

Competition and credit control: extract from a lecture by the Chief Cashier of the Bank of England

The text of part of a Sykes Memorial Lecture given by the Chief Cashier to the Institute of Bankers, 10, Lombard Street, London E.C.3 on 10th November 1971

. . . First, the gilt-edged market; as you will know, last May at the time of the publication of *Competition and credit control*,¹ the Bank announced and put into effect a modification of the extent of their operations in the gilt-edged market. This was no simple decision, representing as it did a substantial change in the basis upon which dealings in the gilt-edged market had taken place for some years.

To put this decision into perspective, it is necessary to review briefly the origin and development of the Bank's place in the gilt-edged market. In origin, the Bank deal in the gilt-edged market in discharge of their function of banker and issuing house to government. In this capacity, the Bank are concerned with the issue of securities, both short and long-term, to finance the needs of government whether these arise from its current financial position or from the maturity of existing debt. Thus, the Bank first entered the gilt-edged market in order to improve the efficiency and smoothness with which they discharge this function, selling one or two new securities and buying in those approaching maturity. Gradually the Bank became willing to deal in a wider range of securities because by so doing it appeared possible to improve the effectiveness of their operations. At the same time, in the late 1950s and early 1960s, smoothing out the fluctuations in interest rates which market forces tended to bring about had come to seem an appropriate objective. Both these considerations worked together to lead the Bank to a position in which they were prepared, at prices of their own choosing, to deal in the whole range of British government securities in the market.

The changes to these arrangements introduced last May were based on three considerations: the effectiveness of monetary policy, the health of the market and the need to preserve the Bank's ability to finance and refinance the needs of government.

The first change, as stated in the document *Competition and credit control*, was that the Bank were no longer prepared to respond to requests to buy stock outright except in the case of stocks with one year or less to maturity. This change was intended – I quote – to “help to limit, further than can be achieved solely by alterations in the Bank's dealing prices, fluctuations in the resources of the banking system arising from official operations in the gilt-edged market.” Some time before the reappraisal of monetary policy which led up to *Competition and credit control* had been completed, the conclusion had been reached that the Bank's operations in the gilt-edged market should pay more regard to their quantitative effects on the monetary aggregates and less regard to the behaviour of interest rates. In application of this conclusion, the Bank's tactics in the gilt-edged market became much more flexible in respect of both the techniques they employed and the prices at which they were prepared to deal. But, for the effectiveness

¹ See June 1971 *Bulletin*, page 189.

of the new arrangements this did not go far enough. So long as monetary policy was closely concerned with the total of bank lending, the banking system's operations in the gilt-edged market were not of critical importance for monetary policy. Under the new arrangements the ability of banks – and others – to deal in large quantities of stock at moments of their own choosing at prices not far removed from those ruling in the market at the time would clearly be unacceptable.

By implication this part of the change made last May was designed to help the effectiveness of a restrictive monetary policy. But any modification to existing arrangements to be complete had also to provide for the implementation of an easy monetary policy under which it might come to be appropriate for expansionary open-market operations to be engaged in. For this reason the Bank reserve the right to make outright purchases of stock with more than a year to run at their discretion and initiative.

The limitation on the extent of the Bank's operations was also addressed to the health of the market. The extension of the Bank's operations to which I have already referred was in part inspired by a developing inadequacy in the resources of the market in relation to the volume of business; that is to say, the Bank extended their operations because they thought that otherwise the marketability of gilt-edged securities, which is one of their principal attractions, would be unduly impaired to the disadvantage of government financing and refinancing. In retrospect, this decision itself probably contributed to the attrition of the market's resources. So long as the Bank were prepared in effect to put substantial resources into ensuring the marketability of gilt-edged, there was no particular reason why others should do so. Furthermore, and especially with the advent of greater flexibility in pricing on the part of the Bank, a market dominated by a dealer with resources far and away beyond those which any other single dealer could possibly command was not one likely to be attractive to newcomers. Also, it is the essence of a market that there should be a variety of views among operators of similar size. The Bank's close presence in the market often meant that in practice there were only two views – those of the Bank and those of everybody else. This situation gave rise to very large speculative transactions and made the speculative management of portfolios altogether too easy. We thus sought to make room in the market for others to operate in more realistic conditions. It is as yet too soon to judge whether or not this objective has been achieved but I have reason to think that we have already made some progress towards it.

Finally, the changes of last May leave intact the system of continuous financing and refinancing of the central government. Alternatives to this system can be conceived but none seems likely to be so effective. The Bank thus continue to be buyers of near-maturing stock, sellers of tap stocks and to engage in switching transactions which help this process and help investors to maintain the length of their portfolios as time elapses.

