

# **Competition and Credit Control**

**By**

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# Competition and Credit Control

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## I. Introduction

The Bank of England's 'consultative document' on *Competition and Credit Control* was published on May 14<sup>th</sup>, 1971. It was a landmark occasion, representing a decisive break with the prior system of maintaining direct controls over the, main components of the, UK banking system; the intention was now to achieve the monetary authorities' objectives of policy via the operation of market mechanisms, notably adjustments in interest rates and open market operations. Although the 'credit control' aspect was, over the next few years, notably less successful than the encouragement of competition amongst the banks, (where the London Clearing Banks previously had maintained a restrictive cartel with the support of the authorities), nevertheless the direction of travel towards a more liberal, market based system, remained, despite a partial reversion towards a partial direct control system in the guise of the 'corset', introduced at the end of 1973, and finally laid to rest in June 1980.

What brought me back to this subject was the death of my friend – earlier in our lives we were colleagues at the Bank – Sir Andrew Crockett. After working with me in the Economic Intelligence Department in the Bank until mid-1970s, Andrew then went to the Chief Cashier's Department. There the work on C&CC was sparked into top gear by a remarkable, though quite typical, and impassioned paper by John Fforde, written on Christmas Eve 1970. Forrest Capie describes this as "undoubtedly the most important document he had written since joining the Bank in 1957 and arguably in his entire career", Capie (2010), p. 488. [This paper is reproduced in Appendix A.]

For a variety of reasons, notably problems at Rolls Royce, neither Fforde, nor the Chief Cashier, John Page, could then, i.e. early in 1971, spare the time to take on the exercise of, first, drafting a note to be taken with the Treasury, and, second, revising that internal note into a public consultative document. So it fell to Andrew Crockett to do the drafting, which he did superbly. As a slight digression, the exercise was undertaken under the title, 'A New Approach to Credit Control and the Banking System' from the outset after Fforde's injection of energy into the exercise until mid-March (19.3.71 – Bank of England file 3A8/12); the first paper in the files entitled 'Competition and Credit

Control' appears on 22.3.71 (file 3A8/12). What discussion led up to the change, to a much better and more concise title, is now probably lost in the sands of time.

Anyhow, in order to prepare myself for a speech about Andrew's earlier work, given both at the Bank and again at the BIS (2013), I needed to refresh my memory at the various files. All the senior officials, who oversaw C&CC, except Kit McMahon, are now dead, and the junior officials, such as Crockett, Tony Coleby, Lionel Price, Bill White and me, are scattered, and mostly retired. When I mentioned this to Paul Tucker, then Deputy Governor of the Bank of England, he encouraged me to write up my own memories of the event.

Fortunately, since memories are inherently fallible, a more complete, comprehensive and thorough record of the birth and travails of C&CC is now available in Forrest Capie's history of *The Bank of England: 1950s to 1979*. C&CC was one of the key, crucial episodes of these years, and so, as is befitting, Capie devoted an entire Chapter, Chapter 10, pp 483-523, to it. It is an excellent account, and involved access to, and assessment of, files and aspects of C&CC that I was not privy to at the time and have had neither the time nor the inclination to pursue now. These include the detailed discussions on the revised operations in the gilts markets, (Capie, op cit, 492-9), and negotiations with the various groups of banks (ibid, 502-7). So, if an overall view of CCC is required, turn to Capie.

But as a participant in the exercise, inevitably I have a somewhat different, and personal viewpoint; similarly I shall place a different emphasis on some of the various features of the exercise. Precisely because Capie has given such an excellent, and balanced, overview of the whole exercise, it gives me more room to expand on those aspects where I feel that Forrest's account is somewhat incomplete.

I shall start with the role of Loan (overdraft) Facilities in playing a leading role in generating problems for a system of direct credit controls, Section II. Then I shall discuss the pervasive intellectual error of placing too much weight on the efficacy of ratio controls, Section III. This will be followed with a description of what warnings were given within the Bank, and by the Bank to HMT, about the difficulties of monetary control, with comments about the possible utilisation of direct constraints on bank deposit rates, Section IV. After C&CC was introduced, I persuaded the Bank to give me a year's sabbatical leave, so I missed much of the period 1972/73, while writing, *Money, Information and Uncertainty* (1975). I returned to the Bank in autumn 1973, just in time to help bring that exercise in 'Credit Control' to a temporary end. I describe my role in devising the 'Corset' at end 1973 in Section V. Section VI concludes.

## II. Loan Facilities and Direct Controls

On page 484, Capie (ibid) notes that there was dissatisfaction with “controls on lending (ceilings and quantitative controls in particular”. This is a considerable understatement. There were many reasons for such unhappiness, e.g. freezing the structure of the banking system, disintermediation into less efficient channels; many of these are repeated in Fforde’s Christmas Eve paper, Appendix A.

But a particularly acute concern was the incoherence of combining a system of providing (legally binding) loan facilities with a system of direct controls over, actually drawn, overdrafts and advances. The ability of a potential borrower to agree with a bank a facility which the borrower can then use at their discretion provides such borrowers with extremely valuable flexibility and added liquidity. It is one of the glories of an efficient modern banking system. But it means that, at any given moment, it is the borrowers, not the bank, which determine the growth in bank lending. Hence, so long as much, most, borrowing is done against previously arranged facilities, a bank cannot (legally) position itself so as to be certain of staying within a prescribed quantitative limit. The banks would have to make an informed guess about the future usage of undrawn, but available, facilities. Moreover, as macro-economic conditions worsened, and tougher credit conditions, possibly tighter controls, loomed larger, borrowers would bring forward their take-up of such facilities, to avoid having them subsequently withdrawn. There was, therefore, something of an adverse dynamic; the greater the pressure on the banks, the greater would be the incentive to crystallise and draw the available undrawn facilities. John Fforde on several occasions noted, “the occasional incompatibility of the overdraft system with the attainment of precise numerical targets set by authority”, (JSFF to JQH, 28/10/69, on ‘Credit Controls’, 3A8/5).

This problem had not gone unnoticed by the Treasury; thus an internal Treasury note (Lovell to Hancock, 10/9/69, on ‘The Use of the Bank of England Act’, 3A8/5) raised the question, “whether a directive might be used to relieve the banks of legal obligations to fulfil a commitment, previously given, to provide overdraft facilities”. But the note continued by noting that the various legal authorities, e.g. the Treasury Solicitor, had taken “the view that the relief of banks from their contractual obligations is impractical”.

Nevertheless the potential claim on a bank, and the associated monetary expansion, is generated when the facility is granted, (with usage at the borrower’s discretion). So, if you want to control bank lending, you really need to go back one step, towards getting a grip on the initial stage of providing facilities. But the authorities, the Bank and HMT, had no idea of what the volume of such facilities might be. Not surprisingly, this appreciation led HMT to press the Bank to collect data on undrawn facilities from the clearing banks. The Bank approached the Chairmen of the London Clearing Banks to ask what data might be made available. In his note, John Fforde (JSFF to The Governor, on ‘Clearing Banks: Information about Changes in Facilities, 16/12/1969, 3A8/5), notes that, “In response to the Treasury’s request, we again raised the matter orally with the C.E.O.s.

Their response was again discouraging. Besides telling us that the statistics would be valueless as 'lead indicators', the CEOs were extremely suspicious that statistics of facilities would in practice lead almost at once to direct official control over the total of facilities." In this, they were, of course, right. Nevertheless, so long as monetary management was *not* going to be undertaken by direct credit controls, Fforde believed in the "intellectual case for information about facilities"; but the clearing banks, fearful of the (indefinite) continuation of direct credit controls remained obdurate and obstructive.

On a personal note, I sympathised with the position taken by the banks. In a note to Fforde (CAEG to JSFF, 'A new deal for the banks', 20/10/69, 3A8/5), I wrote, p. 10, that, "Unfortunately a commitment is such an intangible, nebulous concept that the possibilities for the evasion/avoidance of a control related to commitments would be excessive." And earlier in this same paper, I noted that, one alternative would be,

"To alter the present nature of the banks' lending business, by making access to bank credit conditional rather than unconditional. There are various modifications that could be applied to achieve this result. All of them, if effective, would prevent company treasurers being sure of their access to funds when in difficulty. They would inevitably react by amassing larger holdings of owned liquid assets, including bank deposits. Apart from transitional difficulties, it is hard to see why this result should be to the long run advantage of any group in the economy, companies, banks, or the authorities."

### III. Ratio Controls: An Intellectual Error?

This note of mine was one of three papers written at this time to consider alternative methods, alternative to direct ceilings on bank lending, for control over credit and the monetary aggregates in the autumn of 1969. The first was by Tony Coleby (ALC to JSFF, 'A New Deal for the Banks', 30/9/1969, 3A85); the second mine (op. cit), and the third by Bill White (WRW to JSFF, 'Methods of Credit Control', 11/11/1969, 3A85). These were mentioned by Capie (ibid, p. 484). We were all young then, and Bill and I were relatively new at the Bank, but the senior officials, especially Fforde, were prepared to give us an opportunity to develop our analysis and to treat it seriously. As Capie notes, (p. 484), Fforde wanted to keep focussed on the longer range objectives and mechanisms of monetary management.

It is, perhaps, worth trying to recall the state of analysis on the determination of the supply of money at that juncture. Although monetary control was then actually achieved by direct controls, ceilings, on bank expansion, academic analysis had centred on the money multiplier, relating the high-powered monetary base, via the banks' reserve/deposit ratio (their cash ratio), (and the public's currency/deposit ratio), to the broader monetary aggregates. However, Prof. Richard Sayer had noted, partly by direct observation of money market operations, that, so long as the Central

Bank wants to maintain some target level of short term interest rates, it has got to relieve any pressures on banks' desired cash ratios, up (or down), by withdrawing excess (injecting additional) cash. Otherwise short-term money market rates would diverge sharply from the desired official level of rates. So if the level of short-term interest rates is policy determined, then both the high-powered monetary base (H) and the broader monetary aggregates (M) become endogenous variables. Sayers, who also served on the Radcliffe Committee, was the dominant British monetary academic at this time, and his book *Modern Banking*, in all its various editions, was the standard textbook.

