Monetary management in the United Kingdom

The text of the Jane Hodge Memorial Lecture delivered by the Governor at the University of Wales, Institute of Science and Technology, on Monday, 7th December 1970.

Introduction

This evening I want to say something about the operation of monetary policy in Britain and its place in economic management as a whole. Since the war all governments of the United Kingdom have accepted responsibility for aiming to achieve full employment, growth, relatively stable prices and external balance. Monetary policy has an inescapable part to play in pursuit of these aims. Whatever its stance it will have implications of some sort for demand and prices and the balance of payments. However, it is only one of several levers which policy-makers may pull. Policies adopted in other fields – fiscal policy especially – will affect the contribution to be made by monetary policy and can either ease or complicate its task.

The conduct of monetary policy is never a simple matter. Our understanding of the links between the financial world on the one hand and the real world of output and spending on the other is far from perfect. There is a wide divergence of view about how effective monetary policy is in influencing spending and through what particular channels it should primarily aim to operate. A further complication lies in its potentially strong impact on international capital flows, which can undermine the achievement of its own internal objectives as well as make for difficulties in the management of our foreign exchange reserves.

However, whatever may be the possibilities or the difficulties of operating monetary policy, I want to stress one very important point – often neglected or glossed over in abstract discussion. This is that monetary policy is conducted within a particular framework of institutions and markets. This framework provides opportunities, of course, but it also creates constraints. It is an important responsibility of the central bank to foster the growth and efficiency of the financial system as a whole; and its aims in these directions may, from time to time, clash with the immediate goals of monetary policy. From this potential clash there arises a rather wider problem of monetary management.

Deposit banks

For these reasons, I want to begin my survey of monetary management by looking at the institutional structure. To do this thoroughly would, of course, mean casting my net very wide. The range of institutions and activities which can be called financial and which are in one way or another affected by monetary policy is enormous. To avoid making inordinate claims on your time I shall therefore concentrate on the central part of our financial system – and that part over which the Bank of England has most direct influence – the banking system.

It was not so many years ago that domestic banking in this country was conducted virtually entirely by the

deposit banks; that is, primarily, the London clearing banks. The asset structure of these banks is largely conditioned by the part that they have historically played in operating the money transmission service of the country; and this has meant that they have developed broadly similar asset portfolios and have come to observe similar minimum ratios for cash and liquid assets. The liquidity ratio was formalised as an aid to credit control when monetary policy entered a more active phase in 1951. In addition the rates which the clearing banks pay on deposit accounts and charge to borrowers vary fairly closely in line with Bank rate.

Cash ratio

These conventions should enable the authorities not only to regulate the cost of the banks' lending but also, in principle, to control its availability by influencing the total of their deposits and of their cash and liquid assets through open-market operations. In practice no attempt has been made to use the cash ratio for this purpose. To do so would have meant making major institutional changes in the system. It would also have been likely to produce large fluctuations in short-term interest rates with unwelcome consequences not merely for the money markets, but for many areas (such as the housing mortgage markets) of wider economic significance. These considerations have led the authorities to continue with the present system under which Treasury bills are always interchangeable with cash through the mechanism of the discount market. In this way dislocations which the uneven pattern of Exchequer spending and receipts might otherwise cause in monetary conditions are smoothed out, while the ready marketability of Treasury bills as the residual source of government finance is ensured. This arrangement, coupled with the use of Bank rate, has given the authorities control over most domestic short-term interest rates.

Liquidity ratio

Nor has the liquid assets ratio been a reliable fulcrum for regulating the expansion of the clearing banks' lending. For many years after the war this was not surprising. The limited outlets for private spending during the war and the pressing need of the Government for finance had made the banks little more than intermediaries for channelling savings into official debt. In 1945 the clearing banks' advances amounted to only 17% of their gross deposits and throughout the fifties there was no choice but direct restrictions when their lending had to be restrained. The real transformation in their balance sheets came during the boom at the end of that decade; and when the economy entered its next phase of expansion in 1963, there was some doubt whether their liquid assets base would be able to support the growth of credit that would be needed. At that time the ratio was lowered from 30% to 28%, still somewhat higher perhaps than would have been necessary on prudential grounds alone. It was then too that the clearers' conventions on interest rates again became a live issue. In the event by the mid-sixties their advances had

risen to 50% of deposits while their holdings of gilt-edged had fallen to less than 12%.

This structure has changed little since then and there is no question that at times during the last dozen years the clearing banks' credit base has been under pressure. Even so their holdings of gilt-edged have generally provided them with sufficient latitude to make short-run adjustments. Almost throughout the post-war period, until very recently, the Exchequer was adding, often on a substantial scale, to its domestic borrowing rather than reducing it; and this made it more difficult to contain the banks' lending by debt management alone.

