these factors have to be considered, and not merely the cost to the Government of borrowing on Treasury Bills. The best advice available to the Treasury is that in present circumstances the balance of advantage lies in retaining the present level of rates.

The payment of interest on deposit accounts is a means of encouraging depositors to turn their money over slowly rather than quickly and is to that extent a deterrent against spending. There are no doubt other important considerations affecting the retention of funds in the banks, but nevertheless the offer of interest

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*The clause in square brackets is marked in this way with the word "omit?" against it in the Governor's handwriting.

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interest is useful so far as it goes. The rate of interest paid must, however, not be so high as to encourage people to leave their money with the banks rather than invest it direct in Government issues and the banks have been asked to reduce to 1% all higher rates which they now pay.

.........."

A written reply was not sent, but a memorandum by the Chief Cashier was used as the basis of a discussion with Treasury officials, and on rates this reads: "It might be stressed that such rates as Bank Rate, Treasury Bill Rate and Bankers Deposit Rate are only elements in a closely related system - to alter one is to unsettle many others with repercussions on e.g. Building Societies, Life Assurance Companies."

Sir Richard Hopkins then wrote (15.7.1940) that he thought it would be a good thing for the Chancellor "to take the bull by the horns and deal with the Treasury Bill rate in the forthcoming budget speech". He enclosed a draft which he had prepared.

"..... The Treasury Bill rate is itself related also to a structure of interest rates upon short moneys. The rate normally paid by banks on their deposits (not of course including current accounts) is ½%. The Clearing Banks' rate for short loans secured by Bills of Exchange is 1% and the rate on 3 months Treasury Bills is a few pence in excess of this amount.

It is from time to time pointed out that the present rate is nearly double that which obtained over long periods in the years after 1931. No one could describe that as a normal period and it is no more legitimate in my view to seek to judge the proper rate in war-time by that test than by the test of the rates which obtained prior to 1931 and which of course were immensely higher than any which are in force to-day.

The natural rate, which is fixed by competitive tender, turns upon many complicated factors, of which the volume of Treasury Bills is only one. The short term money market is a very elaborate machine, the effective working of which in war-time

is

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is essential in order to raise the enormous sums that we require. I should perform not a service but a great disservice by taking any ill-considered action to derange it.

In going over past criticisms - and I have considered not only the speeches in the recent Vote of Credit debate but questions raised at an earlier time - I think I can detect two objections in the minds of critics of the present position.

Firstly it is said that banks from whose deposits much of this money directly or indirectly comes should not pay interest on the deposits they receive. They do not of course pay interest upon current accounts. Their normal rate upon ordinary deposit accounts is ½%. It has been the practice in some parts of the country to pay rates of interest up to 2½% on special deposits, and this custom is in fact a legacy from the practice of local banks before the large amalgamations took place. Steps have recently been taken to arrange that for future deposits a maximum of 1% should prevail where previously higher rates have obtained. I see no adequate case for going further at the present time. I think it will be generally accepted that the payment of interest on deposit account is useful, so far as it goes, as a deterrent against spending, and I should be sorry in these days to dispense with any such deterrent.

The second criticism which has been put bluntly on more than one occasion is that the 1% lending rate of the banks yields them an excessive profit, a very large part of which, owing to the volume of Treasury Bills, is ultimately at the expense of the Exchequer. This is a question which I have carefully studied, and in doing so I have had the ready assistance of the banks themselves. Their profitability depends not upon one factor alone but upon the results of all their operations in the times full of difficulty and risk through which we are passing - times in which they have not increased their general charges to their customers.

Starting from this standpoint, I am satisfied that this

criticism

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criticism is unfounded. It may also be a consolation to the critics to reflect that if I am wrong, and the banks were on balance to make largely increased profits, those profits would fall in whole to the Exchequer under the 100% Excess Profits Tax."

The Governor answered (16.7.1940):

"I have read the draft 'words' enclosed with your letter of yesterday and return them unamended.

For my own part I hardly agree that the Chancellor should thus take the bull by the horns and deal with the Treasury Bill rate and other technicalities formally and seriously in the House of Commons. First, because however well and cunningly he may do so this subject cannot there be explained in words under those conditions and because no one who understood the subject (after years of wearing out shoe leather round about Lombard Street) would attempt to explain it.

Secondly, because thus to take the bull by the horns is to assume that those few fellows who wrangled in the House on the vote of credit were in earnest. Nothing, I think, would surprise them more than to be treated as if they were in earnest. They were engaged first on bullyragging the Chancellor and so weakening his position: next on undermining the position of the banks and the City in order the more quickly after our ruin to control this and all the other banks. Therefore, the more the Chancellor treats them with such respect as genuine seekers after truth or improvement, the more trouble shall we have later and if I were he I would leave this subject entirely alone on the occasion you have in mind.