The second domestic market with which the Bank are concerned is the money market and, most directly, that part of the money market which deals in short-term debt of the central government, for here too we are concerned both as an issuing house and as an executant of monetary policy. In framing the proposals in *Competition and credit control* it seemed to us that our objectives could be met without structural change because, despite what the critics may say, that structure serves the interested parties very satisfactorily. Thus, although the discount market's agreements among themselves and with the banks on Treasury bill prices and money rates would go, along with the banks' agreements on interest rates, it seemed desirable and possible to maintain the discount market's role in underwriting the Treasury bill tender and as the channel through which our influence on short-term rates of interest was exerted. Thus we concluded the agreements with the London Discount Market Association described in the paper *Reserve ratios and Special Deposits*.¹

The structure thus remains basically unchanged, but modifications to our techniques have already taken place and further change will be considered as and when necessary. The first change is that the Bank are now free to determine day by day the prices at which they are prepared to deal in Treasury bills. Up to the middle of September, the discount market agreed prices among themselves not only for the tender each week but also for subsequent dealings in long bills in the market. Consistently with this agreement, the Bank themselves dealt in line with the market's prices for Treasury bills and influenced changes in those prices by acting so as to bring about a change in the price at each tender, notably by requiring the market to borrow at a penal rate. It has yet to be decided how far the Bank would be prepared to make use of this new-found flexibility and what therefore might be the implications for the role of Bank rate. The second change of technique, which arises only in part from the new arrangements, is the extension to the discount market of limited borrowing facilities which each house may use at its own discretion for the management of its portfolio – a change which in part restores a position that used to prevail. These facilities are intended to give houses time – but strictly limited time – for adjustment if fluctuations in short-term interest rates become more frequent and larger than recently; and to make a clear distinction between the use of last resort facilities for this purpose and borrowing forced on the market by the Bank, whether in the interests of smoothing out large fluctuations in money flows or as an act of monetary policy.

I now turn to the arrangements made with banks and finance houses. I shall confine myself to certain important matters: the next issue of the Bank's *Quarterly Bulletin* will include an article explaining these arrangements in some detail.² First, in any arrangement intended to give the central bank influence over monetary conditions, there is a problem where to draw the line across the field of financial intermediaries so as to separate those who can appropriately and effectively be influenced by the actions of the

¹ Issued as a supplement to the September 1971 *Bulletin*.
² See page 482.

central bank and those who cannot. So long as the technique of credit control was the requests made by the Bank of England for the observance of quantitative limits on lending, the drawing of such a dividing line gave rise to considerable difficulties for there were always some institutions who did not appropriately come within the purview of the central bank but whose lending activities were only marginally different from those which did. The essential difficulty was that of maintaining equity between those to whom requests were addressed and those to whom they were not.

In the new approach, as I have already said, the essence is a generalised influence on credit conditions through variations of interest rates. In the context of such a system, a clear distinction can be drawn between on the one hand those institutions who finance their activities to a significant extent by taking deposits from the public and those who do not. The former group have a capacity to compete for funds which is not available to the latter. Furthermore, the influence of the Bank is capable of being backed up by the provisions of the Bank of England Act 1946. As you will be aware, the terms of that Act which could be used for the purpose of monetary policy relate only to banking undertakings. Now there is, of course, and has been, room for argument about what constitutes a banking undertaking. But it is eminently clear that an institution not taking deposits is not a banking undertaking. Thus, although there may be room for doubt as to whether or not certain deposit-takers are banking undertakings, confining the provisions for reserve assets and Special Deposits to deposit-taking institutions is not only appropriate but also justified on grounds of efficacy, although I by no means intend to suggest that the use of the provisions of the Bank Act is contemplated.

The arrangements made with banks and deposit-taking finance houses are intended to ensure the responsiveness of those institutions to modifications of policy. For this purpose it appeared not possible for the authorities to rely on the voluntary observance of ratios which banks and finance houses habitually maintain for reasons of commercial prudence for two reasons. First, the dictates of commercial prudence are by no means immutable. A ratio that seemed appropriate at one point in time could well change with circumstances and change appreciably. The impact of monetary policy whether conducted through market operations or through the use of Special Deposits would therefore be uncertain and the degree of uncertainty appeared to be capable of being too great to be acceptable. Secondly, the composition of the liquid assets held for reasons of commercial prudence might also change. In particular, individual deposit-takers might substitute claims on the private sector for claims on the public sector thus once again introducing an uncertainty as to the impact of acts of monetary policy.

Having decided that for the sake of the effectiveness of monetary policy deposit-takers must be required to observe a minimum holding of liquid assets, it does not necessarily follow that the ratio should be the same for all. The diversity of the deposit-taking institutions in this country is well known and as well known to the Bank as to anyone else.

It can fairly be argued that the volume of liquid assets needed by one institution or one set of institutions is significantly different from that needed by others. The Cash Deposits scheme negotiated in early 1968 but never implemented sought to recognise this diversity in full. It did so by relying for its effectiveness on the possibility of Cash Deposits bearing a low or nil rate of interest rather than on the pressure which a call for Cash Deposits could have exerted on holdings of liquid assets. But the application of such a penalty requires that those who may be liable to it should be told of the action they need to take in order to avoid it. Such guidance would most likely be indistinguishable from the system of quantitative rationing which the new approach was designed to replace. In the new arrangements recognition of diversity without slipping back towards ceilings would have meant for the Bank a type of handicapping exercise involving putting weights on each of the horses at the start of the race and being prepared to change those weights as circumstances and fortunes altered. This would have been inappropriate, indeed absurd, and, I would think, unwelcome to the horses. Also, examination of recent practice suggested that the adjustments which uniformity would require of banks were not very large. For these reasons it was decided that the ratio should be the same for all deposit-taking institutions except the deposit-taking finance houses which do not achieve full recognition as banks. . . .