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PRIME MINISTER

NEW TECHNIQUES OF MONETARY AND CREDIT CONTROL

We agreed at your seminar on 17 April to examine further a number of proposals, discussed at the seminar, designed to reduce lending to consumers and improve the techniques of monetary control.

... I attach a paper by Treasury officials which considers these ideas in detail. I believe that there is some promising material here, and that we should now select from these measures a package which would restrain the excessive pressures on consumers to over-extend themselves in borrowing, and which would provide a modest but nevertheless useful reinforcement of our techniques of monetary control.

When you have had a chance to read the paper I would very much welcome an opportunity to go through these measures with you. This minute sets out my initial reactions.

I am attracted to a high-profile campaign - which would involve promising early new DTI legislation - against techniques of credit marketing which many people find highly offensive: banning free gifts with new credit offers, unsolicited increases in credit limits, "0" per cent finance devices; introducing more effective compulsory cooling-off periods, more stringent information requirements, and so on. These proposals are considered in paragraphs 25, 27, 35, 36 and 38 of the paper.

Such a campaign could stand on its own. But I believe it would better be combined with action to reinforce the Bank of England's hand in the money markets. I suggest that the Bank should

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activate the system of reserve requirements, the Special Deposits arrangements, which they have hitherto had as a fallback instrument of money market management. This would require all banks and building societies to place, say, ½ per cent or 1 per cent of their deposit base with the Bank of England, at market or near-market rates of interest. This would strengthen the Bank's control of short-term interest rates, and might at the same time have a useful effect on market psychology.

Would it put up interest rates? not

At the same time I think we should aim at a modest overfund of the PSDR over the coming months. This would not be a return to the open-ended overfunding which we rejected in the mid-1980s, but it could have a useful effect in tightening policy by inducing a small rise in longer-term interest rates. And, taken together with the new reserve requirements, it would enable us to reduce the Treasury Bill issue without jeopardising the Bank's tight control of conditions in the money markets.

I suggest that this overfunding should in part be achieved through a reinvigoration of National Savings. Successive years of public sector repayment, during which we have had no requirement to bring in funds through National Savings, have left the interest rates on some National Savings products very uncompetitive. I propose putting that right with a new savings certificate, a new index-linked savings certificate and a series B Capital Bond. If you agree we could get on with this immediately.

Other proposals in the paper I found less convincing:-

(a) monetary base control, and Gordon Pepper's ideas, seem to me wholly impractical in present circumstances. Although it is attractive to contemplate taking direct control over the growth of notes, coin and bankers' balances, we would have enormous difficulties in knowing what was an appropriate growth path to follow week by

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week and I am sure the consequence would be volatile and at times very high interest rates. The consequence of that would be unpredictable and uncomfortable swings in the exchange rate: it is for these reasons that no other country operates such a system;

(b) reintroducing the 'Corset', ie penal reserve requirements for banks who lend too much. The Dutch terminated their version of this last month, and we are told that they believe that these restrictions were hardly at all effective in controlling credit growth (which was subsiding anyway). Such restrictions would be less effective still in London, as lenders would quickly find many devices for removing lending from their balance sheets - either through the offshore route, through securitisation of mortgages, or through other forms of disintermediation. Some of these devices are explained in paragraph 13 of the paper and I am persuaded that we would gain nothing by going down this route;

(c) direct credit controls, ie controls on the terms of instalment credit, minimum repayment terms for credit cards etc; and a ban on all forms of credit advertising. Measures of this kind would probably be quite effective, at least for a period: I believe more so than controls of the 'Corset' variety. But they are too interfering and their impact would be much too concentrated on certain vulnerable industries; moreover, such a move would run directly counter to our policy for the last decade;

(d) nor am I attracted to the tax measures most likely to restrain credit growth - restricting mortgage interest relief or introducing a consumer credit tax. The other

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tax measures listed in the paper would be unlikely to be very effective in holding back lending.

I have considered whether it would be worthwhile to finance a major advertising campaign in favour of saving, of the kind which Maurice Saatchi has proposed in a letter to you. We have thought hard about this, but my conclusion is that we ought to leave this to the banks and building societies who will have a great deal of advertising to do anyway to launch their new post-Budget products.

Presentation

If these changes are to have the maximum impact on markets and the public, we need to find a very positive way of presenting them.

The best way of achieving this might be to link them with our entry to the ERM since reserve requirements are a technique of control which is widely used in EMS countries. This would give us cover for the call for reserve assets which might otherwise be represented both as the adoption of Opposition policies and as an inadequate response to the monetary situation.

May we discuss? Yes

John M.

[J.M]

17 May 1990

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Monetary Policy and Credit

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Monetary Policy and Credit

Note by Treasury Officials

At the Prime Minister's seminar on 17 April Treasury officials were asked to examine a number of proposals, discussed at the seminar, designed to reduce lending to consumers and improve the techniques of monetary control.

I. FACTUAL BACKGROUND

(a) Consumer credit growth

2. Annex 1 present some of the factual background to recent consumer credit growth. Bank and building society lending grew rapidly from 1986 to autumn 1988, when it peaked at an annual growth rate of nearly 25 per cent. Since then, following the sharp rise in interest rates the rate of growth has fallen back somewhat. But lending is still growing at around 20 per cent a year (see Chart 1 at Annex 1). In 1989-90 the increase in lending came to some £89 billion.

3. Lending for consumer purposes represents a relatively small part of this: of this total, lending for consumption came to only £5 billion, a figure dwarfed by lending to companies of £52 billion and lending for house purchase of £31 billion. In fact, total recorded lending for consumer purposes from all institutions amounted to less than £6 billion.

4. Nevertheless, although total consumer credit growth slowed through 1989, it remains substantial and has shown some signs of picking up in the first quarter of this year. Detailed figures are given in Annex 1. But the annex also shows that in fact consumer credit growth (ie HP, credit card etc lending) is dwarfed by the growth in housing equity withdrawal, a good deal of which is effectively consumer credit. 'Equity withdrawal' means realising some of the wealth which people have locked up in their ownership of their homes. Most equity withdrawal occurs when

houses which have been inherited are sold, or on a move out of owner occupation. The rest takes the form of borrowing on mortgage terms in excess of what is needed for house purchase.

(b) **Consumer credit default**

5. Annex 2 suggests that consumer credit default, like mortgage default, is at a low level, has fallen in recent years, but is showing some signs of rising in the most recent past. This has led the supervisors in recent months to warn institutions about some of the riskier kinds of lending. Nevertheless, beyond this, they do not believe that, on prudential grounds, any general action is required at the present time to restrain the growth of lending.

II. ADMINISTRATIVE RESTRAINTS ON CREDIT GROWTH

Introduction

6. Credit controls were much used throughout the post-war period right up until the early 1980s. Their focus was mainly on borrowing for "non-priority" purposes, the intention being to prevent pressure on the balance of payments and to release resources for investment.

7. By the time credit controls were abolished lenders and borrowers were adopting a wide range of measures to circumvent them, so that the true extent of monetary and credit growth was increasingly going unmeasured by official statistics. Abolition itself gave a new impetus to competition, innovation and investment in the financial sector, and has been an important element both in the expansion of demand for credit and in the parallel growth of personal sector financial assets. Banks and building societies have made heavy investments in recent years to encourage activity on both sides of the personal sector's balance sheet, ie in both borrowing and saving.

8. The increase in the demand for credit has put considerable strain on the principal instrument of monetary control - short term interest rates. It seems to have been necessary to maintain a tighter monetary stance in order to achieve a given level of restraint on the growth of money and credit.

9. The first part of this paper considers what administrative methods might be available, in the absence of a further rise in interest rates, to curb the growth of consumer borrowing, in order to reduce inflationary pressures in the economy and at the same time to protect consumers from excessive selling pressures from lenders.

10. The main measures fall into three categories:-

(a) restraints on credit;

(b) restrictions on credit marketing;

and (c) measures to prevent equity extraction for consumer purposes from mortgage lending.

Also listed are a range of more minor measures.

(a) **Restraints on credit: (i) Controlling the growth of banks' and building societies' balance sheets**

11. Such controls would operate at the level of the lending institution. The fiercest form of ceiling would be a freeze on all new lending. The purpose of such a measure might be to achieve a dramatic impact effect, rather than to find a valid longer-term instrument of monetary control.

