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CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Sir D Wass
Mr Littler
Mr Middleton
Mr Ridley
Mr Riley

Chief Cashier

MONETARY POLICY

I attach a first rapid draft of the paper for Friday's meeting at No 10, which is on the lines which you discussed earlier with Mr Ridley. It requires further work on it here, including the insertion of some figures. But, given the very tight timescale, we would find it very useful to have your reactions to it at this stage, so that they can be reflected in the next version later tonight.

J.M.B.

J M BRIDGEMAN
8 November 1979

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PRIME MINISTER

MONETARY POLICY

I attach the note on possible forms of ^{control over} bank lending for which you asked. But you might find it useful if I set it in context.

2. I think that we are faced with three issues:-

i. what can we do immediately to regain control over the money supply, as quickly as possible;

ii. how can that be best presented as part of a coherent package with the roll forward of the target in the next week or so;

iii. how can we best develop the system of monetary controls.

3. The third is the most important issue in the longer term but it is not the most pressing. ^{But} ~~However, I think that it is important to remember~~ one key point, which came out in the earlier discussions on monetary base control, ^{MBC} ~~namely that it is not a method of avoiding interest rate changes, but one of generating some.~~ In an economy and monetary system which ^{are} is as sophisticated as ours, and one which ^{are} is now open with the relaxation of exchange control, the main methods ^(available open) of the

is relevant to the immediate discussion.

Government^{to} ~~affecting~~ monetary conditions ^{are} ~~has to be~~ what it does in respect of public expenditure and taxation policy, and so the PSBR, ^{what it does} in respect of interest rates, including gilt sales, and ^{has it} ~~in~~ ^{es} ~~intervention~~ policy in the foreign exchange markets. Any attempt at more direct control just ^{is} ~~leads to~~ ~~creating forms of~~ evasion either elsewhere in the uncontrolled sector of the domestic financial markets or through offshore routes. At present, changes in interest rates are partly brought about by the markets, and partly brought about by discretionary action by the authorities. A monetary base system, if it were found practicable, would generate changes in interest rates more automatically, although most people would consider that it would induce wider swings in interest rates. If ^{such a system} ~~one~~ had been operating in the last few months, it would almost certainly have led to ^{the} ~~them~~ being higher interest rates now, with even more unwelcome consequences ~~in relation to~~ ^{for} the cost of finance for industry and for the mortgage rate.

4. The attached note outlines the difficulties which would arise with most methods of trying to achieve a direct effect on bank lending. There would be a further stimulus to credit being channelled through other routes outside the banking system, in ways analogous to those which ^{have} ~~were~~ already brought the SSD scheme into disrepute. Moreover, ^{also} there is now ~~the~~ obvious avoidance route through the Euro-sterling markets. Moreover, forcing the credit into alternative routes would not alter the present upward pressure on interest rates. ^{It is} ~~It is~~

/possible

possible that something might be done to change the present general impression that credit is fairly freely available by the Governor intervening and asking the banks to be severe on ^{the} granting of renewal of a facility. I would welcome the Governor's view on this, although I would expect the effect mainly to be on the atmosphere in markets, rather than on the monetary statistics.

6. I think that the only way we are going to affect the money supply figures for banking ~~in~~ November and December significantly is through getting the gilts market moving again. One element ~~of~~ ^{has} this, ~~is~~ to be the Government reasserting its determination to control the money supply, and ^{being seen to} ~~to~~ take the necessary action to achieve this, whatever it may cost in other respects. If we rule out fiscal action, as I think we must, then we have to act on interest rates, at the very least moving MLR to confirm the move which has already taken place in market rates. I fear that anything less than a move to 16% now would be seen as the action of Canute, and call in question our resolve to adhere to our monetary targets.

7. The Governor will, I am sure, be ready to explain how the Bank would envisage that we should make the most effective use of the change in MLR to secure the necessary gilt sales over the next two months.

8. As I indicated in my minute last night, the other main elements in an announcement next Thursday ought to be the roll forward ^{to} target, and the future of the SSD scheme.

