PM has seen
Econ Pol. 2

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

25 July, 1979

cc Mr Wolfson

Prime Minister
A good letter, explaining for Mr Prior's benefit that direct controls are no substitute for high interest rates.
TL 26/7

Dear Secretary of State,

MONETARY POLICY

You raised the question at 'E' Committee recently why high interest rates were being used to control bank lending, rather than direct restrictions - in terms of either total liabilities or prescribed priorities amongst borrowers.

The short answer is that there already is a form of direct control over the growth of banks' liabilities - the Supplementary Special Deposit scheme - and there is qualitative guidance about categories of lending. To go further with more specific controls over particular types of lending would both run directly counter to our general approach to economic management, and risk damage to the structure of the financial system, without significantly affecting the availability of liquidity and credit. None of these changes would avoid the need for high interest rates until money supply had been brought under control.

Under the Supplementary Special Deposit scheme or "corset", a guideline is set for the growth of each bank's interest bearing eligible liabilities. If such liabilities exceed the guideline, the bank has to place supplementary special deposits on a progressive scale with the Bank: the effect is to increase sharply the effective cost to the bank concerned of securing additional funds for lending, once it has exceeded the guideline. An increasing number of banks are in or approaching this position: two of the clearers are already in the penalty zone.

A bank which needs to cut back on its lending because of the corset has little alternative but to raise interest rates. It can clearly do something by restricting new facilities and renewals of existing facilities, especially for the personal sector, but the effect of this is small because most of the increased lending will be in the form

/of the

The Rt. Hon. James Prior, M.P.

of the increased use of existing facilities. However once a number of banks start to raise their rates to borrowers, this spreads rapidly to other parts of the financial system as the would be customers of those banks seek alternative finance.

Indeed, one of the reasons for raising MLR in the Budget was that it was clear that if bank lending continued at its high level, the rates charged on bank lending and other market interest rates would very soon start to move upward as banks found themselves increasingly constrained by the SSD scheme. Thus it was preferable to pre-empt such an upward drift in rates, which might have looked like a vote of no confidence in our economic strategy: raising MLR last month rather than letting things drift should mean that bank lending will turn down earlier and our gilt sales would be better, both helping to bring forward the time when interest rates can be reduced.

The SSD scheme is supported by qualitative guidance from the Bank to banks, indicating both priority categories - finance for working capital and investment by manufacturing industry, exports and import saving - and ones to be restrained in the interests of priority categories - persons, property companies and purely financial transactions.

There were more specific ceilings over bank lending under the Labour governments in the late 1960s: they were running into increasing difficulties before the 1970 election, and were ended after it. The main difficulty with them was that their effect was as much to encourage finance to by-pass the controlled part of the financial system - whether through secondary banks or direct from company to company - as to control the total amount of credit in the economy. This by-passing of the banks not only led to prudential difficulties, which were one of the causes of the 1973 secondary banking crisis, but involved a degree of discrimination between the banks and their competitors which was hard to justify, and brought the system into disrepute.

But the essential point about the level of interest rates is that, as we all agree, constraint in the growth of the money supply (and so bank lending) is essential to the control of inflation: employers in the public and private sectors must realise that finance will not be available irrespective of the level of wage settlements. This involves restricting the availability of finance and, in as sophisticated and complex a financial system as ours, such restraint in the private sector can only be achieved by price - i.e. interest rates. The level of interest rates necessary to achieve the monetary target will also depend on the constraints imposed on the public sector - the size and composition of the PSBR, and particularly

/the level

the level of public expenditure. The prospect for reductions in interest rates depends very much on what we decide on the last.

Thus, we already have a form of direct control over banks' balance sheets - the Supplementary Special Deposit scheme - but this is not an alternative to increases in interest rates. Indeed it can cause them. To shift to more direct controls would risk similar unfortunate consequences to those of the Labour Government's controls in the late 1960s.

It would involve intervention of a kind which we all regard as counter-productive and it would not achieve the necessary objective of controlling the underlying monetary conditions.

I am sending copies of this letter to the Prime Minister, the other members of 'E' Committee and Sir John Hunt.

Yours sincerely,

Martin Hall

p.p (GEOFFREY HOWE)
[Approved by the Chancellor of the Exchequer and signed in his absence]

25 JUL 1979