12. The measure would require legislation but, given its temporary character, could be pretty crude. It would establish a permitted level for the lending, to persons and companies, of the affected institutions, to take effect after a defined short period from the date of enactment, and it would specify penalties for breach. The institutions would certainly need to include building societies as well as banks; other lenders - retailers, specialist mortgage institutions - would probably have to be covered as well. The adjustment period should be not less than three months nor more than six. Lending would need to be defined fairly broadly, so as to include instruments such as acceptances and - now that there is no exchange control - transactions denominated in other currencies as well as those in sterling. The permitted level would necessarily relate to an immediately historic base period. The penalty might be a requirement to make a non-interest-bearing deposit with the Bank, equal to the amount of any breach, and held for a month.

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13. A measure of this sort could not be anything but a short-term, stop-gap inhibitor of business. The means of circumventing it are numerous and ample, most obviously by booking transactions offshore, by shifting lending off balance-sheet, by securitising mortgages, and by other devices. Borrowers, for example, might find that their access to funds would be unchanged, but that the fine print of the loan documentation would reveal that the lender was eg Barclays S.A (France) rather than Barclays plc. Banks would have an incentive, as they did before the abolition of the 'Corset', to introduce lenders to borrowers direct, so that the transaction would not appear on the banks' balance-sheets. Mortgages would be stripped out of building societies' loan books, bundled together and floated off as free-standing companies; such securitisation is a well-established technique in the United States awaiting its market opportunity in London. Overseas banks looking to add a slice of UK mortgages to their loan books are already negotiating with building societies to transfer these mortgages but to continue to manage them for a fee, enabling the building societies to spread the overheads on their extensive investment in computers. Restrictions on the growth of bank and building society lending would create a new market opportunity for this kind of business - which would make the restrictions ineffective.

14. It might therefore be best to set at the outset a narrowly-defined period for the existence of the scheme, perhaps for it to bite only once, eg six months after introduction. The recent Dutch experiment, described in Annex 3, provides a precedent.

15. At the other extreme we could seek to curb lending by persuasion alone, indicating to the banks and building societies a desired or guideline rate of increase in their lending. It seems very unlikely in today's markets that this would have much impact on credit growth, unless backed by the threat of effective sanctions - which we do not believe are available.

16. In between these options, but requiring legislation, it would be possible to require banks and building societies to contain their lending to individuals within a given percentage increase over a future reference period subject to penalty arrangements. The penalty might, again, be a requirement to make a non-interest-bearing deposit with the Bank perhaps equal to the amount of any breach, and held for a month. This would be similar to the 'Corset' which was abolished in 1980, and is considered further as a reserve requirement in paragraph 79 below.

Restraints on credit: (ii) Terms controls on instalment credit

17. It would also be possible to reintroduce direct controls on consumer lending. Minimum monthly repayments and downpayments could be required on all credit card, hire purchase, and other consumer credit transactions. Minimum monthly repayments could be extended to consumer loans from banks and building societies. This would arguably be the most transparent of the options and would require primary legislation. In today's circumstances the controls would look similar to those operated by previous governments, and finally abolished in 1982. A stringent approach might require a 50 per cent downpayment and a maximum 2 year repayment period.

Restraints on credit: (iii) Minimum repayment terms for credit cards

18. A more limited form of direct controls on lending would be to introduce minimum repayment terms for credit cards alone. Until 1980, a minimum monthly repayment of outstanding credit card debt was required, of whichever was the greater of 15 per cent of the debt or £6. Since then, the minimum repayment has been a matter entirely for the lender's discretion, but in most cases is the greater of 5 per cent or £5. The question to be addressed is whether the restoration of more demanding repayment terms - eg to 15 per cent - could make a useful contribution towards slowing the growth of credit and of consumer spending.

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19. Systematic information on the use of credit cards is hard to find. The CSO series for card credit supplied by banks currently records outstanding debt at about £7 billion. Credit provided through store cards was measured by the MMC in 1987 at £1.4 billion. Of bank-supplied credit, it is estimated that over one half of newly-incurred debt is paid off in full without becoming subject to extended credit terms. That means that something like one-third of the stock of credit outstanding will not be affected by any minimum repayment requirement. If the same proportions apply to store card credit, then the total amount of extended term credit currently outstanding is probably between £5 billion and £6 billion; some of it is paid off much more quickly than is required by the present minimum repayment. This figure may be compared with total bank lending for consumption of about £40 billion, and total lending to the personal sector by M4 institutions of about £320 billion.

20. It is not possible, without a good deal of guesswork to calculate what would be the effect of imposing a minimum repayment percentage of 15 per cent. At most some £300-400 million per month might be involved, progressively reducing until a new 'steady state' was reached.

21. This is accordingly not a measure that could on its own carry much weight as an instrument of adjustment. It might have a part in a package designed to give a sharp jolt to consumer expectations. The question would arise by what authority the requirement would be imposed. Formerly, it existed as a 'request' from the Bank of England, but that would probably no longer be effective, given the more competitive environment and, in particular, the growth of store cards. Primary legislation would therefore probably be required.

22. All these restraints on term or card credit would be likely to lead to a greatly increased reliance on overdraft finance, which could not be controlled by any analogous mechanism.

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23. Generally, one response to this leakage and the leakages described earlier in this paper would be to tolerate them, in the knowledge that a good deal of lending would nevertheless be affected by the restraints. If the intention in reintroducing these controls was to do so, on a temporary basis only, in order to administer a shock to expectations, it would, arguably, not greatly matter if such leakages began to develop. Other countries which have operated similar controls have taken that view. Certainly, the measures which would be needed to control the leakages - such as making loans from offshore bodies unenforceable in the courts - would be draconian. It is for consideration whether legislating to make such loans unenforceable would be sustainable, in Parliament or in the courts; and whether such legislation would fall foul of the EC Capital Movements Directive.

(b) **restrictions on consumer credit marketing; (i) Jack Report**

24. New controls on credit advertising, summarised in Annex 4, were introduced on 1 February. Further, the Code of Practice to be drawn up by the banks and building societies following the Jack Report on banking services is expected to contain provisions encouraging banks to exercise more restraint in their marketing and in particular not to pass confidential information about their customers to their marketing departments without a customer's consent. The Code is also expected to include a requirement that banks and building societies should make additional checks to ensure that material is not sent to minors inadvertently. Lenders seem to be taking both issues seriously following the Chancellor's warning remarks in the Budget Speech.

(ii) **Further measures**

25. It would be possible to build further on these developments as follows:-

(i) Consideration could be given to outright bans on marketing some or all types of credit, for a given period. This would certainly require primary, and highly controversial, legislation.

(ii) Certain methods of credit marketing could be made illegal - for example the offer of free gifts associated with the issue or use of credit cards or the extension of new lines of consumer credit; or the unsolicited offer of higher credit limits on credit cards.

(iii) Compulsory cooling-off periods could be introduced, so that a given interval would be required to elapse between a credit proposal or request, and signature of the credit agreement or loan. The interval might vary according to the amount of credit or the type of transaction. Given that much consumer credit default arises from "impulse" buying, this could be presented as consumer protection. Primary legislation would probably be required if a voluntary scheme could not be negotiated

(iv) Other methods of credit marketing could also be banned: the "0 per cent credit" device could, for example, be banned by a requirement that the interest rate charged could not be less than say 2 per cent below base rate. Such a move should have a useful effect in reducing prices charged for goods.

Benefit to RPI.

(v) Banks have at present a defence under the law if they inadvertently send credit marketing material to minors. This defence could be further weakened, by strengthening section 50 of the Consumer Credit Act.

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(iii) Information requirements

26. More limited measures might be focused on the information which the lender could be required to provide to the potential borrower at the point of sale. The main purpose would be to make clearer to borrowers the full implications and risks of their actions, before they committed themselves to particular deals.

27. There are a variety of improvements which might be made through further revisions to the advertising regulations. For example:-

(i) In the case of variable rate lending (ie not normally HP or most consumer credit) lenders might be required to make clear how repayments would be affected by given changes in interest rates (or other aspects of the repayment terms);

(ii) lenders might be required to provide potential borrowers with full documentation (their rights under the Consumer Credit Act, etc) in relation to instalment agreements before the start of any cooling-off period;

(iii) part of implementing (i) above might be that the precise relationship of interest rates to amounts borrowed could be required to be expressed in cash terms as well as in terms of the APR, which few people seem to understand.

