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PRIME MINISTER

MONETARY POLICY

.... I attach a very preliminary Treasury note on possible forms of direct control over bank lending (as distinct from Monetary Base Control, which I discuss later in this minute). We have not had time to discuss it with the Bank. You may find it useful if I set it in context.

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

(i) How can we best develop the system of monetary control?

(ii) What can we do immediately to regain control over the money supply, as quickly as possible; can we, in the short run, reduce bank lending or sell more gilts?

(iii) How can (ii) be best presented as part of a coherent package including the roll forward of the target in the next week or so?

The system of monetary control

3. This is the most important issue in the longer term. It is not the most pressing, though we may need to make some reference to the development of our thinking on this - a point which I return to below. But I should stress one key point, which came out in the earlier discussions on monetary base control. In an economy and monetary system which are as sophisticated as ours, and ones which are now open with the relaxation of exchange control, the main methods available to the Government to affect

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monetary conditions are what it does to public expenditure, taxation policy, and so the PSBR; what it does through interest rates and gilt sales; and how it intervenes in the foreign exchange markets. Any attempt at more direct control just stimulates 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 by the discretionary actions of the authorities. A monetary base system, if it were found practicable, would generate changes in interest rates more automatically and with less direct political involvement on the part of the authorities. But most people would consider that it would induce wider swings in interest rates. If such a system had been operating in the last few months, it would almost certainly have led to higher interest rates than today's.

4. The attached note on alternative methods of controlling bank lending suggests that almost any method of direct controls open to us is likely to encounter a basic difficulty. It would further stimulate the channelling of credit through other routes outside the banking system, in ways analogous to those which have already brought the SSD scheme into disrepute; all the more so because there is now the obvious additional avenue of avoidance through the Euro-sterling markets. Moreover, forcing the credit into alternative routes is apparently unlikely to alter the present upward pressure on interest rates.

What should be done in the short run?

5. It is possible that something might be gained if one could change the present general impression that credit is fairly freely available. The Governor might ask the banks to be more severe in the granting or renewal of facilities. I would welcome the Governor's view on this, although particularly at the outset I would expect the effect mainly to be on the atmosphere in markets, rather than on the monetary statistics.

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6. It seems pretty clear that the only way we are going significantly to affect the money supply figures for banking November and December is through getting the gilts market moving again. One element in this has to be the Government reasserting its determination to control the money supply, and being seen to take the necessary action to achieve this, whatever it may cost in other respects. The other has to be the Bank following this through in it gilts market oparations. On the first, if we rule out fiscal action, as I think we must, then it still seems difficult to avoid action on interest rates, at the very least moving MLR to confirm the move which has already taken place in market rates. I am strongly advised that anything less than a move to 16 per cent now would be seen as the action of Canute, and call in question our resolve to adhere to our monetary targets. The second is a matter for the Governor.

7. These are, of course, two of the key questions for discussion at our meeting later today.

The announcement next Thursday.

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

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The decision on what the amount of the roll forward should be is, I think, separable from the decision on interest rates and the SSD scheme. I would therefore suggest that we should deal with it separately later. I will put something to you on it early next week.

9. But, I think that it would be useful if we discussed the SSD scheme today. There is a good case in logic for bringing it to an end. 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. We therefore recommend announcing 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, by as much as 3 per cent over a period, as some of the flows which had avoided the corset came back into the banking system. We were therefore retaining it to control the speed at which these flows returned.

10. The presentation would also be helped by including in the Thursday statement our intention to begin consultations shortly on possible forms of the Monetary Base control scheme. The cognoscenti would realize that the SSD scheme, and any monetary base scheme practicable in the absence of exchange control, were not really alternatives. The latter is less a system of direct control, and more a method of generating the necessary changes in interest rates.

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CHANCELLOR OF THE EXCHEQUER

Conclusion

11. The conclusion to which one is driven by the best advice so far available is that controls on bank lending, or other changes in control systems, are not going to produce the immediate improvement in monetary conditions which we need. From this there follows the need to achieve substantial gilt sales, particularly before the end of banking November (21st), if at all possible, and to sustain them thereafter. This requires the Government to do what is necessary to maintain confidence in our determination to carry our policies through: that in turn means we must accept MLR of at least 16 per cent. It must then be followed by successful operations by the Bank in the gilts market to secure the maximum sales. Clearly these are the issues on which we both want to concentrate today.

12. I am sending a copy of this to the Governor.

A M Battishill

Approved by the Chancellor
and signed in his absence

(G.H.)

9 November 1979

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ALTERNATIVE METHODS OF DIRECT CONTROL OVER BANK LENDING

In assessing ways of controlling bank lending one must 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 Lending

2. The ability of banks to control lending is circumscribed particularly in the short run. 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 uncheckable increase in bank lending due to increased utilisation of facilities, which the banks/~~do~~ can nothing to prevent 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.

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. As a rule these reviews are, say, once a year, which means that the opportunities they offer for changing facilities are very limited, particularly over a period of a few weeks. The scope for change is further limited in practice, because a bank may not be able to reduce its overdraft facility to most industrial customers sharply without putting them 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 runn 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 reneging on a contractual

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obligation. The first is through the interest rate which it charges. The second is to offer an alternative source of finance, and to pursuade 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 longer term, the authorities can affect the demand for bank credit by the whole range of their economic policies with their effects on the level of activity, prices, or on company profits and liquidity. For example the increase in VAT will 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 in the short run. For example a company facing a turn down in demand for its products may have little alternative 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 on production may turn on the rate of interest. The effect of interest rates on company decisions may also be muted to the extent 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 he 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.

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Methods of Control by the Authorities

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 as already mentioned. The extent of the effect varies between types of customer, and with the financial situation in which the customer finds himself.

8. The Supplementary Special Deposits Scheme (the corset) may initially have had some effect on the willingness of banks to grant facilities. In those cases where it has bitten it has also had an 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 that credit has been channelled into acceptances. So it probably affects only individual interest rates rather than their general level.

9. The directional guidance requires the banks to exercise such restraint in their lending to low priority categories (persons, property companies and loans to finance purely financial transactions), as may be necessary to ensure that the banks have sufficient funds for priority lending, such as to meet the needs for working capital of manufacturing industry. The directional guidance seems to have restrained banks' lending to persons somewhat when the corset has been on on previous occasions. However, it would appear to have had less effect this time, presumably because the banks 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 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 increases in personal credit in recent months have probably been more important in fostering a general impression that there is not a squeeze on credit, than in adding greatly to the figures.

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b. Other 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. 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. These by their very nature cannot be controlled and moreover they are potentially more dangerous than acceptances, both because their extent cannot be monitored and because of the distortions they create in the domestic financial system.

ii. Moral Suasion

11. It might 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

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expensive goods. Finance houses prefer hire purchase contracts for them because their security is better, 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 been growing at about £100 million a month recently - much the same as last year. This is roughly 20% pa. However, 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:

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

or b. 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.