Sayers never followed through to the above logical conclusion. Instead, he shifted the 'fulcrum' of the multiplier from the cash ratio to the wider liquid asset ratio, a ratio which the banks were then meant to maintain. The idea was that the authorities could squeeze the banks of liquid (primarily public sector) assets, by a combination of fiscal tightness and gilt sales to the non-bank private sector. Of course, that depended on being able to manage gilt-edged sales to the (non-bank) private sector to that end, and that issue, the management of the gilt market, was a perennial sore subject throughout these years.

But, besides the question of gilt-edged market operations, there were two other major problems with control via a liquid asset ratio. The first was that not all liquid assets were from the public sector, notably commercial bills. The banking system, if it so wanted, could manufacture liquid assets by switching relative interest rates, in order to make it more attractive for the private sector to borrow on the basis of commercial bills rather than advances. The second, and more important, was that, if starved of liquidity, the banks could try to get hold of more by bidding for it, i.e. by raising the rate offered (wholesale) deposits. But in the years up till 1969 they had not done so, because a combination of lending ceilings and the 'cartel' had meant that they had no cause to do so. But now the Bank was advocating a simultaneous abolition both of ceilings *and* of the cartel. Against that background ratio controls were unlikely to be effective. What would matter for control purposes would be the flexibility of the general level of interest rates, and, just as important, the relative pattern of interest rates. But these latter relativities had been fixed, by the cartel, for decades, so there was no experience of how shifts in relativities might influence monetary developments. There was some discussion of a possible need to retain a constraint on banks' bidding for funds (a version of Reg Q as operated by the Fed in the USA), but this focussed more on personal sector deposits, in order to protect Building Societies and National Savings, rather than as a means of monetary control.

One possible way of overcoming the first problem, that banks could manufacture private sector liquid assets, would be to require banks to maintain a public (or its inverse a private) sector lending ratio, PSLR. A problem with this, however, is that it would seem (and would be) a repressive method of requiring banks to finance the government, at artificially low yields.

Nevertheless the intellectual context of the time meant that far too much emphasis was placed on the potential efficacy of various forms of ratio controls, and of the ability to make these bite at any time by calls for special deposits. By the same token far too little emphasis was placed on the need for flexible interest rates, and on the potential distortions arising from shifts in relative rates, though it would have been difficult to have done so then, considering the lack of prior experience of shifting relativities, o.a. the cartel.

The application of ratio controls did have some differential effects, as contrasted with pure changes in interest rates. By forcing the banks to hold more low-yielding assets, such ratio controls served as a variable tax on banks. Calls for special deposits could make the upwards pressures on interest rates appear to emanate from the banks, rather than from a policy decision. But basically it was just another mechanism for changing interest rates, working through a slightly varied pattern of relative interest rates. If the politicians would not accept, or allow, flexible interest rates directly, it was not clear why they should accept such flexibility when triggered by pressures on a certain ratio, whether a cash, liquid assets or other ratio.

This was not sufficiently understood at the time. In some cases, this was because many still believed in 'multipliers', somehow divorced from interest rates; that calls for Special Deposits would squeeze banks into constraint without much need for an associated adjustment in interest rates. I would guess that John Page was in this group. Others, almost certainly John Fford, were so keen to dismantle ceiling controls that they were prepared to take risks on the need for interest rate flexibility.

But that is, perhaps, running ahead of the story. Let us now revert to the three 1969 background papers on 'A New Deal for the Banks'. First Tony Coleby (20/10/69). Interestingly he starts, p. 2, by noting that "Our efforts to discover the thinking of the Clearing Banks on how their operations might be modified post Cartel have so far been a complete failure. So one is obliged at this stage simply to speculate on the likely outcome." He argues, p. 7, "The [pure] interest rate solution is a long way from being practical politics, even if it were desirable. So we must conclude, whether we like it or not, that there is a continuing need for a credit control system;..." He recognizes, however, p. 8, that once banks can bid freely for deposits, ratio controls become much harder to enforce. Nevertheless he proposes, as the best available option, a broad-based Private Sector Lending Ratio (PSLR), p. 9, reinforced by calls for Special Deposits *and* constraints on banks capacity to bid for funds, pp 10/11. The remainder of the note focusses mainly on the relationship between money market rates, bank overdraft rates, Local Authority financing and Bank Rate.

In my own note (20/10/69) I focussed on the need to maintain a control on the maximum interest rate that banks could bid for funds, though the maximum could vary with the maturity, form and scale of the funding. Without ceiling controls, the "authorities' chief method of controlling the money supply, at least in principle, is to vary interest rates on their own debt in such a manner as to

cause the public to switch between bank deposits and public sector debt to the desired extent (open market operations). This process is reinforced by, *but does not primarily depend upon*, setting and requiring the observance of ratios of certain kinds of public sector debt to be held by banks.” But, in order to prevent a competitive spiral of interest rates, especially if the political stomach is weak, the ability to constrain banks from bidding for funds would be essential.

Bill White’s note (11/11/69) distinguishes between two ways of restricting credit; the first is by reducing the volume of their (retail) deposits, (n.b. bank reliance on wholesale deposits was only just beginning then), and the second is by requiring banks to shift their portfolio, for a given level of deposit liabilities, more towards public sector assets. The first method primarily involves limiting their ability to compete for funds, while the second would involve some (variable) lending ratio.

In so far as there was a common theme to these papers, it was that the joint abolition of ceiling controls and the cartel needed to have as a counter-weight a continuing power to constrain banks from bidding for funds. Otherwise an interest rate spiral could ensue, which would place political *sang froid*, let alone the real economy, under intense pressure. Meanwhile, a broadly based PSLR could be a useful, but secondary and supporting, mechanism.

#### IV. Prior Warnings about Problems of Credit Control?

The desire to get rid of direct quantitative credit ceilings, widely seen as distortionary and partially ineffective, was widely shared, not only by the banks and the Bank, but also in the Treasury and amongst politicians of all the main parties. The question was what alternative measures could be found to manage and control credit expansion and the monetary aggregates. Thus in October 1969, the Chancellor, Roy Jenkins, agreed with the Bank’s Governor, L.K. O’Brien, that,

“The Treasury and the Bank, jointly, should study intensively and quickly the various alternative methods of compelling the banks to restrict credit to whatever degree the authorities may from time to time require. The Chancellor wishes preliminary results of this study to be completed within two weeks; so that the monetary authorities may subsequently be in a position to introduce an alternative to the present ceiling controls,... Accordingly, a Treasury/Bank working Party has been set up under the Chairmanship of Sir Douglas Allen.”

But as the three Bank papers, described in the previous Section, had noted, it was not easy to find a half-way house between direct credit controls and pure reliance on flexible interest rates and open market mechanisms. The latter was *terra incognita*, since although there had been a few, short periods when such controls had been relaxed, or even lifted, everyone knew, over the years from 1939 onwards, that, should there be a need to tighten monetary policy, the authorities would swiftly



revert to the reimposition of such ceiling controls. The Treasury was scared of abandoning its 'security blanket', and doubtful whether any of the supporting measures, such as variable cash, or special deposits, interacting with one, or another, ratio would do much to provide a satisfactory alternative method of credit control.

Nor, at this stage, did the Bank press for an immediate end to ceilings, and the cartel. So there was no immediate alternative strategy available to put before the Chancellor (Roy Jenkins). Instead of meeting the proposed two week deadline for coming forward with an alternative policy, the Douglas Allen Working Party became transformed into a quasi-academic study group on methods of monetary control, going through (slightly revised versions) of the Bank's earlier internal papers; it met on numerous occasions, but got not much further forward. Nevertheless a read of the papers/Minutes, etc., of this Group's deliberations in 1970, (which I have not had time to do), would provide a good account of how the authorities, at this juncture, analysed the determinants, and potential methods of control, of the money supply.

One interesting, but hypothetical, question is whether a Labour Government, if re-elected in June 1970, would have been as willing to introduce a reform along the lines of Competition and Credit Control, as were the Conservatives. As already noted, Jenkins was unhappy with the continued reliance on direct controls, and the Douglas Allen Working Party was set up under his direction. My (fallible) recollection is that the change in Government brought no noticeable alteration to the tone or direction of discussion, or to the membership of that Working Party. Moreover, so long as the outlook for the real economy appeared much the same, a Labour Government might have been more relaxed about credit and monetary expansion than a Conservative Government, some of whose members were by then beginning to follow the Monetarist analysis put forward by Milton Friedman. My personal impression is that C&CC was a relatively bipartisan measure, (and that the bulk of the criticism of the subsequent explosion of bank lending and broad money came from the Right, not the Left, of the political spectrum).

Nevertheless the arrival of the new Government was one of the factors leading Fforde to press ahead with the Bank's more radical approach, that of getting rid of ceilings and the cartel, without having any alternative 'fool-proof' control mechanism. Thus in his key paper (Appendix A) Fforde notes that the Treasury probably

"are sceptical of obtaining the greater freedom of interest-rate policy which our ideas seem to demand, while anxious lest their Ministers none the less find politically attractive the greater competitive freedom which our ideas entail.... But our responsibility for ensuring, or failing to ensure, the proper evolution of the banking industry is more direct than that of H.M. Treasury. It is our job to make the running in this field and actively to seek the required overriding political decision that will govern the future shape of monetary controls. With six years of ceilings behind us, and a new Government in office, this is a responsibility that we cannot put to one side."

Later in this paper, p. 5, Fforde accepts that interest-rate and gilt-edged management could (would) not be used flexibly enough to achieve sufficient control. But when he comes to such controls (Section III), he focusses mainly on the difficulties of applying common ratios, and other conditions, both to the clearing banks, *and* to the heterogeneous group of other 'outside' banks. Nevertheless he did advocate the maintenance of restrictions on banks bidding for small deposits (to protect National Savings, etc.), and for short-term large deposits, (see proposal (ii), p. 7).