Special Deposits

Because of the difficulty of bearing on the credit base with any precision through open-market operations alone, the possibility of introducing a variable liquidity ratio was explored in the late fifties. The outcome, in 1958, was the Special Deposit scheme, which is essentially similar to a variable liquidity ratio.

While a call for Special Deposits can affect the attitudes of the banks to new lending straight away, there is likely to be some delay before the full effect is seen on the level of advances. In the meantime, and depending on their liquidity position, the banks may sell some investments. But it is open to the authorities – and the banks understand this – to ensure that the whole adjustment by the banks is not completed by such sales of gilts. The initial call for Special Deposits can be supplemented by open-market operations, by action on interest rates or, in due course, by further calls for Special Deposits.

Other banks

So far I have been talking of the deposit banks. Only some dozen years ago the other banks in London accounted for little more than 10% of the deposits held with the banking sector as a whole. Since then – and excluding funds placed among themselves in the inter-bank market – their deposits have increased twenty times to over £17,000 million. This phenomenal expansion came after the widespread move to the convertibility of currencies at the end of 1958 and has been associated with the growth of the euro-dollar market. But, although the bulk of this business is in foreign currencies, these banks have increasingly attracted sterling deposits from British companies and expanded their sterling lending. Their resident sterling deposits, other than on inter-bank account, are now approaching £3,000 million. This represents around 20% of such deposits with the whole banking sector.

These banks are not a homogeneous group. There are the accepting houses, for example; there are head offices of British banks with extensive branch networks abroad; there is an ever-growing number of branches and subsidiaries of foreign banks; and, a most interesting development, there are the subsidiaries of the clearing banks themselves.

I sometimes feel that the clearing banks attract more than their fair share of criticism for being – it is alleged –

unadventurous and slow to react to a changing world. Yet from small beginnings the clearing banks' subsidiaries have grown rapidly to account for well over 10% of deposits with these "other" banks as a whole. If we consider sterling business only, their performance has been even more striking. In the past five years the clearing banks' subsidiaries have increased their sterling resources fivefold; and in the course of doing so they have gained over one third of all the growth in the sterling resources of these "other" banks as a group. I wonder whether those who like to characterise the clearing banks as sleeping giants are really aware of all these developments.

The heavy involvement of the "other" banks in both sterling and foreign currency deposit taking carries implications for the play betwen domestic and external interest rates and for international capital flows. Local authorities look to these banks for temporary money and the price asked will at times be strongly influenced by euro-dollar rates and by the cost of obtaining forward cover in the foreign exchange market. The relationship between rates in the conventional money market, which are effectively determined by the authorities, and rates in the relatively new parallel markets, where our influence is less direct, is one of the problems currently concerning us.

I have already referred to the common code and liquidity conventions observed by the deposit banks. In general, the growing number of "other" banks observe no such conventions: considerations of banking prudence are largely satisfied by ensuring a broad correspondence between the maturity of assets and the maturity of liabilities. The relatively new and efficient markets in local authority and interbank debt, to which I have already referred, enable these banks to adjust their balance sheets to this end very flexibly. The structure of these banks' assets varies very widely, and their liquidity ratios, calculated on almost any basis, range from the very small to the very large indeed.

This diversity of asset structure underlines the problem which has faced us in recent years of devising an effective and reasonably equitable system of credit control, based on liquidity or other asset ratios. In 1967 a scheme of Cash Deposits – analogous to Special Deposits, but designed to bear on earnings as well as liquidity – was worked out for periods of less severe restraint. But circumstances have not yet allowed us to activate this particular scheme. We have been compelled to resort to ceiling controls for relatively prolonged periods – despite their manifest disadvantages.

Lending ceilings

It may seem paradoxical that direct requests should have been used more, rather than less, intensively once the deposit banks' excess liquidity had run off and the Special Deposits scheme had been set up. The reason lies in the circumstances of the sixties, which allowed so little leeway for policy. The external situation was a constant and pressing source of anxiety. Confidence was generally weak, and domestic demand had to be held back both before and after devaluation to encourage the transfer of resources

into exports, and to limit imports. Broadly speaking, lending ceilings and guidelines have been in force since 1965. These have applied to lending on commercial bills as well as advances. The leading hire purchase finance houses have been subject to the same restrictions as the banks; and other financial institutions have been asked to bear the objectives of policy closely in mind.

The advantages of ceiling controls are clear enough. They are unequivocal, both for the banks and their customers; their coverage can be extended in equity to competing financial institutions; and they work quickly. But their drawbacks are no less obvious, notably in checking competition and innovation within the banking sector and encouraging the diversion of credit flows through other channels.