If you ask what is he to do after inviting a question, I should say let these wranglers put down further questions which we can answer shortly and more or less truly as they arise but with little sympathy or encouragement. The general line we take is that these various rates are only elements in a closely related unique system - to alter one is to unsettle others with repercussions not only on the stability of the Clearing Banks but also of other bodies (Building Societies, Insurance Companies, etc.)."

The

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The brief prepared by the Treasury was, however, of assistance to the Financial Secretary on 6th August during the second reading of the Finance Bill, doubtless because Mr.Pethick Lawrence (Labour) referred (not for the first time) to the Treasury Bill Rate, pointing out that the volume of Treasury Bills outstanding had risen from about £1,000 million in July 1939 to £1,725 million in July 1940, and claiming that the rate, which had gone up from a little over ½% to a little over 1%, was too high. Customers' Deposit Rates should be cut and the Treasury Bill Rate reduced to ½% (or at any rate to ¾%). In his reply the Financial Secretary used the draft, but omitted the paragraph referring to the fact that the Treasury Bill Rate was nearly double that of the pre-war years after 1931.

On 12th November 1940 Mr.Craven-Ellis* asked what the effect on the Treasury Bill Rate would be if Bank Rate were reduced to 1%, and what were the advantages of the present high Bank Rate. The Chancellor did not agree that the Bank Rate was high but for the rest referred the member to the answers of 6th August.

Again in April 1941 the Chancellor wished a statement to be prepared for the second reading of the new Finance Bill, in case Mr.Pethick Lawrence or anyone else returned to the suggestions made a year earlier. In their draft the Treasury's remarks on the Treasury Bill Rate were not very happy. A re-draft by the Bank covered a much wider field, including "costless" credit; it dealt with short-term rates only indirectly, pointing out that no less than £456 million of an increase of £486 million in the Clearing Banks' deposits between September 1939 and March 1941 was in current accounts. It also made the point that it would not be well to force down interest rates to a level "which makes it impossible for the insurance institutions of the country to cover long-term contracts and deprives everyone who has retired on a life-time's savings of the greater part of the income they had counted on"; and laid stress on

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*Conservative (Southampton).

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the increased costs of the banks as compared with an income rising much less rapidly.

The Treasury expected a general debate on the Bankers' Deposit Rate and over-draft rates in September 1942, and drew up a memorandum on the subject in the previous month. Incidentally this estimated the saving, if bankers ceased to pay ½% on all deposit accounts, at rather less than £6 million a year, but again emphasised the undesirability of the abolition of the Deposit Rate as likely to encourage spending. The Bank worked also on this draft. Soon after its arrival at the Bank the "Financial Times" (17th August) suggested that a White Paper should be issued to educate Members of Parliament on banking matters, a proposal which the Treasury appear to have adopted by the end of August.

The Bank's re-draft dealt with the Treasury Bill Rate incidentally, in connection with the point that all borrowing rates were far lower than during the last war. Both Treasury and Bank drafts were in the main a defence of the banks by comparing the rise in their expenses with the rise in their receipts. The idea of issuing a White Paper was eventually dropped and only a small and condensed part of the Bank's draft was used by the Chancellor in the House of Commons, during a debate on War Finance and Borrowing Policy on 16th December 1942.

In December 1942 also the Chief Cashier pointed out to the Governors that the total of T.D.R.'s outstanding had reached a figure much the same as that of Treasury Bills, which was maintained at about £1,000 million. Should 6 months Deposit Receipts also be limited in amount, and a new series of 12 months Receipts be issued at, say 1¼%? One disadvantage of this would be the danger that the whole rate structure might be put in the melting pot, so that perhaps it would be better to make no change. The Governors agreed.

In the next two years the existing structure of market rates does not seem to have given rise to so much comment; and in any case enough has perhaps been said to show the nature of the criticisms expressed and of the defence put forward. But from the autumn of 1944 the matter began to be actively revived: the Press again

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again gave a good deal of space to it, and the Bank, and later the Chancellor, received further representations from Lord Kindersley.

To begin with the Press: an article in the Economic Journal of December 1944,* surveying nearly 100 years of money rates, made much of a fact unlikely to have been realised by more than a few analytical minds - that a persistent margin between short and long term rates had appeared only since 1931. The author concluded that, assuming continuance of the existing level of output and prices and no attempt either to reduce the quantity of currency and bank deposits or to ~~fund~~ fund short term loans, both long and short term rates might, within a few years after the war, settle down at about 2-2½% (i.e.at ~~only~~ about ½% lower than rates obtaining during most of the nineteenth century).