Fforde's impassioned *démarche* met no serious opposition, (of which I am aware or in the files that I have seen), in the Bank. With Fforde and Page having to turn to more immediate matters, Andrew Crockett was then put to work to transform JSFF's (and J.B. Page's) ideas into an internal document to be sent to HMT advocating the abolition of both ceiling controls and the cartel. A first draft of this was prepared by ADC in January 1971, entitled 'A New Approach to Credit Control and the Banking System', (January 22, 1971, 3A8/10). This continued to propose restrictions on banks' bidding for small value accounts (paragraph 15) and for short dated large deposits (paragraph 16), but mostly concentrated on how an appropriate ratio could be chosen and made applicable to the banking system as a whole.

Turning to the control of bank credit, Andrew notes (paragraph 43) that

"The weapons available to the monetary authorities under the proposed new scheme would be-

- a) Variation of the proposed ratios through the calling of special deposits,
- b) More flexible use of Bank Rate, and of money market operations to influence short-term interest rates,
- c) More flexible policy in the gilt market to influence longer-term interest rates."

But the power with which any of these could be applied was limited. As earlier noted, so long as the authorities wanted to fix some policy-determined level of interest rates, then ratio control, even when varied by calls for Special Deposits, was a weak reed. Interest rate flexibility was subject to political override, and the then structure of the gilt market, largely based on a couple of weakly capitalised jobbers, was sufficiently fragile that the authorities could never be sure of making positive net sales of gilts, let alone a pre-arranged net volume of sales, in any quarter.

So what exercises were done in the Bank to assess what might happen to bank lending, once C&CC was adopted? This largely fell to me, and there are a series of paper on this subject written in February 1971 (3A8/11). Two main lines of analysis were followed, first a forecast using what UK data were available, and second a study by Bill White of what had happened in Canada previously

under roughly similar conditions, in 'Developments in Canadian Banking since the 1967 (May 1) Amendment to the Banking Act', (24.2.71) (3A8/11).

My assessment was that

- a) "a very considerable jump in such [personal] sector lending would, indeed, be likely",  
and
- b) "we cannot expect to control at all closely the monetary aggregates in any one quarter by varying interest rates, without necessitating really violent interest rate variations. But if we are prepared to aim for control over the medium term, we should be able to achieve this by and large reasonably well by bringing about interest rate changes that are fairly large in comparison with past behaviour, but are not out of the question."

From this work I drew two inferences.

"The first and the more clear cut, is that such structural changes make the case for concentrating on M1, both for our own purposes and for public presentation, as the most important monetary aggregate very powerful. If we continue to use M3, ..., we should be misled after the structural change by substitution effects of possibly large and very uncertain amounts, which have little or no implications for the economy as a whole...

The objections to such a shift are that:-

- 1) M3 is currently hallowed as the 'official index'.
- 2) DCE can be directly related to M3 but not to M1.
- 3) We do not yet have adequate monthly figures for M1....

The second conclusion that I would draw is that we need to consider retaining the powers to retain interest rate ceilings [on banks' bidding for funds], in case interest rate competition becomes disorderly."

These drafts were preparatory work for a Bank paper to be sent to HMT, under cover of a letter from C.W. McMahon, on 'A New Approach to Credit Control: Some Quantitative Implications'. In this latter paper, the suggestion about putting greater weight on M1 survived, but in considerably muted form (p. 4)<sup>1</sup>; the warning about the short-term interest inelasticity of both bank lending, and M3,

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<sup>1</sup> No such shift to greater emphasis on M1 occurred. Unlike M3, the time path of M1 in the next few years remained close to expectations based on prior econometric work on its relationship to incomes, interest rates, etc.

and hence the difficulty of controlling by this route was, with the eye of the initiated, implicit, but never made explicit; and no mention at all was made of a back-stop need for controls over interest rate bidding by banks to prevent a disorderly competition for funds.

Instead the gist of the paper lies in the (correct) statement that, in our Demand for Money exercises (BEQB 1970), Crocket and I found no statistically significant effects of the imposition of ceilings on M3. If there was no effect on M3 of putting on ceilings, why should there be an effect in removing them? The effect, it was suggested, would be more on the asset composition of bank portfolios, than on the overall aggregate. [N.B. This might have been the case had the cartel not been abolished simultaneously with ceiling controls.]

There was nothing in the paper sent to HMT that was not, on its own terms, accurate and believed to be true. Even so, it was drafted so as to allay HMT fears about the potential weakness of the credit control mechanism. It also held back the internal concerns that a few of us felt in the Bank.

Be that as it may, C&CC was then officially adopted as Government policy, and a series of negotiations with the relevant private sector institutions begun. The public paper, unveiling C&CC to the wider world was published on May 14, 1971.

## V. The Debacle and After

As is well known, the Conservative Government embarked on 'a dash for growth' in 1972/73. Under these conditions output, the money stock and inflation would in any case have risen quite sharply. But in this particular case, bank lending and broad money (M3) rose far faster than would have been expected, on the basis of previous (econometric) experience. When this was subsequently followed, in 1973-75, by an upsurge in inflation, to a peak of over 25%, much of the blame was placed, by more monetarist commentators and politicians, on the prior failure of the credit control element within C&CC. How much of this surge in inflation was due to monetary stimulus (including low 'real' interest rates), and how much to a combination of rising input prices (especially the first oil shock in 1973) interacting with the (unnecessary and disastrous) policy of wage indexation, is too large a subject to be addressed here.

Instead the focus here is to ask what caused this surge in bank lending, and why it came as such an (unwelcome) surprise, to the monetary authorities in general and to me in particular. As reported in the study on 'Monetary Developments in the first six banking months of 1973/74', by Mr. Walsh, appended to an HMT note from G. Downey to D. Wass (19/10/1973) (Bank file 6A.50/12), M3 rose by 3700 in this half-year, an annualised rate of increase of almost 30%.

“The main factor giving rise to the increase in M3 was the increase of bank lending to the private and overseas sectors: 2,920.... The main features that emerge from the comparison [of actuals with the prior forecast] are that M3 rose by 1000 more than forecast mainly because of a 890 underestimate of the increase in bank lending to the private and overseas sectors. Perhaps a third of this difference is explained by the resumption of merry-go-round [explained below] operations in July/August: the forecasts had not allowed for this. The underlying growth of credit, however, seems to have been considerably stronger than expected.”

Why had this happened? Prior to C&CC, both bank lending and deposit rates offered by the clearing banks were kept pegged by the Cartel. Consequently the spread, between lending and deposit rates, had been constant over the whole data period. In the various studies of demand for bank lending and for the monetary aggregates, M1 and M3, interest rates had been included, often, e.g. in the bank lending equations mentioned earlier, with negligible econometric significance, but the spread, having been constant, was not.

One of the insights of monetarism is that there is likely to be a fairly stable relationship between agents' access to funds that can be used for payment and their total expenditures. However the question of what funds can be used for payment depends on financial structure. In an overdraft system, as in the UK, unused loan facilities are as much a source of funds available for making payments, as are bank deposits. Most UK companies, certainly all big ones, will simultaneously have unused loan facilities alongside deposits. When an agent has a choice whether to pay a bill by drawing on its unused facilities or by running down its deposits, that choice is determined by the spread between lending and deposit rates. Widen the spread, as now, and there is an incentive to pay bills out of deposits, (not by increasing loans), so both bank lending and monetary growth are (somewhat artificially) reduced. Narrow such spreads and the reverse occurs. When spreads become negative, as happened from time to time in 1972/73, there is even an incentive to borrow just to swell interest-bearing deposit accounts. This latter was termed the 'merry-go-round', also known as 'round-tripping', reported above, (n.b. the merry-go-round can involve borrowing from a bank different from that in which the deposit is made).

What we had not foreseen, when introducing C&CC, was that, in the pursuit of expansion and a competitive increase in each of their market shares, the clearing banks would narrow their spreads, i.e. bid up for deposit funds, while keeping lending rates down to attract business. What was even worse was that a major control method incorporated in C&CC, i.e. calls for Special Deposits, intended to 'starve' banks of funds, actually made the situation worse by narrowing the spread further, thereby giving a further twist to the 'merry-go-round'.

I had myself sought a sabbatical from the Bank in 1972, in order to write my text-book on *Money, Information and Uncertainty*, which was completed in mid 1973, but not published until 1975,

because Macmillans did not want to price it above £10, but could not work out how to do so at a profit, given the sky-rocketing price of wood pulp/paper; their eventual answer was to reduce the size of the type to a headache inducing smallness. I did not return to the Bank until the autumn of 1973, after Gordon Richardson had replaced Leslie O'Brien as Governor. Fairly soon I identified the pattern of relative rates of interest as the main culprit for the froth in the banking system and of the need to end this by driving "a wedge between borrowing and lending rates". All this is set out in my note to the Governors of 9.11.73, reproduced as Appendix B, (taken from file 6A.50/12).

I stand by my then analysis that much of the increase in both bank lending and M3 was artificial, and of little significance for the 'real' economy. That said, there was an unsustainable boom in 1972/73, and monetary factors aided, rather than counteracted it. By the end of 1973 real interest rates were negative, credit was plentiful and the government was still running a significant deficit.

In some large part this inappropriate stance of monetary policy was due to political unwillingness to raise interest rates, especially at a time when prices and incomes controls were being, once again, attempted. Businessmen complained to the Prime Minister that they could hardly be expected to keep prices down if their interest rates were driven up. Accordingly on November 15, 1973, the Chancellor, Barber, wrote to the Governor, effectively to pass on Heath's demand that some other way had to be found to control monetary growth that did not involve further increases in interest rates, (see Capie, op cit, pp 520-521). Richardson spoke to Fforde, who asked me to come up with an answer, which I did a few days later with my paper on 'Alternative Methods of Credit Control', 19/11/73, reproduced as Appendix C, (taken from file 6A.50/12).