All this amounts to saying that quantitative restrictions should be used only when severe restraint is necessary. We are far from happy that we have had to use them so severely and for so long, not only because of their inherent disadvantages but also because of the strain which their prolonged use places upon the very happy co-operative – as distinct from legalistic – relationship which exists in this country between the central bank and the commercial banks. I am a great believer in our system of voluntary co-operation, in which both sides recognise their common interest in the successful development of the economy. And I believe that it is an economical and efficient system in which one side is not continually looking for loopholes in the control and the other side continually trying to plug them. For all that, the longer ceiling restrictions are in force, the greater the strain upon the system. We must all hope that an improvement in our economic conditions such as would permit us to move towards a less restrictive régime will not be too long delayed.

Changing views of monetary policy

From my remarks so far it may be seen that the operation of monetary policy in Britain has developed in a very pragmatic way. The environment conditions policy; and the environment has a habit of changing. So too does opinion about the importance of monetary policy in regulating demand and about the way in which it makes its impact. And recent discussion on these counts has been very lively indeed.

At the end of the war it was widely believed that interest rates should be kept low to finance reconstruction as well as to ease the servicing of a greatly increased national debt; and it was somewhile before it was universally accepted that a slump was not after all inevitable. A fairly comprehensive system of physical controls had been maintained to suppress inflation; and the doctrines of Keynes, at least as interpreted by his followers – it is interesting to speculate on what Keynes himself would have prescribed had he lived to see the shape of the post-war world – had led to a totally new emphasis on fiscal policy. The active drive for cheap money was succeeded by a period in which monetary policy went into limbo. There was general scepticism about its relevance.

The prolongation of controls, however, and the austere budgetary strategy of the time began to generate a reaction in which rising prices and the vulnerability of the reserves also played a part. At the end of 1951 monetary policy again entered an active phase. Having been at 2% almost constantly since 1932, Bank rate was to be varied forty times in the next nineteen years. The changed economic climate and the dismantling of physical controls made it essential to revive monetary policy, but undoubtedly too much was expected of it in the early fifties. Although it has the great advantage over fiscal policy that it can be operated and modified on a day-to-day basis, it is by no means as smooth, speedy or flexible in its effects as is often assumed. As its limitations became more apparent, the need was felt for a reappraisal; and this led to the appointment of the Radcliffe Committee.

You will recall the main lines along which that Committee reported in 1959. They saw changes in interest rates as having a limited and slow effect on capital spending but a potentially significant impact on lending by financial institutions. The money supply was only part of a wider concept of liquidity. People could realise assets, or borrow, as well as run down money balances; and their willingness to do so would be conditioned by prospective income flows. It was on the structure of interest rates therefore that policy should act, chiefly to restrict the availability of credit. In line with this thinking, bank deposits were less important than bank advances. This qualified view of monetary policy, and of the money supply in particular, was to be strongly contested. Even before the Committee was appointed, there had been academic reaction across the Atlantic to the tendency to relegate money to a minor role. In the following years, first in the United States and more recently in this country the monetarist school of thought steadily gained ground.

Monetarist controversy

It is easy to caricature the opposing theories, for some extreme positions have been taken; but it is fair to add that nowadays there are plenty of intermediate positions too. In simplified terms, those who attach only minor importance to the money supply regard financial assets as close substitutes for money, and real assets as a rather different category. On this view a change in the money stock will be associated with only a relatively slight shift in interest rates and people will be content to hold less money in relation to incomes. There will be some effects on spending – through changes in the cost of capital, in the availability of credit and in existing wealth; but the impact will not be pronounced and could more certainly be achieved by acting directly on interest rates in the first place.

On the other hand, those who attach major importance to the money supply see holdings of money as a substitute for a broader range of both financial and real assets, on which the return cannot be generalised. On this view a change in money balances will be associated with erratic movements in interest rates and will then largely be made good

by adjustments in spending, for people will be reluctant to hold less money in relation to incomes. In this case policy could exert a strong influence on demand by acting directly on the money supply.

Much work – including some in the Economic Section of the Bank – has been done to test these theories by trying to establish, through associations between the money stock and interest rates, whether or not money and financial assets are in fact close substitutes. One major difficulty is that changes in interest rates are undoubtedly coloured by expectations about the future course both of the rates themselves and of price inflation. The real, as distinct from the nominal, rates of interest that may be in people's minds when they decide to spend or invest cannot be at all closely estimated statistically.