(c) mortgages: restricting equity withdrawal for consumer credit

28. Equity withdrawal from housing has become an important source of finance for personal spending. It is defined and measured (but only roughly) as the excess of loans for house purchase over the value of sales of new and existing houses. It represents good value for money for borrowers because interest rates are lower compared with those on unsecured lending. The figures in Annex 1 suggest that total equity withdrawal may have been more than three times larger than the increase in consumer

credit outstanding in 1989. About three-quarters of this, however, reflects "last-time sellers" exiting from the market through death, emigration, divorce or a move to renting. Although inheritance and other exits from owner-occupation or private renting can give rise to increased consumption, equity withdrawal might arguably be defined as only covering re-mortgaging loans on houses that have appreciated, or over-mortgaging on trading up to a new house. Equity withdrawal in this narrow sense was probably less than one-quarter of the total amount of wider equity withdrawal as measured by the Bank in 1989. However, such withdrawal would probably still be getting on for half the growth of consumer credit outstanding in 1989.

29. Re-mortgaging and over-mortgaging used to be constrained by mortgage lending guidance rules issued by the Treasury and Bank. The guidance was abandoned because it was becoming unsustainable without legislation in the face of increased competition, the ending of the building societies' cartel, which had made gentlemen's agreements between societies feasible, and the absurdity of refusing banks and building societies access to the best security for their consumer lending.

30. It might be possible to prohibit loans secured on residential property for purposes other than house purchase, repairs or (perhaps) improvements, with remortgaging limited to advancing exactly the same amount as repaid. But this would be an odd change to make on prudential grounds: it would oblige banks and building societies to lend unsecured, ie more riskily. It might, too, be difficult to achieve in practice, given that most mortgage deeds provide the lender with security for any debts to him the debtor may have, whether or not they are mentioned in the mortgage deed. Finally, there would be some serious practical problems in this approach, which the following paragraphs explore.

31. If home improvements were allowed to be financed on mortgages, penalties would be needed to require lenders to check that repairs and improvements were actually carried out to the value of the amounts advanced for that purpose. Exceptions would

presumably have to be made for small businesses where the owners often use their houses as security, for parents who wish to extract some of their wealth locked up in their homes to finance their children's education, and for the elderly, raising money to live on in their retirement. It would be impractical (and perhaps undesirable) to prevent first-time borrowers in particular taking out more than they "needed" for the purchase of a new house. Double invoicing avoidance techniques would abound in building contracts on both new houses and home improvements, and special measures might be required to deal with these.

32. There would also have to be rules to prevent borrowers from raising the funds offshore (eg through the subsidiaries which many banks and building societies have recently established in the Channel Islands). The implications for our obligations under the EC Capital Movements Directive would also need to be checked carefully. If home improvements were caught, the effects on the building industry would also have to be carefully considered.

33. The broad conclusion on equity withdrawal is that it would be impossible to make the restrictions waterproof; they would quickly leak and it would be very disagreeable to prevent them doing so. Any new constraints on equity withdrawal would need to have legal backing if they were to be reasonably effective and equitable. Moral pressure on the banks and building societies could dampen the scale of lending in the short term, but in the longer term would simply shift the business back to other and in some cases less reputable lenders. Legislation would be needed to ensure that all lenders were covered.

(d) **Minor Measures**

34. There is also a range of other, more minor, possible consumer credit restraint measures which might be considered.

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(i) **Repayment insurance**

35. It might be made compulsory to offer insurance against contingencies such as sickness, unemployment etc in association with an offer of credit. This could be presented as a form of consumer protection, and primary legislation would be required. However, it is clear that the insurance policies which are typically offered with credit carry extremely high charges. There might also be a case for simultaneously referring these practices to the OFT.

(ii) **Extortionate credit terms**

36. The Consumer Credit Act allows agreements to be reopened if the terms of a loan are alleged to be extortionate, but only at the instigation of the borrower. This rather limited power has resulted in very few cases being brought. If powers were given to the OFT to instigate proceedings in cases of alleged extortion, that could have a greater effect. Fresh primary legislation would be needed.

(iii) **Information between Creditors**

37. There is scope for greater exchange of information between lenders, to help them discriminate more effectively between applicants for credit. On the other hand, a balance must be struck with the requirements of the Data Protection Act and the sensitivities many people feel about use of confidential information. Very careful consideration would need to be given before any extension to the current limits could be contemplated.

(iv) **Education and Advice**

38. Annex 5 provides a number of suggestions for longer-term measures to improve the information and advice available to consumers, and to increase awareness of the problems of over-indebtedness. These would have presentational as well as

intrinsic advantages, and would build on the report of the Finance Houses Association's Money Advice Working Party, which contains proposals for an industry contribution to the education process.

III. TAX CHANGES DESIGNED TO REDUCE CREDIT GROWTH

39. In principle, it would be possible to use the tax system to raise the cost of credit and thus restrain its growth. The following paragraphs outline some options.

40. Option A would be to limit mortgage interest relief, most obviously by restricting it to the basic rate. That would raise the cost of borrowing for about 1¼ million mortgage payers, and yield about £500 million a year. But the objections are extremely well known.

41. Option B would be to impose a consumer credit tax. Ministers considered this exhaustively before the Budget. It was ruled out for four main reasons:

- to be effective, it would have to apply to mortgage lending
- it would in practice be difficult to distinguish between lending to consumers and lending to small businesses
- it could penalise UK lenders relative to their overseas competitors, and so drive business offshore, and
- it could not be implemented until January 1992 at the earliest.

42. Option C would be to extend national insurance contributions (NICs) to subsidised mortgages. There are over a quarter of a million of these. The simplest course would be to apply only employers' NICs, and so raise the cost to employers of lending to their employees. (Many of the employees who have subsidised mortgages are above the upper earnings limit for NICs, and so would be unaffected even if their mortgages were in principle subject to employee NICs.) The yield would be up to £50 million a year, mostly from financial institutions. The change would

require social security legislation, and the next available Bill is likely to be next year. It is unlikely that revenue could be collected before April 1993.

43. Option D would be to tighten the rules for tax relief on non-sovereign bad debts, by disallowing relief on doubtful debts. This would reduce the capital which the banks have available to support an increase in lending, and so make them less aggressive in expanding their balance sheets by lending more.

44. The British direct tax system gives relief on bad <u>and doubtful</u> debts, whereas some other tax systems are less lenient: eg the Americans normally give relief only on bad debts. In principle, we could disallow relief on doubtful debts, either for banks and building societies alone, or for traders who extend credit as well. We have considered this proposal in the past, but decided not to pursue it (and the 1990 Budget included a measure, which was widely welcomed, making the VAT treatment of bad debts more lenient). Among the reasons were these:

- it would probably not make much difference to lending, because the relief at stake is not worth a great deal: writes-offs on non-sovereign debt amount to only about 1 per cent of bank and building society lending.

- relief on doubtful debts affects only the <u>timing</u> of tax payments, not the ultimate amounts: the lenders would get the tax relief when the debt proved to be bad - ie later.

- any legislation might make the banks more reluctant to lend to small businesses, and indeed have more effect on businesses than consumers.

- to have the biggest chance of having a significant effect, any restriction would have to be retrospective, applying to existing loans.

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45. Option E would be to go further and disallow relief not only on doubtful but also on bad non-sovereign debts. But this would mean taxing firms, including banks, on profits they simply do not have; or discriminating specifically against banks, if that is what Ministers wanted, and if it could be done.

46. Option F would be to tighten further the rules for tax relief on sovereign debt. We have just had a thorough review of these, and the Chancellor announced the conclusions in the Budget. To make a radical departure so soon after that could leave the Government open to accusations of bad faith; and might make little difference to the cost of non-sovereign lending. But Ministers could, if they wish, consider changing the precise phasing rules, to make them less generous, either as a Committee Stage amendment in this year's Finance Bill or in the run-up to the next Budget.

47. There are of course variants of all these options. We should be happy to provide further advice, in consultation with the Inland Revenue, on any which Ministers would like to pursue further.

48. All of them would be candidates for a Finance Bill, except for the option of extending NICs to subsidised mortgages: that would require primary legislation from the DSS.

49. As to timing, it would now be difficult, though not impossible, to make significant changes in time for <u>this</u> year's Finance Bill. But if Ministers saw attraction in this, it might be possible to announce this summer an intention to act in next year's Finance Bill.

50. In addition to options designed to raise the cost of credit, there may be a case for simply raising more revenue from the banks and other financial institutions. To act in mid-year would risk giving the appearance of introducing a mini Budget, increasing the tax yield; an alternative would be for Ministers to look again at the options before the next Budget.

51. The principal problem here is that the two most obvious options are to all intents and purposes blocked off.

52. First, to impose an effective value-added-tax on financial transactions would be illegal under EC law, even if a way could be found to do it.

53. Second, to impose a special tax on bank profits would require the Government to find a way round the clear undertaking given by Mr Lawson in 1981, when there was a similar tax on banks' balances: "I gladly repeat the categorical assurance that this is a once-for-all tax. As such, it follows that it will not be repeated, not merely in this form but in some slightly altered form. It is genuinely a once-for-all tax."