As an economist, I was aware that a balance sheet had two sides, and that one could focus on average, or marginal, conditions. Hence there were four possibilities, to impose an average, or marginal, control on bank lending, or on bank bidding for funds. My strong conclusion was that the best buy was to penalise bank bidding for additional interest-bearing funds, partly because that was what had got the system into such difficulties, i.e. the punishment fitted the crime. This paper was the genesis of the 'corset' control (the term 'corset' was invented by Gilbert Wood, to indicate an external constraint to disguise and conceal internal flab), in operation most, but not all of the time, from then until summer 1980. No doubt in my absence others might have gone down this same road. Moreover, as will be obvious from reading this paper, it was written in a deeply cynical spirit. Nevertheless it was, I would contend, the best possible answer to a tricky, and unavoidable, problem. I remain proud of having written this paper, one of the highlights of my career. This story is not fully set out by Capie (see p. 521), so I am glad to have had the chance of adding to the record.

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## Appendix A

24.12.70

THE GOVERNORS

### BANKING SYSTEM (AND CREDIT CONTROL)

I attach, for discussion, a curious and rather emotional note on this subject. It is a little less than fair to the autumn paper we sent to Whitehall, and covers somewhat the same ground. It has been written after discussion with C.W.M. and the Chief Cashier. It is intended to express our concern lest the grass gets pushed up under our feet. None the less, the specific suggestions it contains (and in particular the suggestion about the gilt-edged market) commit no-one but the author.

J.S.Ff.

24th December 1970.



## COMPETITION, OFFICIAL CONTROLS AND THE BANKING SYSTEM

By April 1971 the "outside" banks and the principal finance houses will have been subjected to uninterrupted ceiling controls for longer than the second world war. The clearing and Scottish banks will celebrate an anniversary that is only slightly less miserable. Unless we mount a strong offensive, it is likely that the present system of control will be prolonged for the whole of a seventh year, and indefinitely. To use the current word, I find this latter prospect "unacceptable". This note accordingly discusses the problem and argues, often polemically, that the Bank should move rather more onto the offensive than we are at present.

### I. WHY WE ARE NOT MAKING MUCH PROGRESS

Late in the autumn, we thought that a fresh approach to these stale problems might find favour in Whitehall subsequent to the change of Government. So we put in to Sir Douglas Allen's working group a paper which revealed in fairly general terms the shape of our thinking. We did not put forward proposals for any radical reform of the entire system, including reform of the cartel. Instead, we suggested a "voluntary" renegotiation of parts of the Cash Deposit scheme that might enable us to substitute collective ratio controls (for individual ceiling controls) over those non-clearing banks who preferred the former. We also suggested that a similar scheme should be discussed with the finance houses. Depending on how things developed, these would be the first steps in a more profound transformation involving modifications to the cartel, to liquidity and cash conventions across the board, and even to deposit competition in the uncartelised sector. It was emphasised in our paper that controls less direct than ceilings would necessarily (at least in appearance) be somewhat less precise in their impact upon bank lending-to the private sector; and that they might need stronger support from interest-rate policy.

It is apparent that Treasury officials are in no great hurry to join us in any attack upon the system of control that we now have. They appear nervous of, not to say hostile towards, any suggestion which seems to them to imply a less strict administration of monetary policy. It is probable that they are sceptical of obtaining the greater freedom of interest-rate policy which our ideas seem to demand, while anxious lest their Ministers none the less find politically attractive the greater competitive freedom which our ideas entail. So Treasury officials have shown little inclination to push ahead with the suggestions we have made. On the contrary, they have made it pretty clear that they would be happy enough to see our ideas put aside for yet some other "review" to be carried out some other time.

The Treasury view deserves a certain respect. To-day, Treasury officials must give first priority to maintaining the effectiveness of such tools of demand management as exist and can be used firmly, as against untried innovations. So, up to a point, must the Bank. But our responsibility for ensuring, or failing to ensure, the proper evolution of the banking industry is more direct than that of H.M. Treasury. It is our job to make the running in this field and actively to seek the required overriding political decision that will govern the future shape of monetary controls. With six years of ceilings behind us, and a new Government in office, this is a responsibility that we cannot put to one side. We should not wait until the Treasury, with its interest in the general management of the economy (at a difficult phase) finds it opportune to pull our chestnuts out of the fire.

In these circumstances, the "soft sell" of our autumn paper, with its step-by-step approach, may not suffice. So we need to try the "hard sell" of a tougher approach. If this latter course were to fail, it may be that we ought to favour resort to a Public Enquiry.

## II. WHY WE OUGHT NOT TO COUNTENANCE AN INDEFINITE PROLONGATION OF CEILINGS

Firstly, mere repetition of our own oft-repeated views, about the damaging effect of prolonged ceiling controls, makes us look ridiculous. We have had ceiling controls in operation for longer than we have had any other type of control. It is rather bad to go on and on wringing our hands about these damaging effects, pleading that the emergency persists, and making no determined effort to change the system. The same goes for our attitude towards the clearing banks' cartel. We have made it fairly clear in public that we would not oppose sensible changes in the cartel. We took the same view in Whitehall when the cartel was officially reviewed by a working party in 1968/69. Nor have we made much secret of our readiness to take another look at the agreed minimum cash and liquidity ratios. We ought not to go on accompanying these views with an inaction which we justify by the need to maintain a present system of credit control which we are doing little to alter. Our credibility suffers. Worse, prolongation of the present system is inconsistent with the Bank's fundamental and correct view that the shape of the banking industry, and its capability for change, should not be notably subordinated to the requirements of monetary policy. Banking, as a legitimate commercial activity, often inconveniences the Government of the day. There is accordingly a persistent temptation to convert the banks into mere slaves of official policy. We have always said, and rightly, that this is a temptation that must be resisted. The strength of our resistance to temptation can be judged by six years of ceilings.

But we need not be too unfair on ourselves. Our system of controls, by a delightful paradox, quite largely derives from a devoted adherence to the fundamental attitude mentioned above. It was fashioned according to the shape of the banking industry as we found it. It was intended to be entirely without prejudice to the development of that industry. But the credibility of this intention rested upon the presumption that the controls were only temporary, and their nature justified by the existence of an impermanent emergency. The idea that strict curbs on bank lending would be the rule rather than the exception finds no place in the official thinking of the early and middle 1960's upon which the present system of credit control was founded. This optimistic presumption, which finds favour in some quarters even to-day, has hitherto proved unfounded; and I do not think we should now presume that the long-delayed justification will soon arrive.

So although we started with the best intentions, we have got to the stage where our credibility is endangered and our fundamental doctrine is being ignored. Although the case in support of this proposition is a strong one, the Bank can easily be lured into its de facto rejection. A feature of official British policy-making, whether in the central bank or elsewhere, is the excessive influence of short-term factors and arguments to the neglect of the longer-run but less immediately visible consequences of this or that short-term policy. At present and for some time past, there has been much official demand for a very "firm" monetary policy. Any suggestions that can be construed as having a flavour of "weakness" are regarded with the utmost suspicion, whether they be founded upon a concern for the long-run survival of British-owned industry in the U.K. or upon concern for the proper evolution of the financial system, or both (for both are closely connected). For a variety of reasons the degree of "firmness" has come to be associated with success in restraining the level of bank advances within some predetermined figure; and there can be little doubt that ceiling controls, or something very near to them, are best suited to secure such an objective. Because, therefore, the Bank likes to be seen to be "firm", we can too easily be persuaded to put up with an inherently bad system of control for "just another year or so". We are particularly vulnerable to such persuasion in that we have not ourselves developed a comprehensive long-run strategic view about the framework within which the banking industry should operate, notwithstanding our recent attitudes towards clearing bank mergers and towards "disclosure". Instead, a firm short-run strategy

has often been accompanied by a relatively weak and passive long-term outlook which has tended passively to accept whatever shape the banking industry happened to have. It may be that a positive long-run strategy, properly effective on short-run policies, is not something that we can adopt for ourselves. But the need for one remains and may have to be determined politically, or as the result of a Public Enquiry.

It is often argued, mainly by outside critics, that all the problems arising from the direct control of bank credit could easily be swept aside if only the authorities would behave sensibly and much more firmly with their other weapons of policy. These weapons are money-rate policy and gilt-edged policy. Maybe these arguments need yet further consideration by the authorities. But there is little in the experience of the past few years to suggest either that a yet more aggressive official policy in the gilt-edged market would in practice achieve a much closer control over the lendable resources of the banks or that advocacy of a much more flexible money-rate policy would prevail against external objections and politically-sensitive domestic resistance. Accordingly, I do not dispute the conclusion that these "orthodox" weapons need the assistance of a permanent system of direct control which may be capable of use, on occasions, as the principal cutting edge of monetary policy.

A final reason for increasing discomfort with the present arrangements is that they are almost universally condemned by opinion-forming critics and commentators. These include, at least so far as the cartel goes, the two public investigatory institutions who have taken a look at the banking system in recent years (the Monopolies Commission and the Prices & Incomes Board). The only usable defence remaining to us is that an emergency requires emergency methods. But this defence vanishes once we admit, as I believe we should, that the so-called emergency is more like the normal state of affairs and that the emergency methods are mere makeshifts whose replacement is overdue.

At this point the reader will assuredly say that something more is required than abusive generalities; and the reader is right. Yet he should be warned against expecting a supporting case that is as solidly based on hard fact as, for instance, an established statistical series. He who argues for fundamental change must, to some degree, be preaching a faith. If one does not believe that competition is capable of stimulating efficiency and innovation, then presumably one ought not to object to a permanent system of ceiling controls on banks. But if competition has any virtue, we ought not to have a system that stifles it.

### III. THE APPROACH TO RADICAL REFORM

An absolutely central feature of our arrangements is the division of the banking system into two parts, the clearing and Scottish banks on the one hand and the "outside" banks on the other. The former comprise the cartelised sector, which is equipped (inter alia) with officially-agreed minimum cash and liquidity ratios. The latter comprises the uncartelised sector, without officially-agreed minimum-ratios. The boundary between the two is precise and absolute. A company that owns banks of both species must be represented on both sides of the boundary and each bank must conform to the rules applying to each side, whether these rules are those of credit control or of banking practice. The existence of the cartel is thus fundamental to our system of credit control; or, to be more precise, our system of control consists of a set of arrangements for treating banks differently, for purposes of credit control, according to whether or not they adhere to a particular set of restrictive practices. . The essential reason why the boundary between our arrangements for credit control is co-terminous with the boundary of the cartel is that the presence or absence of restrictive practices radically affects the response that one can expect from a given change in, e.g., compulsory interest-bearing Deposits at the Bank of England. A subsidiary but I now suspect far less

important reason, with which much play has been made in the past, is that the diversity of the uncartelised banks makes them-unsuited to the same treatment as we accord to the clearing banks.