The decision on what the amount of the roll forward should be is, I think, separable from the decision on interest rates in the SSD scheme, and I would therefore suggest that we might deal with it separately later. I will put something to you on it early next week. ^{//} But, I think that it would be useful if we discussed the SSD scheme ^{by day} tomorrow. There is a good case in logic for bringing it to an end. ~~And~~ Ways round it have now become so developed that it is having little, if any, effect on either liquidity or credit. This is obvious to all informed commentators. Moreover, there is a distinct risk that if it is continued, it will encourage disintermediation into offshore banking - the Euro-sterling market. However, the Governor and I consider that there would be an adverse reaction, particularly abroad, if we were seen to take it off tout court. I therefore envisage that we should announce that it is intended to phase out the SSD scheme: we would justify that domestically by explaining that, while we accepted the scheme was no longer having a significant effect on liquidity of credit, its ending would lead to the inflation of a sterling M3 statistic as some of the flows which had avoided the corset came back to the banking system and we were retaining it to control that rate of return. The presentation would also be helped by the announcement that we were considering a monetary base scheme to come in after it, although the cognoscenti would realise that the two were not really alternatives, since the ¹ matter is essentially a method of generating the required interest rate changes.

In assessing possible ways of controlling bank lending it is useful to separate the effect on the banks, and their ability and willingness to control their advances to private sector customers, and the effects on the customers' demand for bank credit.

Banks' Ability to Control Advances

2. The ability of banks to control advances is circumscribed. The first reason for this is the general practice of granting facilities, which are then used at the customer's discretion. The overdraft system is the classic example of this, where a bank normally agrees with a customer an overdraft ceiling, which is subject to review usually annually: the customer then has a virtual contractual right to use that facility at his discretion until the time of the next review. The average utilisation of such facilities normally varies between 50% and 60%, and at present is at the top end of that range. Hence there is considerable scope for an increase in bank lending due to increased utilisation of facilities, which the banks cannot control in the short term. In recent years, there has been a progressive switch from overdraft to term loans, but here again the normal practice is to negotiate facilities, which can then be drawn down at the customer's discretion. The degree of utilisation is currently about [%].

3. The main opportunity for banks to vary the scale of their lending is therefore ^{at} the time when facilities are either

requested from them or renewed. Even this is limited in practice, because in the case of many industrial customers a bank may not be able to reduce its overdraft facility sharply without putting the customer out of business. The ability to cut back on lending is probably greater in the personal sector, where there are more personal loans for particular purposes which are being run off in accordance with a pre-determined schedule.

4. Banks can influence the use which is made of facilities already granted in only two ways, short of renegeing on a contractual obligation. The first is through the interest rate which it charges. The second is to offer an alternative source of finance, and to persuade the customer to use it rather than to draw on the facility: this may well have been happening to some extent in the recent past with the growth of acceptances, and could obviously happen in the future by offering a loan in the euro-sterling market from an overseas associate.

The Demand for Credit

5. In the long^{er} term, the authorities can affect the demand for bank credit by ~~the~~ whole range of their economic policies, whether affecting the level of activity or prices, or causing particular pressures on company liquidity: eg the increase in VAT should have had a once-for-all effect on company liquidity, which should have reduced the demand for bank lending.

More specifically, the authorities can affect the demand through interest rates, although it is clear that certain types of lending at least are not very sensitive, ^{particularly} ~~at least~~ in the short run: for example a company facing a turn down in demand for its products may have little ^{alternative} ~~opportunity~~ but to build up stocks in the short run, financing it from its bank facility, although its decision about whether to maintain those stocks thereafter or cut back in production may turn on the rate of interest. The effect of interest rates on company decisions may ^{also} be muted by the fact that interest payments are a charge against profits before tax.

6. The amount of credit which is taken by the borrower may be affected by the ease with which ^{it} can obtain facilities. But, given the sophistication of the British financial system, to the extent that some channels of credit are closed, it will usually be possible to find others - here again acceptances are a clear example at present, and euro-sterling loans could be in future. It may be harder for personal sector borrowers ^{than for companies} to find alternative sources of credit.

Alternative Methods of Control

a. Existing

7. The present monetary methods for controlling bank lending, as one of the counterparts of the money supply, are interest rates, the Supplementary Special Deposits Scheme and directional guidance. Interest rates, which are essentially

the price of credit, tend to have their effect after a substantial lag. The extent of the effect varies between types of customer, and with the financial situation in which the customer finds himself - for example the case of involuntary stockbuilding referred to above.

