Bank lending, monetary control and funding policy

Note of a paper for the Bank's Panel of Academic Consultants.

The Bank's Panel of Academic Consultants met on 9 July, and had as its theme for discussion: 'Bank lending, monetary control and funding policy'. The main paper for that meeting was prepared by Professor A D Bain, and has been issued in a slightly revised form as Panel paper No 19. Copies are now available from the Bank at the address given on the reverse of the contents page in this *Bulletin.*

The theme was prompted by recent monetary developments. Pressure for growth of the broad monetary aggregates in the last eighteen months or so has come from the growth of bank lending to the private sector, and the authorities' policy of 'overfunding' has been conducted against this background. In the June *Bulletin,*[1] these questions were considered in some detail and the policy of overfunding was shown as a continuation of what funding policy has always been aimed at. The measures announced on 25 June by the Chancellor (see page 353) were intended to facilitate the present stance of funding policy.

Professor Bain's analysis of the underlying situation which has led to the policy of overfunding argues, as his title implies, that there is a structural imbalance in the UK financial markets. The imbalance is seen in terms of a surplus of long-term funds and a corresponding deficiency of short and medium-term finance; and is regarded as structural because changes in relative interest rates would do little to resolve it, or would need to be very large—given the strength of portfolio preferences in the private sector—to affect significantly the behaviour of savers and investors. The paper therefore considers the merits and demerits of policies aimed at redirecting funds without substantial relative price adjustments.

Two possible responses are first rejected. The structural imbalance might be met by a combination of the banks obtaining overseas deposits and the financial institutions acquiring long-term foreign assets. Professor Bain argues that this course could create undesirable future risks both for the exchange rate and for the domestic financial system. To some extent this sort of development has recently taken place. He similarly rejects a relaxation of monetary targets as a solution on the grounds that faster monetary growth might lead to more inflation in the long run and that anticipations of it would negate the downward pressure of faster monetary growth on nominal interest rates in the short run.

Professor Bain goes on to consider three categories of policy response. The first would aim to affect the choices open to savers and investors and would call for a '... more even-handed tax treatment of different forms of saving'. This might be achieved, for example, by favourable tax treatment of medium-term deposits or by full inflation adjustment of company and personal tax systems. He sees little merit in a subsidy to firms issuing new long-dated fixed-interest loans designed to compensate them for the inflation risk they incurred. The second would be directed towards influencing the portfolio behaviour of institutions so that they might find it attractive to hold some medium-term assets rather than long-term assets as at present. One possibility, for example, would be for institutions to refinance a block of bank loans directly. The third category would involve the intervention of the authorities to compensate for the structural imbalance. Thus, the authorities could continue their recent policy of 'overfunding' which involves '... biassing the government's own borrowing operations towards the long end of the market' coupled with the refinancing of bank lending. Variations on this theme are suggested. One conclusion of Professor Bain's paper is that the '... need for public sector refinancing of bank lending is likely to continue'.

(1) Pages 179-82.