If the cartel is central to our peculiar system of control, that system acts in turn to reinforce the cartel. The naturally cosy conditions within the restrictive-practice area are protected by the maintenance of individual ceilings on the restricted lending of all possible "outside" competitors. More interestingly, perhaps, the cosiness is even protected from the competition which might arise between each clearing-bank group of companies, from the expansion and development of the uncartelised members of each group. You can't even compete with yourself.

So far as I am aware, the Bank sees no great objection to the cartel (and the associated cash and liquidity ratios) being substantially modified. Governmental desire to maintain the 5½% fixed rate for medium-term export finance used to be an awkward snag. But this has now been mostly removed, and may be entirely removed before long. The present Government has told the banks that they should not be called upon to subsidise exports. So we can now reasonably consider modifications to the cartel as practical politics. These might, off-the-cuff, include –

- (i) derestriction of competition for time deposits (including C.D.s) with, say, an original minimum life of three months and over, and a minimum amount of, illustratively, £10,000. This would effectively enable the clearing banks to compete in their own name for large deposits whose owners were willing to invest somewhat more than day to day.
- (ii) maintenance of restrictions on large deposits placed for periods shorter than three months, though the maximum rate might be raised to, say, BR - 1.
- (iii) raising the maximum interest rate payable on small deposits of specified terms up to the maximum offered by, say, the Trustee Savings Banks - at least until the proposed Enquiry into public sector savings institutions has reported. The determination of rates paid on personal savings covers an administered-price area far wider than the clearing and Scottish banks. There would be no sense in encouraging the clearing banks to upset this whole area, at least until some alternative arrangements had been agreed for the public sector institutions.
- (iv) probable disappearance of the agreed minimum lending rates, but we would not need to insist on this.
- (v) application of the minimum cash ratio to balances-held at the Bank only, to the exclusion of till money. The amount of currency and coin that the clearing banks find it necessary to hold, in support of the "current account" services they provide for the public, is a matter which we should leave them to determine. Our concern, for management of the money market, is that they should work to a specified minimum cash balance at the Bank; and this minimum should be founded on current practice. A minimum of 1½% would seem to be about right.
- (vi) reduction of the minimum liquidity ratio, which is useful to us as a "fulcrum" on which Special Deposits exert leverage, right down to the level of genuine liquidity which the clearing banks actually maintain. "Genuine liquidity" excludes those relatively illiquid assets, encashable only in an extraordinary emergency, which have been transferred from Advances (with our assistance) in order to keep formal liquidity at 28% or above. "Real liquidity" should include only cash at the Bank, money in the Discount Market, Treasury Bills and B.G.S. maturing within, say, six months. The required minimum ratio on this definition should probably be no higher than 12½%.

It is to be noted that these superficially drastic changes in the required minimum ratios, which would accompany a modest and sensible dismantling of major restrictive practices, would neither release resources that are at present locked up within the 28% ratio nor in any way diminish the "leverage"

of a given call for Special Deposits. This is because much that is now contained within the 28% is either already firmly lent to the private sector (in the form of "refinanceable credits") or else consists of currency and coin in the pipeline. The so-called drastic change of the minimum ratios would merely give formal recognition to a reality that we already have.

If clearing bank agreements and ratios were to be modified on the above unfrightening lines, much of the essential but partly already false contrast (for present purposes) between the clearing banks and the "outside" banks would have fallen away. It would then at once be asked whether and why we needed to maintain a system of control over the "outside" banks that was separate from the one in use with the clearing banks. Would not the two sectors be sufficiently alike for the Special Deposits scheme to be applied uniformly across the entire banking system?

The answer would be that the continued absence of agreed minimum ratios at the "outside" banks, together with a freedom from restrictive practices that was still greater than with the clearing banks (in particular with respect to competition for short-term deposits), would continue to justify their separate treatment for purposes of credit control. Their response to a given call for Deposits at the Bank could be sufficiently different, and this difference sufficiently attributable to the differences in ratios and restrictive practices, that separate treatment would remain essential to the equity and efficacy of policy measures. This would be unfortunate, because the uncertainty of response by the "outside" banks, and perhaps also the severity with which Deposits would have to be called, would probably mean that ceiling controls, or something very like them, would continue to be used and competition restricted. Uniformity, if it could be achieved, would be much better.

To get this uniformity, the "outside" banks would need to adopt broadly the same practices and ratios that would apply to the "modified cartel". There do not seem to be insuperable obstacles to this. A minimum liquidity ratio of 12½%, composed of the assets mentioned earlier, would not be particularly onerous for the Accepting Houses or very far out of line with their current practice as a group. Nor would it be particularly onerous for the British overseas banks or the Americans. A restriction on competition for small deposits would scarcely worry the "outside" banks because they are not much interested in such deposits in any case. A restriction on competition for wage deposits shorter than three months could cause difficulty but might be essential if a uniformity of credit control was to be equitable between the clearing banks and the other banks. But for those of the "outside" banks who really wished to try to develop their private sector lending business in a fully-competitive situation, without the straitjacket of the present physical controls, the advantages of a uniform Special Deposits system would be so great that various minor restrictions on complete freedom should prove acceptable. "Outside" banks who did not wish to participate in this competitive world could presumably opt out, and presumably continue with a fixed quota of private-sector lending which would only be changeable at very infrequent intervals.

A uniform system of control operating on a banking system that would be uniform with respect to restrictive practices and liquidity ratios would have the following advantages –

- (i) Both by force of competition and as a result of the re-integration (of parent with subsidiary) which the new arrangements would allow, the clearing banks would be encouraged to develop a fuller range of facilities than are at present available.
- (ii) Force of competition, accentuated by the disclosure of true profits, would encourage the banks to seek greater remuneration from a given volume of lending. This in turn should encourage a decline in the importance of the overdraft and its part replacement by repayable loan facilities tailored to the specific needs of each customer. There should result from this an improvement in the financial management of many businesses and a desirably closer and more sophisticated relationship between banker and customer.

- (iii) At times when a "tough" monetary policy was being pursued, the greater flexibility of interest rates together with the greater flow of loan repayments would diminish the degree of physical rationing of credit and the degree of protection accorded to "regular customers" with established overdraft facilities. If one has sufficient faith in market economics, one should conclude that the allocation of resources would be better than under our present arrangements.
- (iv) Subject to advice from experts, our banking system would become better equipped for U.K. membership of the Common Market.

#### IV. APPRAISAL

Critics of this (not very) radical approach are seemingly of two kinds. There are firstly those who argue that it would represent an unjustified and arbitrary interference in the business of banking as determined by bankers exercising their free will. These argue that it is not for us to try and upset the clearing banks' cartel arrangements, including the relationship between parent and subsidiary, and it is not up to us to impose any sort of practice on the "outside" banks which they have not themselves chosen in the ordinary course of their business. They go on to argue that the suggested uniform system would prove so inequitable as to be impracticable of operation, so that we would be led back to something very like the system which we have got. It is then concluded that the present system is the best that we can get and that a restoration of effective competition must come through a substantial relaxation of credit policy. The second type of critic, who will readily derive comfort from the first, is the one who argues that a radical change represents, for the precision and effectiveness of credit control, a dangerous leap in the dark for which the time is certainly not ripe. Among the various arguments for not doing something, this is known as the "principle of unright time". It does little more than say that a cautious and prudent man should be apprehensive of radical changes.

Personally, I feel very unconvinced by the arguments of the first type of critic mentioned above. The radical approach can certainly be called "interventionist" but the suggested uniformity of treatment over the entire banking sector would in practice be (in my opinion) the almost inevitable consequence of any sensible modification of the clearing banks' cartel. One can only preserve the present settlement by preserving the cartel in its entirety. To me, this is an indefensible position. Not only do I think that there are positive advantages to be gained from the kind of change suggested, I am nearly convinced that they are inevitable anyway.

The second of the two critics is in a more powerful position than the first, given our present politico-economic situation. To meet him, it should be possible to devise a "transitional" period during which the system could adjust to the new regime. During this period, guidance might remain fairly close and each individual bank might undertake not to increase its lending to the private sector by more than double the percentage indicated as desired for the system as a whole. This latter suggestion need not be taken too precisely. But the idea of a transitional period deserves exploration. Apart from this, the advocate of "unright time" would have to be content with assurances that an appropriate combination of the money-rate and Special Deposit weapons would be used with whatever ruthlessness proved necessary.

If this reassurance did not suffice, I think we might have to consider a further change in our management of the gilt-edged market. The change I have in mind would be the restoration of discretionary buying operations, near-maturities excepted, in place of the present obligatory arrangement. Such a change would certainly cause a notable reduction in the marketability of B.G.S. But I am no longer convinced that it would still unacceptably impair our ability to sell stock to

"genuine" investors through our present continuous-funding technique. If such a change of management proved necessary to secure consent to a reform of the banking system, the risk could well be worth taking. Certainly, maintenance of obligatory buying of stock (at a price of our choosing) would become extremely difficult to sustain if we were to have the freer system of credit control and banking practice that has been discussed in this paper. The freer the system (and the more ruthless the potential use of Special Deposits), the more damaging would be the customary criticism whenever the gilt-edged market was falling and we were, in the normal course, buying in such stock as we were offered and inflating the money supply.