8. The Supplementary Special Deposits Scheme may initially have ^{had} some effect on the willingness of banks to grant ^{facilities} credit. It has also had a potential effect on interest rates, because of provisions in some medium term loan agreements which enable banks to pass on part of any penalties which they incur under the SSD scheme. However, it would appear that the banks have now found sufficient ways round the SSD scheme, eg through acceptances, for it to be having little effect on their willingness to grant credit, although in some cases ^{but credit-} it has been channelled into acceptances.

9. The directional guidance requires the banks to ^{exercise} show sufficient restraint in their lending to low priority categories, notably persons and loans to finance purely financial transactions, as is necessary to ensure that they have sufficient funds for priority lending, such as to meet the needs for working capital of manufacturing industry. The directional guidance certainly has the effect of inhibiting banks' lending to persons, particularly ^{since} since the corset has been on on previous occasions. However, it would appear to have had less effect this time, presumably because they were

confident that they could channel sufficient of the demand for credit from their other customers through the acceptances and other loopholes. The banks have nevertheless recently been taking some measures to constrain personal lending. But the increase in personal lending in recent months since the post-Budget spending boom, has been significantly less than one tenth of the total increase in bank lending outstanding. The availability of personal credit in recent months has probably been more important in affecting the general attitude that there is not a squeeze on credit, than in the absolute amount involved.

Other

b. Alternative Methods of Control

i. Controls on Banks

10. There are a range of methods of control which would seek to constrain more directly than the SSD scheme the growth of bank lending within banks' balance sheets. These include:-

- a. ceilings on bank lending, as used in the 1960s;
- b. penalties on lending over a guideline - eg a tax on the excess: this would in effect be a switch of the SSD scheme from banks' liabilities to a block of their assets;

- c. a reserve or liquidity ratio system, which would require bank lending to be matched by the holding of a proportion of the amount lent in specified assets, the total of which could be controlled by the authorities.

The problem with them all is that they would cause the banks to channel business outside the control, without affecting underlying liquidity and credit conditions, in the same way that has already happened with the SSD scheme eg through acceptances. If the scope of the control were widened to cover one loophole, for example acceptances, other channels would develop, notably the inter-company market and offshore banking, which by their very nature cannot be controlled - moreover they are potentially more dangerous than acceptances, both because their extent cannot be monitored and because of the damage to the domestic financial system.

ii. Moral Suasion

11. It would be possible for the Governor to reinforce his directional guidance, by specifically asking all British banks to exercise restraint in granting or renewing facilities. The main banks would undoubtedly comply with the letter of the request. But it would not stop disintermediation: the demand for credit would not be affected and the supply would undoubtedly be forthcoming for most customers from other sources, eg the inter-company market and offshore.

iii. Hire Purchase and Other Terms Controls

12. At present hire purchase terms controls still apply to cars and certain electrical goods, and banks are asked to match those terms when giving personal loans or overdrafts for the purchase of such goods. The controls probably still have some effect in relation to expensive goods, since finance houses prefer hire purchase contracts for them for reasons of security, and since banks usually know when a facility is being used for that purpose. But, particularly since the Consumer Credit Act, the range of forms of credit for smaller purchases has become so great - overdrafts, personal loans, bank credit cards, departmental credit cards, charge accounts and retailers credit generally - that any attempt to reimpose hire purchase terms controls on smaller goods could be readily evaded. Moreover the Department of Trade no longer have enforcement staff.

13. The amount of consumer credit other than bank lending has not been growing fast recently:

[Give figures]

Moreover, given the extent to which the banks finance house subsidiaries have been financed by acceptances recently, it is doubtful whether the tightening or extension of terms controls would have much effect on the bank lending or money supply statistics.

iv. Credit Cards

14. The money advanced on bank credit cards is within the total of bank lending to persons. It would be possible to ask them again to tighten the repayment requirements - and to abstain from further increases in credit ceilings. But it would be difficult to justify singling out this one form of personal credit (which is already relatively expensive) for special treatment.

v. Tax

15. A theoretical option for making interest rates more effective as a means of regulating demand for credit would be to tax the borrower. This could take the form of either:-

(i) disallowing interest - presumably above some base level - as a charge against profit in computing corporation tax liability;

or (ii) levying a tax on financing charges (interest etc) for consumer credit.

But both would almost certainly be complex, if they were practicable at all. It is difficult to see either being introduced very quickly, if they were thought desirable.