The Times (29.1.1945), before accepting these conclusions, preferred to examine the question further and devoted the greater part of its City columns to doing so. The Times article pointed out that before 1931, after which critical year the persistent margin of 2% or more had appeared, there had indeed been very wide gaps, but only for short seasonal periods or in the process of adjustment under an automatic gold standard. Short term rates were now protected against former risks by the absence of automatic deflationary reactions to adverse exchange movements, by exchange control and by "cushion" funds used by the authorities to offset temporary exchange tendencies. The Times concluded that although conditions might well lead to a very different relationship between different types of money rates from those existing before 1914..... short term rates, on past evidence, seemed unlikely to rise to more than 1½% with the long term rate at 3% (with no implication that the latter would settle around 3%).

Lord

*"The Future of Interest Rates" (E.V.Morgan).

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Lord Kindersley's assault began with a letter to the Governor (30.11.1944). Unable to account for the failure of the $1\frac{3}{4}\%$ Exchequer Bond issue, he was inclined to attribute it to the failure of the bankers to reduce their deposit rate, while the yield on medium-term Government loans had been made less attractive by lengthening the term of years to maturity. Was not the remedy a reduction by a 1/4 - 3/8% all round in Bankers' Deposit Rates (with a 1/4% rate on anything less than 6 months) and a rate of 7/8% only on T.D.R.s?

In a note on this letter the Chief Cashier pointed out that if such action were taken "the whole rate structure would become unhinged". Lord Kindersley's viewpoint, not unnaturally, was the day to day subscriptions to tap issues; but he had been advocating a lowering of rates on deposits and advances (not excluding Bank Rate) for some years. The Governor replied to Lord Kindersley (6.12.1944) in general terms, referring to a talk which they had had in the interim.

In mid-December the Deputy Governor and Chief Cashier also had discussions on the subject with Lord Kindersley. They seem at least to have persuaded him that a reduction in the T.D.R. rate would have little connection with the inclinations of depositors and that the deposit and T.D.R. rates could not be altered in isolation.

The Deputy Governor, however, (in a note to the Chief Cashier) felt that to "the rank and file of folk who see a continual reduction in long and medium rates but no alternative alteration ? in the short rate" it must appear that professional lenders were....."getting a rake-off and to a mild extent they are".

On 5th February 1945 Lord Kindersley wrote to the Chancellor strongly urging adjustment "of the present illogical policy of continuing to keep deposit rate up while reducing the attractions of medium and long-term loans". But for the outlet by way of T.D.R.'s the "very weight of additional deposits would cause the interest on short money to decline."

Commenting

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Commenting on this last point the Chief Cashier said "....the weight of deposits would have been there in any event": if the Government's needs had not been borrowed on T.D.R's some other device would have been necessary. A short answer to Lord Kindersley, in his opinion, would be on the lines that there must surely be something in the theory that progressive reduction in rates increased decreased? the incentive to save. In practice there must be "a limit to the extent to which we can fairly - andindeed wisely - apply the screw (vide 1¾% Exchequer Bonds); and in my mind that limit has been reached."

Sir Otto Niemeyer (in a note which the Governor marked for availability on file when he should next talk with Lord Kindersley) pointed out that since the vital object of saving was abstinence from consumption it would be better to fix it in long-term securities. He added a warning against encouragement of unnatural investment in Government stocks by offering special facilities for bank lending against such stocks (with memories, perhaps, of its inflationary effect during 1914-18).

These criticisms notwithstanding, the course seems to have been fairly well set for the reduction in all short-term rates which inevitably followed the Labour Government's return to power and the new Chancellor's drive towards cheaper Government borrowing all round. Reductions came at the instigation first of H.M.Treasury. On 22nd August*, the Bank reassured the Treasury that since the Banks were not asked to take up T.D.R's until they had received the money through Government disbursements, though they might protest at any reduction in the rate of interest, they would "accept any reasonable arrangement without undue fuss". **

The Treasury Bill rate and the bankers' call and short money rates were reduced to ½% as from 19th October 1945. Cuts in the interest rates on Treasury Deposit Receipts and on Tax Reserve Certificates followed - the former immediately (to 5/8% on 22.10.1945), the latter after nearly 6 months (to ¾% on 11.4.1946). (See also Sections on these instruments.)

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*Meeting at Bank: Sir H.Brittain, Deputy Governor and Mr.Cobbold.
** In Court (17.10.1945) the Governor said that "... he wishes to make it →

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