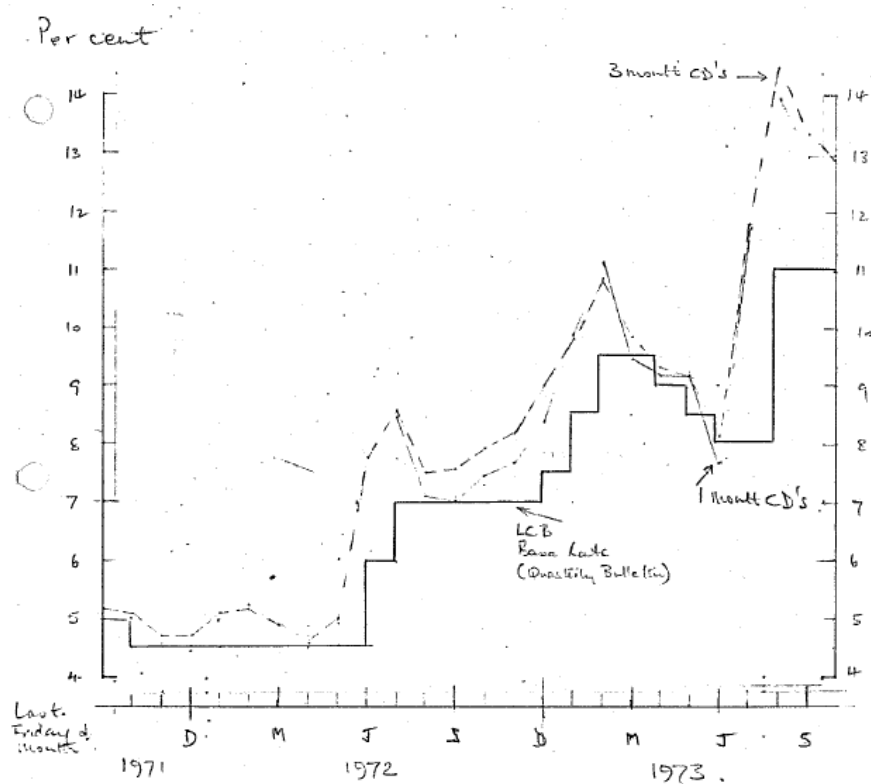
It is for your consideration whether, after reading this note, we should change our tactics and go straight for the radical alternative in place of the first step advocated in our autumn paper.

24th December 1970

## THE GOVERNORS

The Pattern of Rates in the Banking SystemA. The Present Problem

Whether, or not, the absolute level of domestic interest rates is now about right, there is no doubt that movements in the relative pattern of rates within the banking system have compounded the difficulties of monitoring and controlling bank lending and the money supply. The main problem is that the banks, especially the clearing banks, when under liquidity pressure, will bid for funds in the market, driving up deposit rates in the money markets relative to their stickier lending rates. This is illustrated in the Chart on the next page, which shows the movement of 1-month and 3-month CD rates relative to the clearing banks' base rate since September 1971. Practically every time that the banking system has come under pressure, in some cases as a result of official operations, say by calling Special Deposits - in other cases as a result of other factors, e.g. external outflows - deposit rates have risen relative to lending rates at least for a time; in fact this has persisted for several months on this last occasion. This phenomenon, moreover, is not unique to the UK. It has been experienced in other competitive banking systems, such as the US and Canada, though perhaps in a more muted form.





Such relative rate movements have at times been sufficient to allow a pure arbitrage turn to be made by borrowing from the banks and immediately redepositing the same funds back with another bank in the system. Such, pure merry-go-round operations can have very little effect on the real economy. The operator with a temporary increase in both bank borrowing and CDs will not be under any illusion that his real wealth or liquidity position has changed significantly as a result of such arbitrage transactions. He is simply extracting from the banks a slice of their profits; a redistribution of existing profits with very few economic consequences. It does, however, complicate our task of trying to discern what is happening within the system, and its main consequence, arguably, could be to divert the authorities' aim.

Besides such direct arbitrage, there is a more diffuse effect of such movements, even when less extreme, in relative rates. Those with a cash outflow to finance will borrow from their banks rather than run down their deposits, while those with a cash inflow will amass interest-bearing deposits, perhaps instead of reducing an overdraft in another account. This swells both sides of banks' balance sheets, a monetary "bubble".

Why should this matter really, apart from presentational problems, though these may at times have much force? There are two reasons. First, though possibly less serious at this moment, the private sector, but especially industrial and commercial companies, now command in their deposits a very large *masse de manoeuvre*. This can be used at any moment by them for expenditure purposes, and thus represents an overhang over the economy. On the other hand the government has been keen to encourage capital expenditures by companies, and has been worried by their sluggish response observed to date in this respect. So if they did make use of this "overhang" for this purpose, the authorities would in general be pleased, and would try to make room for it within the economy. Even so, perhaps, the "overhang" now appears so large that there must be some danger of expenditures in the company sector developing at a pace and in directions (e.g. speculative stockbuilding of raw materials) that would cause stress.

Even though the "bubble" has been blown up mainly by increased borrowing and deposit holding within the company sector, there is no assurance that it will not leak out and affect expenditures elsewhere in the system, with a lower priority call on economic resources. Thus qualitative guidance could be circumvented. Property companies could obtain finance, say by leasing, from other companies with easier access to bank borrowing. While the company sector is so liquid, they may be willing to provide in turn more credit to personal customers, who might borrow then from stores rather than from banks. The links between borrowing and expenditure need not be direct, and it is not possible to tell just how much the expansion of credit and liquidity is now and could in future be affecting expenditures outside the company sector.

The real test, though, is whether the present pattern, and level, of expenditures in the economy is about right. Insofar as it is, this only remains a potential source of danger. On the other hand, if it could be checked without otherwise damaging effects, it is as well to remove even potential dangers, and it would have obvious presentational advantages.

We have already responded to this problem by trying to manage rates in the parallel markets in such a way as to damp down some of the more exaggerated movements in relative rates. But there are constraints on our ability to operate in this way. Some of these constraints derive from exchange rate policy, some from domestic considerations, e.g. on housing finance, and some from presentational difficulties, which are a factor at times inhibiting a more flexible use of Special Deposits, e.g. in October. It would be difficult for us, certainly in present circumstances, to achieve and to maintain desired relativities in rates through market management operations, the use of Special Deposits and consultations with banks over the appropriate level of their base rates. We

could provide more direct guidance to the banks in setting their base rates (and use our market management operations to influence parallel money market rates), but, apart from any other considerations, this would place base rates on a clearly administered basis with all the consequent political and presentational difficulties, for example, for banks themselves in justifying their moves to their customers. We must, therefore, look at various alternative measures which could help to achieve the desired relative pattern of rates within the banking system. Here, and subsequently, reference is principally to the clearing banks, the main source of the problem. The difficulties of applying such measures to the banking system as a whole, which may vary according to the method chosen, are only touched on here and there, being taken as of lesser importance at this stage.

## B. Alternative Measures

There are a number of ways of classifying such measures, e.g. whether their main effect is on bank assets or liabilities. For the purpose of this note, however, the measures will be divided into two main groups, those which represent developments in banking practice that banks might be persuaded to operate themselves, more or less willingly under pressure from us, and those that would involve us in imposing controls upon the banks. In the first group we consider three options,

(a) Term loans instead of overdrafts. The spins of the merry-go-round mainly involve large companies drawing on their overdraft facilities with clearing banks to provide funds for redepositing. It has been suggested that it is the ease with which these overdraft facilities can be brought into play that is largely responsible for this situation. So would it not help if all loans with the clearing banks were put on a term basis?

But if term loans could be arranged with the clearers for one week or one month, it would not alter the arbitrage opportunities so long as the constellation of rates remained the same, though it might reveal more clearly to the banks who were undertaking such operations. If short-term loans were forbidden, it would drastically lessen the flexibility of our present banking system; indeed any restriction of the overdraft system would have this effect. Even if this measure did substantially lessen the pure arbitrage merry-go-round it would have no appreciable impact on the more fundamental problem so long as advances (or term loan) rates are charged on a Base rate plus basis and so often appear relatively cheap compared with deposit rates.

(b) A more progressive rate structure. The suggestion is that banks should raise rates to borrowers more steeply as the latter make increasing use of their facilities. This is attractive, on first sight, because it penalises the individual borrower making "excessive" use of bank facilities and it builds on existing bank practice. On examination, there would seem to be two major difficulties in making the measure effective. First, borrowers could try to avoid it simply by arranging facilities with a larger number of banks. Since it is large companies and local authorities who would be most affected by this scheme, it would seem likely that the other banks would only be too happy to pick up bits of extra business put their way. Second, borrowers who were moving into the more expensive higher tranches would seek to borrow from those borrowing in the lower tranches, thus leading to a form of disintermediation and a reactivation of the inter-company market without leading to any reduction in bank lending. We should like to explore with the banks whether these difficulties can be met, because, if they could be effectively surmounted, this might be a possible solution to the problem. In any case moves in this direction might play a useful supporting role, although it could take many months to make them fully effective, because of the need to renegotiate existing arrangements - a slow process,

(c) Widening margins between borrowing and lending rates. The object of the exercise is to find some technique for ensuring at least a minimum margin between bank deposit and bank lending rates. This could be achieved in principle either by leaving deposit rates free to vary and relating (some) lending rates to these, (e.g. base rate for large borrowers to be at 3-month CD rate plus x%), or by leaving lending rates free to vary and by restricting rates which the banks can offer on liabilities, (e.g. by some version of Regulation Q). In the latter case a sliding variant, for example maximum deposit rate allowable to be base rate minus x%, would be preferable to the rigid fixed Regulation Q as used in the US. However, banks have more real need for flexibility on their liability side, so tying base rates to some set of market rates, a floating base rate, is far more preferable than any variant of Regulation Q.

This proposal, of a floating base rate, has certain advantages in comparison with the earlier suggestion of more direct guidance from us to the banks on lending rates. The key difference is that base rate would be related to market rates rather than directly administered. This should be easier politically and for the banks to explain and to defend to their customers. It might also be desirable, on both administrative (i.e. bank accounting costs) and equity grounds, to separate the process of rate setting for large and small loans. For small loans under £1 million, say, the rate might be determined in some more stable manner, e.g. in relation to Bank rate (Minimum Lending Rate), while rates on large loans could be market determined. This split rate scheme has features in common with present practice in the US. It is likely to penalise the large borrower relative to the small. This should be politically and presentationally attractive but also raises the question of the treatment of public sector borrowers, local authorities and public corporations.