IV. IMPROVING THE TECHNIQUES OF MONETARY CONTROL

54. There are currently a number of proposals by outside commentators for improving the techniques of monetary control:-

(a) introducing monetary base control (a proposal recently revived by Professor Gordon Pepper);

(b) introducing reserve asset ratios for banks and building societies;

(c) overfunding.

55. Quite separately, there is a case to be made for altering the balance of funding policy to permit a reinvigoration of National Savings, which could have a useful effect on attitudes to saving; or, put another way, if the public perception of National Savings becomes even more negative than it is now avoidable damage could be done to attitudes to saving.

(a) Monetary base control

56. The monetary base is defined as the total monetary liabilities of the monetary authorities themselves. It is of special importance because not only are these liabilities capital certain and absolutely liquid but they are also entirely free of default since the monetary authorities could, if necessary, rely on the taxing power to honour these liabilities if the need arose. The monetary base is sometimes called the "high powered money" of the system. In the UK, these liabilities consist of

- notes and coin; about £17¼ billion

- bankers' balances at the Bank of England; about £150-200 million.

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57. Monetary base control (MBC) schemes of monetary control make use of the fact that the authorities should, in principle, have absolute control over the growth of their own monetary liabilities. If, for example, these liabilities were deemed to be growing too quickly and the Government was in budget surplus, it could use part of that surplus to buy back its monetary liabilities. Even if it were in deficit, it could sell non-base money debt - gilts or Treasury bills to the rest of the economy - receiving payment in cash or bringing about a fall in bankers' balances at the Bank.

58. In considering how this can be used to control monetary growth in general, it is useful to distinguish between mandatory and non-mandatory versions of MBC.

(i) Mandatory Monetary Base Control

59. In a modern economy most money consists of deposits with the banking system rather than public sector liabilities, such as notes and coin. Deposits with banks and building societies currently stand at about £430 billion, many times the monetary authorities' liabilities. Under mandatory MBC, banks and building societies (and any other deposit-taking institution) would be required to hold a fixed proportion of their deposit liabilities in the form of base assets - notes and coin or balances at the Bank of England. This would in effect be a form of non-interest bearing reserve asset requirement It would be a requirement made for monetary policy and not for prudential reasons, and would thus be quite separate from the requirement currently in force in the UK and all OECD countries that banks must hold, for prudential reasons, a minimum proportion of their assets in rock-solid form (cash, gilts, Treasury bills etc).

60. Since the authorities would control the growth rates of the monetary base, the fixed proportions required by mandatory MBC would limit the growth of banking system deposits to the same rate. If the banking system, as a whole, wished to expand its deposits at a faster rate, it would come up against an

insufficency of base assets to allow it to meet its requirements. It would then have no alternative but to bid less aggressively for deposits, reducing deposit rates offered. It would correspondingly have less funds available for on-lending.

61. The difficulty with a rigorous mandatory scheme of this kind is the incentive it sets up for financial institutions to evade the onerous non-interest bearing requirements placed upon them. Experience of the Corset operating in the 1970s yielded a rich variety of domestic manoeuvres which the banks were able to utilise to continue to conduct their business whilst not formally increasing their deposits (and thus attracting penalties under the Corset). Since the abolition of exchange controls, a new set of evasion opportunities has become available. Banks could arrange for their deposits and lending to take place in the euromarkets, outside the scope of the mandatory MBC scheme. Some of their business might be diverted to foreign banks in these markets. Recognising this scope for evasion, Gordon Pepper, who was a leading advocate of a mandatory scheme in the early 1980s, now recommends against such a system because of the distortions it would bring.

(ii) Non-mandatory Monetary Base Control

62. Non-mandatory systems of MBC rely on the fact that it is in a prudent banker's commercial self-interest to ensure that he has adequate holdings of base assets in relation to his deposits. Depositors are generally happy to hold their money with banks only on condition that the banks are able to honour their liabilities, returning them without question in the form of notes or coin of the realm, if they were requested to do so. A bank which was suspected of not being able to return deposits placed with it on demand would quickly lose its depositors, and risk failure.

63. Consequently, even without a mandatory requirement, banks will have a natural appetite (but an appetite of an uncertain size) for base assets. If base assets in total are constrained, that will therefore act as a deterrent to the growth of bank

deposits as a whole. In practice, the mechanism will operate through the interbank deposit market. A bank which is short of base assets can bid deposits away from another bank. The bank gaining deposits will find its balances at the Bank of England increased (part of the monetary base) whilst the bank losing deposits would have its balances at the Bank of England reduced. But as banks compete to increase their deposits at the Bank of England in this way, interbank interest rates will be bid up. That, in turn, will mean banks can on-lend profitably only at higher rates and the volume of lending will thus decline, because of its higher price to the customer.

64. Several comments can be made about this system of control:

(a) there is unlikely to be any precise relationship between banks' desired balances at the Bank of England and the rise in the size of their balance sheets. So at the best controlling the monetary base is only likely to affect broader monetary growth over the medium term. In the shorter term, there could be significant variations in broad money, even with a constant monetary base*;

(b) we would not know how much extra base money the new system was causing banks to hold for prudential reasons. So there would be a period during which we would face a new dimension of uncertainty in the interpretation of Mo growth;

(c) as set out above, the monetary control mechanism operates entirely through interest rates. That is what governs the demand for credit and thus the extent that banks can create money by bidding profitably for

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* During the debates on monetary control at the beginning of the 1980s, Karl Brunner - a leading advocate of non-mandatory MBC - suggested that it was reasonable to expect a good correlation between broad monetary growth and the monetary base over years or decades but not over shorter periods.

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deposits. By controlling the monetary base, the authorities push interest rates to higher or lower levels depending on how tightly they restrict it. But it is not clear why, in principle, this approach should give a better outcome than choosing the appropriate interest rate and then supplying the necessary base assets to bring that interest rate about. In fact, purely for reasons of operational convenience, monetary authorities generally prefer the second approach. The Federal Reserve experimented with non-mandatory MBC for a period between 1979-1982 but has since reverted to its earlier practice;

(d) monetary base control would be likely to lead to a considerable increase in the volatility of interest rates. This could make exchange rate management very difficult or impossible. The demand for money varies sharply at different times of the year and the authorities' skill at removing these seasonal influences from the figures is limited. Errors in the permitted seasonal adjustments for money supply growth lead to sharp rise and falls in short interest rates;

(e) the ultimate discipline in the system depends on allowing a bank which has expanded imprudently quickly in relation to the total monetary base available to go into default. If the authorities were prepared to bail out such a bank by supplying base assets to it when no one else would - acting as lender of last resort - then they would lose control of the monetary base. If banks know that, in extremis, they could always force the authorities to give them base assets when required, then the force of the control system would be seriously impaired.

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(iii) Professor Pepper's Proposal

65. Gordon Pepper has recently proposed a related scheme of monetary control.* In fact, the proposal itself is for non-mandatory MBC, straightforwardly. This is set out on p58:

> "The proposal is, therefore very simple, but the effect is a little more complicated. If the Bank were to control the total of its assets, it would also control the total of its liabilities. Its main liabilities are notes in circulation with the public banks' vault cash and bankers' deposits. These liabilities comprise 'high-powered money' on which the liquidity of the monetary system ultimately depends. If the Bank were to control the size of its balance sheet, it would control the supply of high-powered money. The control of high-powered money would in turn restrict banks' ability to supply bank deposits, ie. it would ultimately control the supply of money."

66. The main point about Professor Pepper's monograph, however, is that he disputes that non-mandatory MBC is just another way of setting interest rates and so exercising monetary control in that way. He argues that restricting the monetary base would exercise some further restraint on broader monetary growth beyond its impact in raising interest rates. Consequently, it would, in his view, be more effective in controlling monetary growth at lower interest rates.

67. The mechanism he envisages is set out on pp62-67 of the monograph:

(a) as the Bank of England restricted the supply of base assets, interest rates would be bid up, as set out earlier. Nevertheless, there would be further effects;

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* G.Pepper: "Money, Credit and Inflation: An Historical Indictment of UK Monetary Policy and a Proposal for Change" IEA Research Monograph 44. April 1990.

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(b) some banks would remain short of the base assets they would really like to hold even at the higher interest rates. Pepper suggests that decision-taking inertia is the reason why price (interest rates) does not, as it were, clear the market completely;

(c) reacting to these shortages, the banks concerned will try to eliminate them by selling their investments - principally gilt-edged stock - to non-banks;

(d) the non-banks will pay for these gilts by drawing down their bank deposits, thus reducing the money stock.

