Key issues in monetary and credit policy

Text of an address by the Governor to the International Banking Conference in Munich on 28th May 1971

As many of you will be aware, we in the United Kingdom have recently embarked on a major change in our approach to monetary policy. Much of the detail of our new proposals, which are, of course, still being discussed with the banks and other institutions concerned, will be primarily of interest to banks operating in the United Kingdom. But I believe our proposals raise some fundamental questions which may be of general interest. Basically, they reflect a change in the official attitude towards two key questions: first, what monetary variable should the authorities attempt to influence; and, second, by what means should they attempt to influence it?

Let us first take the question of what monetary variable the authorities should attempt to influence. Of course, real life being more complicated than the textbooks, it is seldom possible or desirable for the authorities to put all their eggs in one monetary basket. One must in practice take account of movements in many financial indicators, varying the relative importance attached to them as circumstances change. With this qualification, however, it is fair to say that for the past six or seven years we in the United Kingdom have laid particular stress in our monetary policy on influencing the volume of bank lending in sterling to the private sector. There is some evidence that bank lending to particular elements in the economy – for example, to consumers – is an important direct influence on spending. Moreover, there may often be advantage in attempting to discriminate between different forms of economic expenditure – encouraging exports and restraining consumption, for example – and persuading the banks to be more generous to one activity and less to another may do something to help achieve this aim.

Against this, however, we must remember that financial systems are infinitely adaptable and the channels whereby money and credit end up as spending are many and various. We must beware of believing that if we do succeed in restraining bank lending we have necessarily and to the same extent been operating a restrictive credit policy. We may by our very actions stimulate the provision of credit through non-bank channels; we may introduce distortions into the financial system; and we may indeed be distorting in harmful ways the deployment of the real resources of the country. For these reasons we have increasingly shifted our emphasis towards the broader monetary aggregates – to use the inelegant but apparently unavoidable term: the money supply under one or more of its many definitions, for example, or domestic credit expansion.

My second basic question concerns the means whereby the authorities affect whatever it is they wish to affect. Obviously the more stress one lays on precisely controlling bank lending to the private sector, the more tempting it is to achieve that control in the most direct possible way by formal requests to the banks to lend no more than such and such an amount in total; to observe such and such priorities and so on. We in the United Kingdom have in fact been operating a system of bank lending ceilings with declared official priorities almost continuously since 1965. We have, however, been increasingly unhappy about the effects of operating monetary policy in this way over a prolonged period. In this audience I do not need to labour the ill effects. It is obvious that physical rationing of this kind can lead to serious misallocation of resources, both in the economy and in the financial system, and that inhibiting competition between banks can do much damage to the vigour and vitality of the entire banking system.

Here again we have over the last couple of years begun to move away from reliance on physical control, in that we have been prepared to see greater movements of interest rates throughout the system and consequently a greater reliance on the price mechanism in allocating credit. But as long as our major control continued to be ceilings on bank lending, we could not be said to have gone very far in this direction.

This month, however, we have taken a major new initiative. We have put proposals to all the banks for a new approach to credit control which, if agreement can be reached between the authorities and the banks, will enable us to abandon ceiling controls altogether.

Perhaps I could now outline the details of our new proposals. Basically what we have in mind is a system under which *the allocation of credit is primarily determined by its cost.* It accords with this general aim that the clearing and Scottish banks (the major deposit banks in the United Kingdom) should abandon their long-standing cartel arrangements, which have provided for uniform deposit rates linked to Bank rate, and also the convention which has governed the relationship of their lending rates to Bank rate. In future, the authorities would seek to influence the structure of interest rates through a general control over the liquidity of the whole banking system. In order to render such control more efficient and less imprecise, we are proposing a minimum reserve assets ratio applying uniformly to all the banks. At the same time our right to call for Special Deposits at the Bank of England would similarly be extended uniformly to cover all banks.