Subject to this qualification, the evidence supports neither extreme. It suggests that changes in the amount of money may have some consequences for money incomes but that in the short run the relationship is neither strong nor predictable. Although the association between changes in money stock and money incomes is undoubtedly strong in the long run, so that movements in the money stock may be useful as an indicator of movements in income, this fact tells us nothing about causation. In particular, since the authorities have not operated in a strictly monetarist way over the past twenty years but have broadly accommodated the rising demand for money balances as incomes rose, statistical associations derived from this period cannot tell us what would happen if policies were radically different.

Official attitudes to monetary policy

Yet, though the argument has not yet been conclusive, it has already served a useful purpose in provoking a general reappraisal of attitudes. The liabilities of the banks have always been significant for policy, of course, since deposits are a key factor in the determination of advances; and it is important that this aspect should not be neglected even if lending ceilings are in force. In recent years, however, we have certainly given more attention than formerly to the growth of monetary aggregates in evaluating policy. These include not only the money supply but also what has come to be known as D.C.E., or domestic credit expansion. Movements in the money supply are influenced among other things by the balance of payments and by inflows and outflows of foreign funds. D.C.E. is some measure – in an arithmetical sense – of the internal factors associated with changes in the money stock, before these are overlaid by external influences. It is thus, in an open economy like ours, sometimes a more useful indicator than the money supply.

But, although there has been some shift of emphasis in recent years, this should be seen in perspective. I certainly accept that such aggregates as the money supply and D.C.E. can be useful indicators of monetary conditions and the impact of policy generally. In particular, it is not a simple matter in an inflationary age to judge the level of interest rates most appropriate to the thrust of policy;

and the growth of the monetary aggregates may offer some guidance in this respect. But to focus solely on the money supply or D.C.E. among the financial, let alone the economic, variables is not enough. It is essential to the understanding of monetary processes and their implications to look much more widely at the stocks of financial assets held throughout the financial sector – and indeed throughout the economy as a whole – and at the financial flows between all the major sectors. We have been concentrating much effort on this in the Bank and shall continue to do so.

Gilt-edged market

In short, while we are keeping a close watch on developments in the monetary aggregates, we are looking at them as guidelines for overall policy rather than as targets. I doubt whether it would be possible to force through a predetermined volume of sales even at the cost of marked instability in interest rates; but even if it were possible, to attempt it would in many circumstances be both damaging and purposeless. For expectations play a large and unpredictable role in investors' decisions. Even when the Government is running a large revenue surplus, as at present, maturities of nearly £2,000 million a year require careful handling if adequate refinance is to be forthcoming. By the same token it would be mistaken to put much weight on short-term deviations in the path of the money supply or D.C.E., which can reflect not only these factors but also bunching in bank lending as well as purely random influences.

There has been much argument about our tactics in the gilt-edged market. There is no need, I think, to go over all the ground here. I suspect, however, that people do not always make a clear distinction between our tactics and our ends. Apart from the needs of government finance, our main end is to achieve the degree of monetary restraint judged to be appropriate to the economic situation and the overall direction of policy. Any particular degree of restraint in any particular circumstances will involve a certain level and pattern of interest rates which will have to be accepted. The burden of high interest rates on the Exchequer and balance of payments, though always a consideration, is not a foremost one. Rising nominal rates can often be illusory when seen in real terms; and to hold rates artificially low can only create a consistently weak market and lead to steady monetisation of the debt. It is this last consideration which has perhaps become more important in our minds recently as inflation has accelerated. Consequently unprecedentedly high nominal rates have seemed appropriate and our tactics in market management have become more flexible so that the market has been allowed to make sharper adjustments than in the past.

While we at the Bank naturally do not mind constructive and well-informed criticism of our market tactics – indeed we welcome it if it can help us towards improving the way we do our job – there is, I think, a real danger in much of the argument and criticism that is actually deployed. Many people apparently believe, or appear to believe, that a purely tactical change in the relatively arcane sphere

of operations in the gilt-edged market can magically and painlessly do wonders for the real economy. It cannot be emphasised too strongly or too often that attacking a severe inflation simply by holding down the growth of the money supply means reducing real activity: or in more homely terms a lot of bankruptcies and unemployment. Thus the proper questions for discussion in a situation such as the present are first how much reduction in real activity is appropriate; and secondly how much weight should be placed on monetary policy in achieving it?

But in general it should be recognised that excessive reliance on monetary policy is bound to place severe strains on financial markets and the financial position of companies and may have serious effects on the nation's productive investment and housebuilding. At the same time it will have implications for external capital flows; and this raises doubt about how far monetary policy can in any case be pushed in an open economy without frustrating, at least in part, the authorities' objectives both domestically and externally.