There are also a number of difficulties with this suggestion. There would be a technical problem in deciding to what rate(s) to tie base rate, and how often to revise it. The Finance Houses, who operate such a floating scheme, change their base rate monthly on the basis of rates over the previous eight weeks, but this relatively long lag has on occasions made their base rate appear to move well out of line with rates generally. Second, there could be problems analogous to those occurring already with a floating Bank rate (MLR). We can never be sure how market rates will behave, and sometimes the resulting movements of bank lending rates might appear inappropriate. So the extent of the margin of lending rates over deposit rates might from time to time need to be a subject of discussion. On balance this seems the most attractive of these first three options; in particular we should be able to introduce it much more quickly than the progressive rate structure scheme.

Imposed Controls. If, however, it proved impracticable to deal with this problem by building on existing banking practice, it would be necessary to consider imposing external constraints upon the environment in which the banks operate. The purpose of these constraints would be to force a wedge between their borrowing and lending rates, say by a levy upon the banks' marginal lending, as is done in France, or upon their additional borrowing of wholesale money. Such levies may be imposed in the form of a non-interest bearing ratio. In general this would have to be imposed incrementally, i.e. upon the addition to deposits or to lending beyond some base starting point. If it was imposed as a ratio to the total rather than to the increment, it would either have an excessively penal impact on total profits or, if that were avoided, the effect on the rate of return which the banks could offer on additional deposits or charge on additional loans would be minimal. Indeed incremental ratios for this purpose have to be rather steep to be effective, for example more than 10% of additional loans or wholesale deposits, beyond some starting point, might have to be paid into special non-interest bearing deposits.

Again, in principle, such a levy could be imposed either on the asset or the deposit side. In this case, however, the balance of advantage would seem to lie in imposing it on wholesale liabilities. If it was

imposed on marginal loans, the need to choose starting points, allowable increases, would put us well on the way to a return to ceilings. The imposition of such incremental ratios would need to be across the board over all kinds of lending, but there would soon be a chorus to allow priorities for certain kinds of lending, and from past experience this would knock the stuffing out of the control. On the other hand such levies on the deposit side could be aimed at incremental wholesale borrowing. It could be presented as action to lower bank profits and as improving equity between the small depositor, already subjected to a Regulation Q, and the large depositor. There would, however, be problems of identifying "wholesale liabilities", and we will have to give further consideration to these problems, which would affect the form and coverage of any such scheme.

We have, however, already managed to negotiate arrangements for incremental special deposits on overseas deposits, and this encourages us to believe that the difficulties of introducing such a scheme should not be insuperable. Even so, it would have serious drawbacks in comparison with a voluntary scheme. How do you set the allowable increase after which the incremental ratio/levy will come into effect? There would be base date inequities between the position of various banks e.g. the differing reliance on wholesale money. Having started the scheme, how does one update it for normal growth? Just stop and start again? Then again this scheme would be much more likely to lead to disintermediation and serious structural inefficiencies than getting the clearers to move on to a split, market related base rate. The scheme could probably be made to work, but it would be unpleasant both for the banks and for us, and could hardly constitute a permanent solution to the problem.

### Conclusions

So far in this exercise we find ourselves preferring the alternative of aiming to bring about a suitable change in banking practice, (with the preferred option probably a "floating" base rate), whether or not this involves some pressure and arm twisting, rather than trying to impose an external constraint on the banks' environment, to drive a wedge between borrowing and lending rates. The former change could be confined to the clearing banks, but the latter would have to extend over the whole banking system. Nevertheless the latter could be presented as a realistic threat of what we might be forced to do if the clearers do not adjust their own practices voluntarily.

CAEG

9th November 1973

THE GOVERNORS

Alternative Methods of Direct Control

The attached paper considers the reasons for examining at this time various methods of direct controls over banks. The main reason is seen to be that of restraining monetary expansion without an unpalatable increase in interest rates. This can be achieved by preventing the banks, by controls, from carrying out their role as intermediaries, though this needs to be reinforced by an agreement with the clearing banks, at least, that they will not profiteer from such direct rationing by charging what the traffic will bear. However the business diverted from the banks will, in the main (except for restraints on persons), flow through other credit channels. So the introduction of such controls would have mainly a cosmetic effect, without much impact, and certainly not an easily measurable impact, on the real economy.

Four alternative methods of control to achieve this end are considered in the light of a number of presentational and technical criteria. The methods are (i) ceilings on bank lending to the private sector; (ii) an incremental ratio (levy) on additional lending; (iii) Regulation Q on rates which banks can offer on deposits; and (iv) an incremental ratio on banks' additional interest-bearing deposits. These measures are reviewed against several criteria, e.g. likely statistical effects on the monetary aggregates, flexibility, problems of ensuring compliance, effect on bank profits, negotiability and possible speed of introduction, problems of subsequent adjustment, and the resulting difficulties involved in returning again to a freely competitive system (more graphically described by Mr. Fford as the On-Off problem). This Section, though almost certainly not exhaustive in its coverage, is nevertheless lengthy and dense.

This survey does, however, allow a ranking to be made of the relative advantages and weaknesses of the four methods. Though none are intrinsically desirable, since all involve some distortion of the financial system with real structural costs, in order to achieve a largely presentational advantage, the worst option of all would be a direct return to ceilings. The least harmful would probably be the imposition of a high ratio, say 25%, (in the form of non-interest-bearing supplementary deposits) on the increment of banks' interest-bearing deposits above some slowly rising base. This is a somewhat complicated scheme; the reasons for having it so are spelt out in the attached note. Moreover the novelty of this new gimmick might even distract attention from its real function, to prevent the banks doing business that they could profitably take on.

CAEG

19th November 1973  
C.A.E.G. (4104)

## The Imposition of Controls on the Banks

### A. The Background

Even if the present discussions with the clearing banks on possible changes in banking practice come to a successful conclusion, it is now necessary to examine also more far-reaching changes in the banking system in the form of externally imposed direct controls. For one reason or another, for example if agreed voluntary changes in banking practice should not appear to be inducing a sufficient moderation in monetary expansion, contingency plans for further direct action have to be in readiness.

Apart from the opportunities for arbitrage provided on occasions by the pattern of relative interest rates, the main criticism of the present system is that restraint of monetary expansion seems to require increases in interest rates to unpalatable levels. The present remit, therefore, is to consider schemes which would bring about some desired restraint in monetary expansion with a lesser increase in bank lending and deposit rates.

These schemes all involve rationing in some guise or another, either by preventing banks taking on more business, by ceilings on lending or by Regulation Q, which prevents them bidding for funds at market rates, or by making it so expensive for banks to expand their business, by levies on their incremental lending or borrowing business, that they would be forced to introduce rationing for themselves. If the supply of bank lending is rationed in one or other of these ways, it still leaves it open, however, for the banks to charge as much as the traffic will bear. Thus rationing by itself does not necessarily hold interest rates down. In previous periods of ceilings the clearing banks' cartel agreement prevented them from taking advantage of excess borrowing demand to raise lending rates. The other banks, whose rate structure is less visible, may have charged considerably more for loans during these periods of ceilings - and, indeed, thereby have introduced some flexibility into the system. So any scheme introduced now would probably need to be accompanied by an understanding with the clearing banks, at least, that they would adhere to an agreed structure of lending rates, linked say to MLR or to market rates, in order to prevent profiteering. It would be harder to negotiate such a self-denying ordinance with all the banks, and that would leave the non-clearers under all these schemes at a relative advantage. If the business of the banks was absolutely restricted (e.g. by ceilings or by Regulation Q), the non-clearers could charge more for their limited provision of loans. If expansion was made expensive (e.g. by incremental levies), they would be in a position to take some more of the business from the clearing banks, by offsetting the higher costs of extra business by higher charges to all their customers.

Since all these schemes work in a roughly similar way, either by greatly increasing the expense of, or directly prohibiting, additional intermediation by the banks, their effects on the economy - for a given degree of restraint - should not be very dissimilar. Frustrated borrowers will turn to other sources of credit, if they can. In those cases where they can find alternative funds at little extra cost, whether by running down assets, e.g. gilts or local authority debt, or by borrowing, say in a revived inter-company market, there will be little real economic effect. If the purpose was actually to be restrictive, to reduce real demand, all such rationing schemes should be aimed directly at those sectors (e.g. persons, perhaps small companies) which cannot easily turn to alternative sources. Qualitative guidance, amounting informally to a covert ceiling, on lending to persons has already been given. But, especially in view of the currently swollen liquidity of the company sector, it is probable that the introduction of a scheme to control bank intermediation by some form of rationing would have little economic effect on companies.

It is, however, doubtful whether a restrictive economic effect is currently desired in any case. The apparent main object of this exercise is presentational, to reduce the observed rate of growth of the monetary aggregates, without necessarily or even desirably having any effect on the real economy. The choice between these various schemes, which are all quite similar in effect, then depends on presentational and technical considerations. Some of these are considered in the next Section.

## B. Presentational and Technical Considerations

### 1. Effects on the monetary aggregates

Regulation Q, and levies (ratios) on incremental interest-bearing deposits, prevent the banks bidding for additional funds. These instruments can, therefore, be quite effective in reducing the growth of  $M_3$ . Within the restricted available total of liabilities, banks may try to meet their private sector customers' needs by reducing their cushion of public sector debt, beyond that required for reserve assets and special deposits. So these schemes have a less direct impact on bank lending to the private sector. At this moment, however, this cushion is slim, and an enforced reduction in the rate of growth of  $M_3$  should serve to make the banks reduce the pace of expansion of their advances.

Credit ceilings, and levies on additional (incremental) lending, will have a more direct effect on bank lending to the private sector. The frustrated borrowers will turn to other sources for funds, or may sell assets themselves to raise funds. In either case some public sector debt will be unloaded - by the intermediaries or the frustrated borrower - to meet demands for funds. The authorities will sell less debt to the non-bank public. At the limit  $M_3$  would not be affected at all; there would just be a rearrangement of bank portfolios, including more public but less private sector debt. Our econometric research failed to find any effect of previous ceilings controls on the growth of  $M_3$ .