68. Prima facie, it seems reasonable that banks might behave in the way Pepper suggests, if base assets were restricted. Selling gilts could be one way an individual bank <u>could</u> try to restore its holding of base assets (though there is no way of knowing in advance if banks <u>would</u> react in this way). But the main doubt must be as to the practical importance of any such effects. Banks' holdings of gilts in total amount to less than £5½ billion, whilst building societies hold a further £4 billion. Even if all of these gilts were sold off in response to base asset pressure, and that must surely be implausible, they would amount to only about 2 per cent of the current level of M4 (around £450 billion). With M4 growing at about 17-18 per cent a year, a once-and-for-all decline in the growth rate of less than 2 per cent would be close to negligible. At the same time the sales of gilts - likely to be mainly short gilts - <u>would</u> raise interest rates.

(b) **Introducing reserve asset ratios**

69. Reserve requirements come in a variety of forms. Some bear interest, some not. Some remain almost permanently at a fixed rate of call, others are frequently varied. Some are based on a simple sum of banks' deposits, others apply different weightings depending on the category (eg the maturity) of the deposits. A

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table summarising different reserve requirements in OECD countries was recently published by the Bundesbank and is attached as Annex 6.

70. There is an even greater variety of understanding about what reserve requirements can contribute to the conduct of monetary policy. The principal division of view concerns whether they serve simply as a means of managing interest rates, or whether they can enforce non-price rationing of credit and thereby provide an alternative instrument to interest rates.

(i) Managing interest rates

71. In order to maintain effective control over market interest rates, central banks must ensure that there is regularly a shortage of funds in the money market. Market participants are then obliged to pay the rate that the central bank sets on the money it provides, and market rates are influenced accordingly. There are two basic techniques for creating market shortages. One is by pre-emptive sale of debt, eg at the weekly auction of Treasury Bills, on a sufficient scale to absorb more than the prospective cash flow of the subscribers. The other is to make a call for the obligatory placing of deposits with the central bank by the commercial banks. It is common ground that compulsory reserve requirements can serve this purpose of assisting interest rate management.

72. In countries with relatively undeveloped financial markets, the choice between the two techniques may effectively be determined by their lack of capacity to absorb the necessary pre-emptive sales of debt. Countries with better developed markets tend to prefer the option that gives them of using the market-based technique. But there can nevertheless be circumstances in which compulsory reserve requirements could better meet the immediate objective of policy - and that is when the central bank is seeking to resist upward pressures on interest rates in the market. It needs at such times to be liberal in supplying funds to the market at its existing rate structure, and

cannot create the necessary shortages by selling additional Treasury Bills because that would simply drive up interest rates in that area of the money market. The calling of compulsory reserves avoids that problem, and the arrangements for doing so exist in the UK in the form of Special Deposits.

73. It should be noted that the creation of market shortage is achieved equally effectively whether the compulsory reserves earn interest or not. But if the policy objective is to hold interest rates down, calling for non-interest-bearing reserves would be counter-productive. That is because banks will seek to widen the margin they earn on their income-producing assets in order to compensate for the proportion that has ceased to earn income. An additional 'wedge' will be inserted between wholesale money market rates and the rates at which they lend to their customers, and the latter will be pushed up. Special Deposits are interest-bearing, and therefore avoid that adverse consequence.

(ii) Restraining credit

74. Some have argued that the 'tax' on financial intermediation attributable to non-interest-bearing reserve requirements could have a useful part to play in restraining credit growth. So it could (provided it were not too easily escaped by diverting flows through other channels where the 'tax' did not apply). But the way in which the restraint would bite would be by raising the rate of interest paid by borrowers. It is not an alternative instrument to interest rates, but a way of influencing them.

75. There is nevertheless a school of thought which claims that reserve requirements can work in such a way as to contribute an element of non-price rationing in the supply of credit. The difficulty is to pin down how the mechanism is supposed to work. The Bundesbank, for example, appears to be officially committed to the view that such an effect exists, but its attempted explanation of it is incomprehensible.

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76. The essential point is that reserves for the banks can come into existence only if the central bank supplies them. If the central bank provides in full the amount of the obligation it has imposed on the banks, then there is no reason for their credit-supplying behaviour to change. If it is grudging in its supply, then the banks will scramble among themselves to obtain what is available, and hid up the price, ie interest rates. There is no doubt that reserve requirements can be a powerful factor in influencing interest rates, but no mechanism for them to enforce non-price rationing of credit has been identified.

77. There may, nevertheless, be a case for introducing reserve requirements, or special deposits, as a means for underlining the firmness of the authorities' resolve to manage interest rates, to ensure that there are money market shortages in the months to come, and to permit a reduction in the Treasury bill issue.

78. Such reserves would, under existing money market arrangements, need to be remunerated at current market interest rates; and it would be necessary to bring the building societies into the net. This should be negotiable, but would require careful handling.

79. It would be possible to go beyond this, and to reintroduce a version of the Corset as envisaged in paragraphs 11 to 16 above. Banks and building societies could be told that, if their total liabilities grew at more than say, 5 per cent a year, they would suffer a progressive interest rate penalty on their special deposits at the Bank of England. Such an arrangement would either require primary legislation or the threat of it. We would not wish these arrangements to bite too hard, and too generally, lest they caused the banks and building societies to raise their mortgage lending rates, as envisaged in paragraphs 73 & 74 above. Nor could this arrangement be permanent, given the possibilities described earlier in this paper for offshore routing of lending, for disintermediation, and for other avoidance possibilities. But

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it could be introduced, on a temporary basis, as part of a package designed to change expectations and induce a step change in M4 lending growth.

(c) Overfunding

80. "Overfunding" is either

(i) when the public sector borrows more than it needs to finance a deficit, by selling gilts or national savings to the public and financial institutions. The proceeds of this extra borrowing are invested in short-term instruments - eg commercial bills or bank deposits - or used to redeem short-term Treasury bills or bank loans;

or (ii) when there is a fiscal surplus, as now, "overfunding" occurs when the public sector uses its surplus not to repay gilts or national savings, but to run up short term financial assets, such as commercial bills or bank deposits (or to repay Treasury bills or banks loans).

Effect on broad money

81. In the early 1980s overfunding was used as a way of reducing the growth of broad money, M3. Overfunding makes the public sector counterpart to broad money negative. If there is no offsetting change in the growth of the other counterparts, notably bank lending, then this reduces the growth of broad money.

82. Assuming no offsets, so that overfunding has a one for one effect on broad money :

- in 1985 it required £1¼ billion of extra gilts sales (overfunding) to reduce the annual rate of growth of M3 by 1 per cent.

- today it would require £4½ billion of extra gilt sales (or reduced gilt purchases) to reduce the growth of M4 by 1 per cent, from 17½ per cent to 16½ per cent.

83. In fact there are offsets. Overfunding is likely to lead to an increase in bank lending. This works as follows. Extra gilt sales tend to push up long term interest rates. This discourages companies from borrowing long term in the bond market, and encourages them to borrow more from the banks. So bank lending rises.

84. This means that overfunding has less effect on broad money than suggested in paragraph 82. It also leads to an increase in bank lending.

Disadvantages of sustained overfunding

85. Sustained overfunding on a large scale gets the Government into trouble, as it did in 1985. The Government becomes a large financial intermediary, borrowing more in gilts and national savings than it needs, and lending the proceeds back by placing them short-term with the banks. This distorts the financial system, and brings policy into disrepute. That is why the policy was abandoned in 1985.

86. Overfunding on the scale needed make any significant difference to the M4 growth rate would quickly get us back into the same kind of difficulty.

Case for temporary overfunding

87. But more modest and temporary overfunding may be useful. It works by raising long term interest rates. Even small amounts of extra gilts sales, or reduced gilt purchases, can push long term rates up. This tightens policy, without raising short-term rates.

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88. In some circumstances it is better to avoid this. For example when policy is aimed at trying to reduce consumer lending, but not industrial investment it is best to keep bank and building society lending rates high, by raising short term interest rates, while keeping down the interest rate on long-term funds for industrial investment.

89. The description of funding policy in this year's Red Book envisages that there may be temporary periods of overfunding. For example, the authorities have not regarded it as sensible to offset the effects of foreign exchange intervention by funding that intervention immediately; perhaps not even within the financial year in which it occurs. We also want to overfund to limit the increase in the weekly Treasury bill tender.

90. For these reasons we are currently aiming to overfund by a modest amount. This may require a switch from net purchases of gilts to net sales and a reduction in net outflows from National Savings, despite the prospective PSDR for 1990-91.