External aspects

Sterling, like all currencies which are used internationally, is sensitive to capital flows, whether arising out of changes in yield differentials or from speculation on exchange rate adjustments. Exchange controls have limited the movement of resident funds; but leads and lags, transfers over intra-company accounts and switching by the banks in London are all important potential channels for capital movements. Meanwhile the growth of the euro-dollar market has seen a vast increase over recent years in the volume and mobility of international funds.

It is true that movements of interest sensitive funds will tend to slow down once investors have adjusted their portfolios and, in the case of covered transactions, as the forward rate reacts; but an attempt to offset them by further monetary action can renew the process. In Britain there has on the whole been little conflict of this kind since the war. During the sixties, for instance, when economic conditions generally pointed to the maintenance of high interest rates, arbitrage movements were often submerged by speculative flows which in themselves worked to tighten liquidity. But the dilemma has not been uncommon abroad; and it is one with which in future we may have to reckon ourselves now that the balance of payments is on a sounder basis.

Speculative flows present a special problem. There are a variety of techniques that can be used in an attempt to discourage arbitrage flows. These include attempting to change the relationship between short and long-term interest rates; intervention in the forward market; and the kind of specific measures applied by Germany and Switzerland in the face of speculative movements during the sixties. In practice, however, it is not simple to sustain an artificial relationship between short and long rates. Nor is it necessarily a straightforward matter to identify the nature of capital flows and to determine whether they would be susceptible to intervention in the forward market. Yet, once committed, it is impossible to withdraw from the market

without intensifying speculation if the judgment should prove wrong.

As banks and corporations become more internationally-minded and sophisticated in their financial operations, the difficulties of conducting monetary policy in an open economy are not going to diminish. Recent years have underlined the pervasive influence, largely transmitted through the euro-dollar market, that credit conditions in the United States can have elsewhere in the world. For all these reasons we shall have to think hard over the next few years about the effects of our monetary policies on the rest of the world and the limitations imposed on us by the monetary policies of other important countries. It will be important to develop further the international co-operation and inter-dependence which has already been taken further than many would have thought possible a generation ago.

Forward view

I have tried to give a broad survey of the problems and possibilities of monetary management in Britain in the changing environment of the past twenty-five years. Before concluding, I should like to take a brief look forward.

The most pressing economic problem, not only for this country but in virtually all the major industrialised nations in the years ahead, is likely to be that of cost inflation. Much thought and discussion about this problem will be necessary, not merely among policy-makers, but among all the elements and individuals of our societies. Whatever role is assigned to monetary policy, there will doubtless be need to evolve our techniques and our thinking as we have done in the past. One obvious example of the necessity to adjust which has already made itself felt is the importance of distinguishing between nominal and real rates of interest.

Whatever our success in coping with inflation, the familiar problems of demand management will obviously continue with us. Here, to the extent that the financial position of the public sector remains under firm control and the balance of payments remains in surplus (and in my belief these two areas are very closely related), the strains on monetary policy and the institutional framework in which it operates could be significantly eased.

If this should prove to be the case, we may be able to make more progress with an aspect of monetary management to which I referred at the beginning of my talk, fostering the growth of an efficient and competitive financial system. As I have emphasised, our aims in this direction have in recent years been frequently in conflict with the need to maintain strict control over bank lending. It is true that, despite the heavy and unwelcome quantitative controls which we have imposed, the banking world has certainly not ceased to evolve. I have referred to the rapid growth of the subsidiaries of the clearing banks and of many other forms of British and foreign banks; and to the growth and development of new markets both in sterling and foreign currency. Individual banks have extended the range of their services in many ways and, by merging among themselves and forming international ties, have been

able to match the financial needs of ever-growing industrial groupings and multi-national concerns.

I have no doubt that the banks will want to innovate further and in all sorts of ways. The clearers are experimenting rather more with term loans, for example, which afford them closer control over their advances. They recently increased the margin between their lending rates and Bank rate; and it may be that they will want to widen it further, or change their practices on interest rates completely. Developments of these kinds could lead to some breaking down of the line between the deposit banks and that other very heterogeneous group which, for want of a better term, we call simply the "other" banks. In these circumstances credit allocation could come to be determined more by price than by physical rationing throughout the banking sector.

The way in which the banking system evolves will be conditioned by credit control, and is bound to have implications for credit control. Some developments could make life easier, others could complicate it. In principle it is important that control should not be imposed and stifle innovation; but rather should allow innovation to take place and then adapt to it. We may hope that in the fullness of time a greater use of such mechanisms as Special and Cash Deposits, buttressed perhaps by the acceptance of greater variability of short-term interest rates, could lead to a more flexible framework for monetary management.