If bank deposit rates were held down, say by Regulation Q or by a levy on incremental interest-bearing deposits,  $M_1$  would probably grow rather faster. There is no strong reason to expect the rate of growth of  $M_1$  to be affected at all by controls on bank lending.

### 2. Directional Control

Controls on the banks' ability to bid for funds leave them free to determine how they on-lend such funds. Controls over their lending can be adjusted directionally to allocate priorities for certain forms of lending. This may sound like an advantage for controls over lending. In reality probably the reverse is true. "Priority" lending would be exploited to the full - and it will often be easy to do so, as it is impossible to trace to what use the borrowed funds have actually been put - and lent on to low priority companies needing funds. Exceptions in favour of "priority" purposes would probably do little to alter the pattern of expenditure, but could well succeed in weakening the effects of lending restrictions drastically.

### 3. Flexibility

Ceilings and Regulation Q give the banking system little flexibility to meet commitments, or unforeseen requirements for funds, though banks in difficulties could still borrow through the inter-bank market or the euro-dollar market under Regulation Q. Incremental levies allow banks to adjust to unforeseen calls on their funds, but at a rising cost.

#### 4. Compliance, Policing and Avoidance

Because of the inherent lack of flexibility of ceilings controls, it may often be difficult or impossible for banks to adhere closely to them. So some degree of non-compliance may provide a necessary element of flexibility. But how does one distinguish between occasional overshooting and deliberate flouting? If flouting appears, how will it be disciplined? If the discipline is to be severe, it may be necessary to obtain legal backing - a lengthy process. If the penalties are weak, will the ceilings be respected?

There has not, on available information, been much difficulty in obtaining compliance with Regulation Q controls in the USA, or with similar "voluntary" restrictions in Canada (e.g. the Winnipeg Agreement of 1971). To some extent observance of such a control might be self-policing (competitors would blow the whistle on offenders), but the question of how to deal with offenders when caught, within the context of a "voluntarily" negotiated scheme, would still remain. The main problem with Regulation Q in any case is not of ensuring compliance but of preventing avoidance by the issue of new types of non-deposit paper, e.g. bank-issued commercial paper, participations, etc., and by their drawing on external sources, e.g. through the euro-dollar market (which might, or might not, be desirable on balance of payments grounds). This same problem, of avoidance, would arise with levies on additional interest-bearing deposits.

Expansion is not prohibited under incremental levies; it simply involves a monetary penalty. This should make these latter schemes easier to enforce. In order to police and to monitor these incremental schemes, it is, however, desirable for their statistical basis to be straightforward and easily calculable. The simplest basis for a levy (ratio) on incremental interest-bearing deposits would be to impose it on the increase in the sum of total eligible liabilities less non-interest-bearing deposits. Both, of these totals are already identified in the statistics. Attempts to identify "wholesale" money more narrowly proved to be too complicated. Basing the levy on the increment in total eligible liabilities would lead, at present, to a double penalty on non-interest bearing deposits. Moreover banks need not bid for interest-bearing deposits, but they cannot refuse to accept additional non-interest-bearing deposits, so the wider base would not be under their own control. The total of bank lending in sterling to the UK private sector would, presumably, be the base for an incremental levy on bank lending.

#### 5. Effect on Bank Profits

A ceiling on bank lending would lead banks to bid less vigorously for funds. So under a ceiling, as under Regulation Q, margins between bank lending and deposit rates should widen. On the other hand the size of the total portfolio would be restricted. On balance profits would probably be lower, but it would be very difficult to calculate by how much.

Incremental levies make expansion costly. If in this situation banks preferred not to expand, their profit position could be the same as with ceilings. If they did expand, they would lose profits. Thus they would have more choice with incremental levies, but their profits would probably be hit more severely. This would be particularly resented in the case of levies on incremental interest-bearing deposits, since, it may be argued, these arise in part as a counterpart of the public sector fiscal deficit - not from the banks' own lending operations. The counter argument is that the banks need not have bid for the funds.



## 6. Negotiability and Speed of Introduction

Recourse to Parliament for stronger legal backing for the imposition of controls on banks would take a long time, and could have other disadvantages (e.g. such a move might have a bearing on the question of the harmonisation of banking laws within the EEC). With the growth of the number of banks in the system, it might not be possible though, to ensure compliance with ceilings - and perhaps not with Regulation Q - without legal backing. In any case, given existing commitments, it would take a lengthy period of adjustment, many months, for the banks to be able "voluntarily" to accede to any restrictive ceilings.

Incremental levies, and probably Regulation Q, should be capable of a more rapid introduction. If a tight Regulation Q were to be quickly introduced, it would, however, catch many banks with large forthcoming commitments, and would force them into the inter-bank or euro-dollar markets to cover these. Whether it would be possible to arrange a "voluntarily" negotiated incremental levy rapidly would presumably depend on the reductions in bank profits entailed. These could in some circumstances be quite large. Say that 30% of any increase in interest-bearing deposits above some given starting point was required to be paid into non-interest bearing supplementary deposits, and that the annual increase in such deposits was 15% (less than half the rate of growth during the last year), then by the end of one year about £1,000 mn. of non-interest bearing supplementary deposits would have been handed over. This would make quite a hole in bank profits. So during the negotiation of any such incremental scheme, it would almost certainly be necessary to agree to limit both the maximum size of the ratio and the manner in which the increments would continue to accumulate (see below).

## 7. Base date inequities, subsequent adjustments and Pay-Back problems

The imposition of ceilings and incremental ratios would involve base date inequities between banks, though these could be smoothed somewhat by averaging over recent observations (Regulation Q would not cause base date inequities in such acute form). Ceilings, and quite possibly incremental lending ratios, will also involve inequities between companies, with the advantage going to those companies which had made most use of their facilities at the base date.

The maximum permitted deposit rate under Regulation Q can be varied easily enough. Similarly the permitted growth of bank lending under ceiling controls can be varied from time to time without serious complication. There is, however, the embarrassing feature that those banks most in excess of the existing limits get the largest benefit when the ceilings are readjusted.

There are greater difficulties involved in adjusting incremental ratios. The longer a given base is maintained fixed, the larger the proportion of banks' business that will be forced, given the normal pressures of expansion, into the penalised incremental range.

The penalty on expansion is less the nearer the date comes for rebasing the whole incremental ratio. Meanwhile, as expansion takes place, the non-interest-bearing supplementary deposits would pile up over time; would they all, or mostly, be released on the date of rebasing? Would there be regular funding of the paid-back supplementary deposits into, say, short-dated gilts on each rebasing date? It would seem an undesirably jerky process. A better alternative would be to have a moving base. In this case a desired rate of growth of interest-bearing deposits or bank lending to the private sector would be selected (on what basis?), so that the base above which the incremental ratio would come into effect would itself be rising over time. This should avoid a massive build-up and subsequent

funding of non-interest-bearing supplementary deposits, that would occur if a base was fixed and then readjusted after a lapse of several quarters. A moving base would also lessen the profit penalty on banks and so should make the scheme more acceptable to them. An incremental ratio, on a moving base, is a somewhat complicated concept. Nevertheless the novelty and the complication of the idea might distract people's attention from the fact that it is merely an alternative way, instead of ceilings and Regulation Q, of limiting the banks' role as financial intermediaries.

#### 8. Problems of return to a competitive system

All the methods considered here limit the banks' ability to compete for business. The adoption of controls over lending, whether in the form of ceilings or incremental ratios on additional lending, makes it harder to move back at some later date to a freely competitive system again. The reason is that the fear of reimposition of lending based controls will encourage both the banks and their customers during periods of freedom to expand their lending to the utmost in order to establish a higher base in advance of the anticipated reimposition of lending based controls.

On the other hand the adoption of deposit based controls, whether Regulation Q, or incremental ratios on interest-bearing deposits should make it easier to return to a free system. If the banks fear a reimposition of such deposit based controls, they would be the less likely to expand their facilities greatly on return to freedom for fear that a return to deposit based controls would make it harder and/or more expensive subsequently to obtain the deposit funds to honour their lending commitments.

#### C. Conclusions

Four alternative techniques of direct control have been considered above, credit ceilings, incremental ratios on additional bank lending to the private sector, Regulation Q, incremental ratios on additional interest-bearing bank deposits. All these methods have a similar purpose, to prevent the banking system from undertaking additional business as intermediaries, basically with the objective of presenting more attractive looking monetary statistics, a cosmetic job. The choice between these methods depends on which allows the best face lift with the least accompanying structural damage.

Of these methods clearly the worst is a flat return to ceilings. They are inflexible, hard to negotiate, could require legal backing to ensure compliance, have an uncertain effect on  $M_3$  and make the problem of returning to a competitive system subsequently much harder. It is difficult to choose whether a form of Regulation Q or some form of incremental ratio on additional bank lending would be the less desirable. The incremental ratio on bank lending would probably be less effective in controlling  $M_3$  and might not even be effective in controlling total bank lending to the private sector if various forms of "priority" borrowing were exempted from the controls. It would also make the re-entry problem to a competitive system somewhat worse, and it is a more complicated scheme. On the other hand Regulation Q would seem to be a less flexible technique, and it might be harder for the authorities to prevent the banks avoiding the control.

On balance the least offensive of these direct controls now appears to be the levy on additional interest-bearing deposits, to take the form of a non-interest-bearing supplementary deposit. Although it may appear as a complication, the scheme would work more smoothly on a sliding base. It would represent, in effect, a more flexible version of Regulation Q. To give a concrete suggestion, as a starting point for discussion, one might take the average value of the last (two) months'

interest-bearing deposits, calculated as the total of eligible liabilities less non-interest-bearing deposits, or the latest value of this total, whichever is the higher, as the base. This base might then be allowed to rise from month to month at 1% per month. Thirty per cent, 30%, of any increment in total interest-bearing deposits above this moving base level would then have to be deposited as a supplementary deposit with the authorities.