The minimum reserve assets ratio will be expressed as a fixed percentage of sterling deposit liabilities and will have to be held in certain specified reserve assets. These assets will comprise cash at the Bank of England and certain other assets which the Bank are normally prepared to convert into cash, either through open-market operations or by lending. These include Treasury bills, money at call in the discount market and gilt-edged stocks of up to one year's maturity. The ratio is designed to provide a known firm base on which the Bank of England can operate, both in market operations and by calls for Special Deposits, to neutralise excess liquidity which the banking system might acquire.

As far as our interest rate operations are concerned, we shall of course continue to use the traditional instrument of Bank rate to affect short-term rates; indeed we envisage using Bank rate more flexibly than in the past. It was, moreover, important for the working of the new system that we should reduce the extent of our intervention in the long-term gilt-edged market. For this reason we announced on 14th May that the Bank of England no longer felt obliged to provide, as in the past, outright support for the gilt-edged market in stocks having a maturity of over one year. This does not mean that we have discontinued our normal operations of selling longer-dated gilt-edged against purchases of short-dated stocks, as a technically efficient way of refinancing maturities. But it does mean that we shall not generally be prepared to buy stock outright. Thus we shall not normally be prepared to facilitate movements out of gilt-edged by the banks, even if their sales should cause the market temporarily to weaken quite sharply.

These changes could, of course, mean that some gilt-edged holders may prefer to stay shorter than hitherto; but their policies will, no doubt, be influenced by the structure of rates as well as by the extent to which private institutions are stimulated to make a better market in gilt-edged than hitherto.

The second leg of our policy is represented by our ability to call for Special Deposits. Any calls would be made from all banks uniformly: and all the deposits called would bear interest at a rate equivalent to the Treasury bill rate. The call for Special Deposits might be related only to deposits obtained from overseas, or the call might be different for overseas and resident deposits; but in either case it would be applied uniformly to all banks.

It is not expected that the mechanism of the minimum asset ratio and Special Deposits can be used to achieve some precise multiple contraction or expansion of bank assets. Rather the intention is to use our control over liquidity, which these instruments will reinforce, to influence the structure of interest rates. The resulting changes in relative rates of return will then induce shifts in the asset portfolios of both the public and the banks. Of course, we do not envisage that there can be a nicely calculated relationship between the size of calls for Special Deposits and the achievement of a desired objective. We expect rather to achieve our objectives through market mechanisms. Special Deposits can be used not only to mop up any abnormal excess liquidity, but also to oblige the banking system to seek to dispose of assets not eligible for the liquidity ratio, for example gilt-edged stocks of over one year's maturity. By using Special Deposits in this way we shall be able to exert, when appropriate, upward pressure on interest rates – not only rates in the inter-bank market but also rates in the local authority market and yields on short-term gilt-edged stock.

Of course, the extent of the pressure we shall be able to bring to bear on interest rates by our open-market policies, backed up if necessary by calls for Special Deposits, will be affected by many factors: for example, the financial position of the central government or the current sensitivity of foreign exchange flows to short-term rates in London. However, no limitation is envisaged on the authorities' ability to neutralise excess liquidity or to bring about sufficiently strong upward pressure on bank lending rates.

What we are therefore adopting is a new approach to credit control designed to permit the price mechanism to function efficiently in the allocation of credit, and to free the banks from rigidities and restraints which have for far too long inhibited them from efficiently fulfilling their intermediary role in the financial system. At the same time, it is hoped that these changes will favour innovation and competition, and in their way make some contribution to faster and sounder economic growth. These changes are consistent with the broad policy aims of the present Government of the United Kingdom. We judge the present situation of low international interest rates, relatively slack demand for loans and a strong balance of payments to be a propitious moment in which to introduce these changes; and we also believe that they are not inconsistent with the United Kingdom's application to join the E.E.C. or out of line with the general movement towards the harmonisation of credit controls which seems likely to take place on the road to monetary union.