(d) **National Savings**

(i) Products

91. In recent years, with prospects of PSDRs and balanced budgets stretching into the future, we have aimed at a controlled outflow from National Savings, with switches from lower quality funding products like matured savings certificates, which are repayable on demand, to products like the Capital Bond which tie up money for an extended period.

92. That has meant that we have deliberately kept the interest rates on some National Savings products low, to encourage outflows, balanced by inflows from the continuing appeal to non-taxpayers of other National Savings products.

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93. But the tax concessions to savers generally in the Budget are about to remove the appeal of the latter products; and National Savings interest rates have fallen so far below market rates in recent months that it has become necessary to reinvigorate National Savings in order to avoid attracting unfavourable publicity to its present position and prospects, and thus to the government.

94. There is a strong case for introducing a new savings certificate, a new index-linked certificate and a new Capital Bond. With the advent of Tax Exempt Special Savings Accounts (TESSAs) in the Budget, and the prospects of abolition of Composite Rate Tax, the likelihood is that, unless such action is taken, there could be an increasing and excessive net outflow from National Savings later this year.

95. These proposals are set out in more detail in Annex 7.

(ii) Advertising

96. National Savings compete in the same market as banks and building societies. If there are substantial net outflows later in the year as a result of CRT abolition and TESSA, they will go mainly to banks and building societies. Similarly, if National Savings rates were improved, this would reduce net flows from National Savings to these institutions.

97. Maurice Saatchi has recently written to the Prime Minister, and has had a meeting with Treasury Ministers, proposing a major advertising campaign to change British attitudes to spending and saving. His letter is attached at Annex 8.

98. There are attractions in this idea. But we have doubts about the efficacy of a generic campaign of this kind, in favour of savings generally rather than particular savings products of media, and intend to suggest to Saatchis that they persuade the

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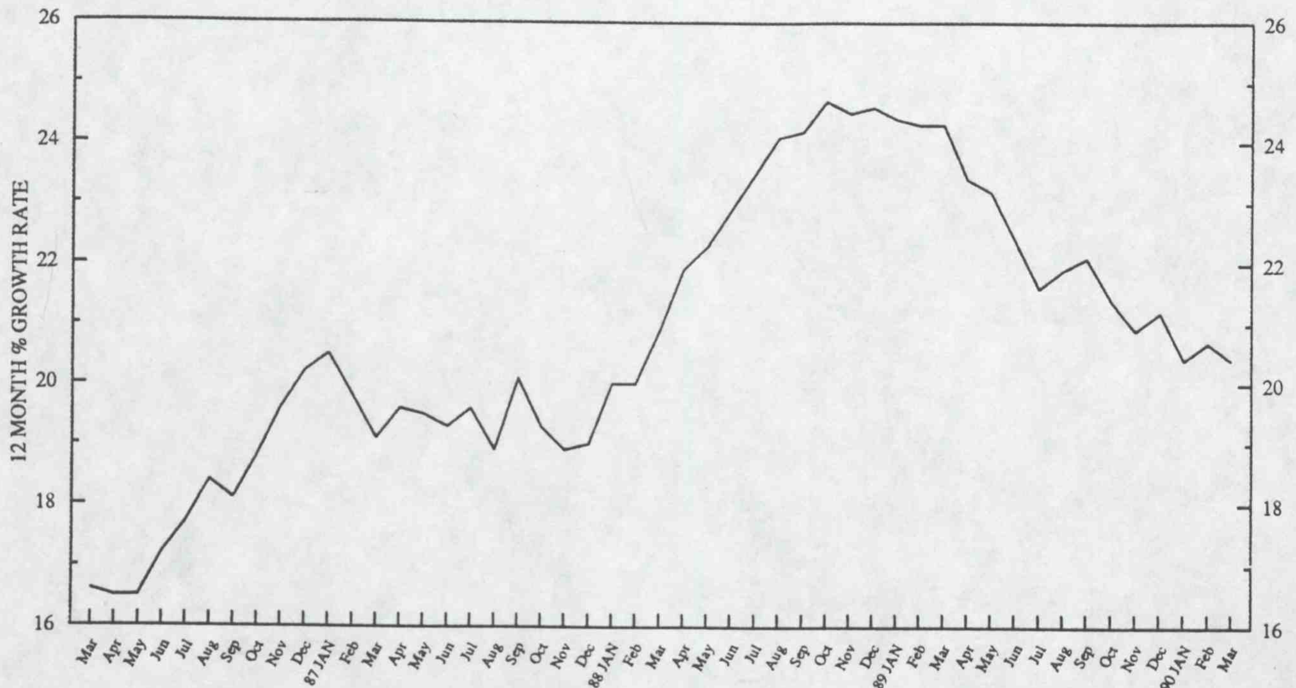
banks and building societies, who have just been given considerable new opportunities by the Budget, to finance such a campaign alongside their stepped-up campaign for their individual competing products. A somewhat larger advertising budget for National Savings could be (a small) part of this process.

HM Treasury
17 May 1990

BORROWING BY HOUSEHOLDS

1. Chart 1 below shows the growth rate of total lending by banks and building societies to the UK private sector (M4 lending for short).

Chart 1: Bank & Building Society Lending



Growth has been falling since the end of 1988 but remains at high levels.

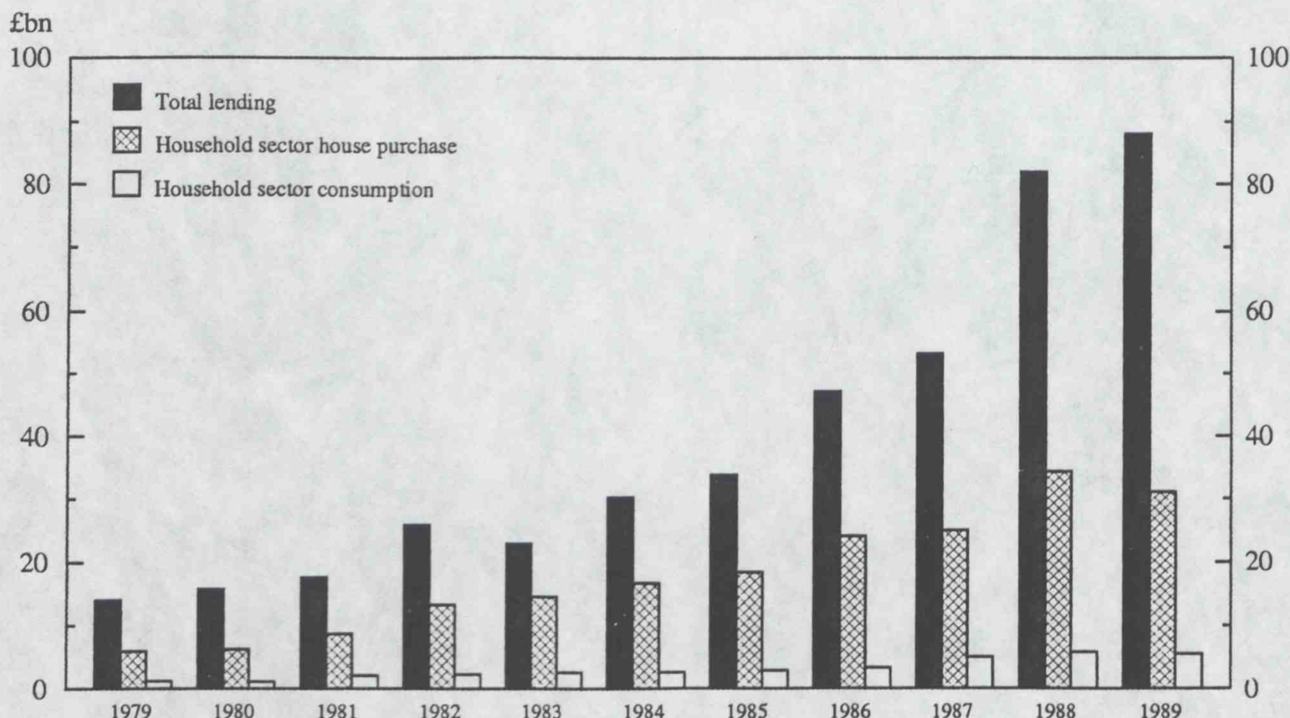
Contribution of Households to Total Borrowing

2. Chart 2 compares the increases in M4 lending with bank and building society lending to households for house purchase and for consumption. Apart from lending to households for house purchase and for consumption, M4 lending includes lending to companies and lending to unincorporated businesses. The main features of the chart are:

(i) lending for consumption has been and is small both in relation to lending for house purchase and, therefore, in relation to M4 lending as a whole;

(ii) the proportion of M4 lending accounted for by lending for house purchase has varied significantly over the last 10 years.

Chart 2: Lending to Households and M4 Lending



3. Recently, the share of lending accounted for by lending to households for house purchase and consumption combined has declined. In 1989 it was about 40 per cent compared, for example, with nearly 60 per cent in 1986. This change reflects the greater reliance of companies on bank borrowing since the stock market crash of 1987, which made equity finance less attractive.

Table 1: Share of Lending to Households in Total M4 Lending

	%
1986	58
1987	56
1988	49
1989	41

4. At the end of 1989, lending to households was increasing at just over 15½ per cent a year; lending to companies was growing at

over 28 per cent a year. Total M4 lending was growing at just over 21 per cent a year.

Consumer Credit

5. Lending by banks and building societies for consumption makes up the bulk of consumption lending. But consumers also borrow from other institutions - from retailers, insurance companies and other non-bank credit companies. Table 2 below shows the composition of consumer credit including borrowing from these sources. At the end of 1989, borrowing from the M4 institutions amounted to over three quarters of total identified consumer borrowing; bank credit cards accounted for only about 15 per cent of the total.

Table 2: The Breakdown of Consumer Borrowing £ billion

	Borrowing from M4 Institutions			Borrowing from other sources			TOTAL CONSUMER BORROWING
	Bank Credit Card	Other Bank & Building Society Lending	Total	Non-Bank Credit Companies	Insurance Companies	Retailers	
Increases							
1985	0.8	2.1	2.9	0.6	0.1	0.2	3.8
1986	1.1	2.2	3.3	0.8	0.1	0.1	4.3
1987	0.8	4.2	5.0	0.7	-	0.4	6.2
1988	0.7	5.1	5.8	0.4	0.1	0.3	6.5
1989	0.5	5.0	5.5	0.6	0.1	0.1	6.3
Total 1985-1989	3.9	18.6	22.5	3.4	0.4	1.1	27.1
Amounts outstanding (End-year)							
1989	7.2	32.6	39.8	5.2	1.0	2.7	48.7

Sources: CSO, Bank of England

Equity Withdrawal

6. But even including borrowing from non-M4 institutions does not fully indicate the resources available to consumers to finance

[co]nsumption. In addition to explicit borrowing for consumption purposes, consumers have in recent years been extracting equity from their ownership of houses. As the figures below show estimated equity withdrawal has been considerably greater than identified consumer borrowing.

Table 3: Consumer Borrowing and Housing Equity Withdrawal

	Consumer Borrowing	Housing Equity Withdrawal
1985	3.8	10.1
1986	4.3	15.8
1987	6.2	16.9
1988	6.5	24.3
1989	6.3	16.8

7. As explained in the main text, the measurement of equity withdrawal is by no means straightforward. The figures shown above relate to the 'wide' measure. 'Narrow' equity withdrawal - that arising from remortgaging on houses that have appreciated in value and overmortgaging on trading up to a new house - probably accounts for only around a quarter of this. Nevertheless even 'narrow' equity withdrawal is of comparable size with identified consumer credit.

8. Most of the gap between 'wide' and 'narrow' equity withdrawal reflects 'last time sales', in particular the proceeds of inheritance sales. While this kind of equity withdrawal clearly adds to the resources available for consumption, it is not directly affected by monetary policy. It is one of the factors monetary policy has to take into account. 'Narrow' equity withdrawal represents borrowing which, although nominally for house purchase, is in fact for consumption. Consumers are evidently using their houses as security to borrow at more favourable rates than would be possible by borrowing without security. 'Narrow' equity withdrawal is likely to be directly affected by monetary policy which affects mortgage rates.

9. The detailed derivation of the figures for 'wide' equity withdrawal are shown in the table overleaf.

ANNEX

Table 4: Equity extraction

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989[1]
(1) Change in outstanding loans for house purchase £ mn	4262	5441	6516	7368	9483	14127	14501	17030	19032	26468	29578	40831	34068
(2) Private sector residential fixed investment £ mn	3452	4091	5312	6115	6174	6850	7757	8987	9392	10852	12571	15394	15645
(3) Council house sales £ mn	94	248	396	769	991	1941	1458	1196	1253	1335	1676	2750	3242
(4) Government capital grants to private sector for housing purposes £ mn	578	733	708	768	651	1027	1833	2204	1619	1420	1441	1455	1469
(5) Slum Clearance £ mn[2]	102	107	128	164	161	158	121	91	100	127	139	125	125
(6) Net cash withdrawal[3]													
- £ mn	1396	1942	1646	1416	3130	6521	7242	9142	10106	15828	16911	24267	16775
- as a % of change in outstanding	32.8	35.7	25.3	19.2	33.0	46.2	49.9	53.7	53.1	59.8	57.2	59.4	49.2

1 Estimate based on first three quarters for most rows.

2 Slum clearance data particularly uncertain.

3 Net cash withdrawal defined as (1)-(2)-(3)+(4)+(5)

Annex 2

Consumer credit default

There is very little reliable information on consumer credit default. The only consistent time series we are aware of is amounts written off by finance houses and specialist consumer credit grantors[3] which over the last few years have declined as a per cent of credit outstanding at the start of the year from 2.31% in 1986 to 1.89% in 1988 but stabilised in 1989 as a whole. Within last year amounts written off in the second half were 25% higher than write-offs in the first half. (These figures should be interpreted with caution since they may be influenced by changes in institutions' writing-off practices, but we have not been able to find any evidence of this. There is no evidence of significant seasonality in the figures for earlier years.)

The results of a recent PSI survey[4] shows that 6% of those with loans from finance houses were in arrears at the time of the survey and a further 4% had been in arrears during the previous year. Thus 10% of people with loans from finance houses have been in arrears at some time during the last year. The corresponding figures for most other one-off credit agreements were lower (credit or store card 3%; building society loans 3%; bank loans 4%; mail order instalments 5% and HP instalments 6%) but arrears on 'other loans' (from commercial sources other than those mentioned) occurred in 28% of cases

The concept of arrears does not apply directly into overdrafts, but the percentage of those with overdrafts that were worried about them (8%) was higher than for any other commitment[5] with the exception of rent.

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(3) These accounted for about £19 1/2 bn of outstanding consumer credit at the end of last year - just over 40% of the total coverage of the CSO broader measure.

(4) The survey was conducted by the Policy Studies Institute as part of their study of credit and debt. The Bank is one of the sponsors of the study.

(5) The classification used here is coarser than that discussed in the previous paragraph, in particular bank, building society and 'other' loans are grouped together.

MORTGAGE DEFAULT

CHART 1 PROPERTIES TAKEN INTO POSSESSION

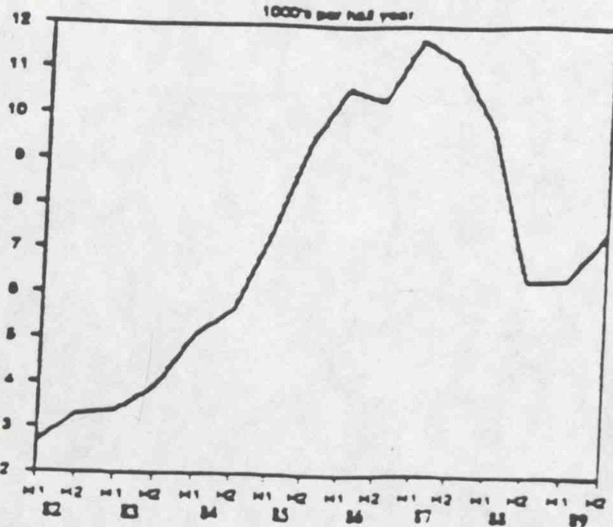
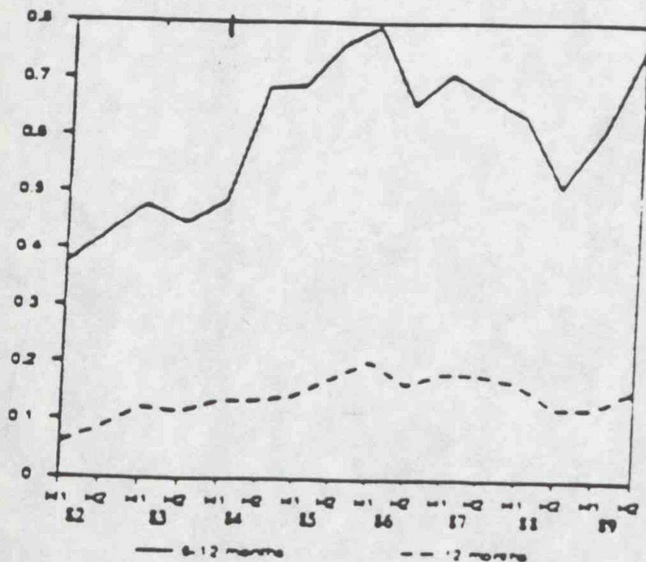


CHART 2 MORTGAGES IN ARREARS, %



The latest figures provided by the Council c Mortgage Lenders show that the number c properties taken into possession during 1989 a a whole was the lowest recorded since 1984 an was 14 per cent lower than in 1988. However there was a 17 per cent increase in the numbe of properties taken into possession between th first and second halves of the year (Chart 1) There was also an increase in the number o: mortgages in arrears. Mortgages 6-12 months in arrears rose by 29.5 per cent between the twc halves of last year, to 58,380. This is the highest ever recorded figure, but the percentage of mortgages in arrears has been higher (Chart 2), and the absolute percentage remains very low. Mortgages 12 months or more in arrears rose by 30.7 per cent between the two halves of 1989, to 12,100. These figures are likely to understate both the level and the rise in potential indebtedness because some borrowers are on annual adjustment schemes, arrears less than 6 months are not included, and the first effect of a rise in interest rates and hence monthly payments due will be a reduction in the number of months' payments represented by any absolute amount of arrears. According to the Financial Times of 27 February, a senior executive of a large building society stated that "we believe about 6 or 7 per cent of customers are in arrears around the two months level." The PSI survey found that 2 per cent of people with mortgages were in arrears at the time of the survey and a further 3 per cent had been in arrears during the previous 12 months.

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SECRET AND PERSONAL

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Annex 3

The Netherlands monetary cash reserve

1 The current formulation of Dutch monetary policy allows for the introduction of temporary arrangements (monetary cash reserves) designed to restrict net money creation. NMC is defined as the sum of lending to the private sector, long term lending to the public sector and other capital market invesments less increases in savings deposits and other long term liabilities. 'Savings deposits' include categories which would fall within UK definitions of broad money, so the Dutch definition of 'money' is less demanding than our own.

2 Under the latest arrangement, introduced in July 1989 but relaxed three months ahead of schedule from 1 April, banks were permitted each month to expand their NMC up to a maximum annual rate of 5%; any excess lending was subject to a proportionate penalty, consisting of a notional requirement to hold non-interest bearing deposits with the central bank; however, in order to avoid introducing extra demand pressure into the Dutch money markets (which would occur if banks had to acquire funds to meet any penalties incurred), penalties were payable only upon completion of the whole arrangement (which in the present case would originally have been June 1990); the arrangement did not, therefore, constitute an obligation to increase deposits with the central bank whilst the monetary cash reserve was in force, in contrast to the system operated by the Bundesbank, for example, in which banks are obliged to meet a minimum reserve requirement set each month.

3 The introduction of the arrangement was accompanied by a significant slowdown in NMC during the second half of 1989 (with NMC negative in the third quarter). However, it is by no means clear that the monetary cash reserve system was responsible for this; indeed, the Dutch central bank has admitted in private that the slowdown may have been more a consequence of higher interest rates (money market rates having risen by 1.9% points to just under 9% between July and December 1989). Furthermore, the rapid growth in NMC in the months preceding July 1989 suggests that the banks may have altered their lending behaviour in anticipation of the imposition of restrictions; the monetary cash reserve system may therefore have affected only the volatility, and not the growth, of NMC.

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Annex 4

REGULATION OF ADVERTISEMENTS FOR CONSUMER CREDIT

An "advertisement" is defined in section 189 of the Consumer Credit Act 1974. Section 44 of the Act confers on the Secretary of State a power to make regulations to ensure that advertisements "convey a fair and reasonably comprehensive indication of the nature of the credit ... facilities offered ... and their true cost." Section 46 provides that an advertiser commits an offence if an advertisement contains materially false or misleading information. The latest (1989) regulations, which are described below, came into force on 1 February 1990.

The Consumer Credit (Advertising) Regulations 1989

Coverage

2. These regulations apply to most credit and hire advertisements directed at consumers, which are published by consumer credit businesses, consumer hire businesses and businesses which provide individuals with credit of any amount secured on land. They also apply to advertisements published by credit-brokers. Business credit is not covered.

Categories of advertisement

3. Part II of the Regulations prescribe three categories of advertisement:

(i) "Simple" advertisements are designed to keep the name of the business in the public eye. They may contain any or all of the maximum information specified in the Regulations. That is name, logo, address, telephone number, occupation and any other information other than information that a firm is willing to provide credit or, the price of any goods, services or land;

(ii) "Intermediate" advertisements allow some choice as to amount and type of information provided. The maximum information they must contain is specified. The inclusion of certain information is compulsory. For

example, the advertisement must offer to provide on request a written quotation. Where a cash price of any goods, services etc is given, and their purchase may be financed by credit, the APR must be quoted, or alternatively a statement must be included indicating that the total amount payable by the debtor is not greater than the total cash price;

(iii) "Full" advertisements are the most detailed. The Regulations specify the minimum information which must be included. This includes a statement that individuals may obtain on request a written quotation; the APR; whether the offer is restricted to a class or group of persons (eg homeowners); the nature of any security required not affecting the debtors home; frequency, number and amount of repayments of credit, and the total amount payable to the debtor.

Specific warnings

4. Intermediate and full advertisements for loans secured on property must contain the following warning:

> "Your home is at risk if you do not keep up repayments on a mortgage or other loans secured on it."

5. Intermediate and full advertisements for foreign currency mortgages must contain the following warning:

> "The sterling equivalent of your liability under a foreign currency mortgage may be increased by exchange rate movements."

Special provisions for credit advertisements in dealers' catalogues

6. Credit advertisements in dealers' publications which cover a calendar or seasonal period throughout which goods or services are available (eg a holiday brochure) do not have to comply with the

general rules described above. They must instead include the name and address of the creditor, a statement of the general nature of his occupation, and an indication that written information about the terms of an offer is available. If the advertisement contains any other indication that credit is available, the normal rules apply.

Special provision for credit advertisements in shops and business premises

7. Except where the advertisements are designed to be taken away, the name of the advertiser need not be given. In addition the proximity of advertisements to the goods offered is covered.

The Consumer Credit (Quotations) Regulations 1989

8. These regulations also came into force on 1 February 1990 and cover the same businesses as the advertising regulations. The Quotations Regulations prescribe the form and content of quotations given to prospective customers and the circumstances in which such quotations are to be provided. A quotation must be provided in response to a request for written information made in writing, orally on the trader's premises or, in certain circumstances, by telephone and must contain similar information to a "full" credit advertisement. In addition, the following warning must be included:

> "Be sure you can afford the repayments before entering into a credit (or hire) agreement."

INFORMATION INCLUDING EDUCATION

There are three areas where general information to the public might play a part in reducing the burden of debt borne by the personal sector. This could include educational measures in schools and campaigns in the mass media. It would be intended to explain such matters as the concept of borrowing, the meaning and purpose of interest rates, and so on. And it could be supplemented by advice through the Citizens Advice Bureaux and money advice centres.

(i) Education in the schools

At present there is little or no teaching in schools of how to manage personal finances. It is clear that many pupils leave school with only the sketchiest ideas about household budgeting, and borrowing and lending. Plainly it would be highly desirable to improve financial education.

The National Curriculum could provide an opportunity to impose on schools a requirement to give pupils a proper grounding in these matters. Money management could become an element in the mathematics curriculum, for example. This would need to be discussed further with DES. Source material would also need to be prepared. One possibility might be for the OFT to make available the information it gathers to fulfil the Director General's statutory duty to advise the Secretary of State on social and commercial developments relating to the provision of credit.

(ii) Education through the media

Improving the provision of financial education in schools would not of course be sufficient to raise the general standard of financial education. There could be a case for a separate public information campaign. This might focus more on the positive benefits of saving, rather than the negative aspects of borrowing. The form it would take would need to be considered carefully. The

OFT's comic 'Money Fax', which is aimed at young people, was promoted on Radio One and over one and a half million copies have been distributed. Further material on these lines might be prepared. Poster and other advertising material could also be considered. Lead policy action would be for DTI; but the banks might be persuaded to pay for the costs of the campaign, given the commercial advantages they would derive from it.

(iii) Independent sources of financial advice

Campaigns in the media could be supplemented by advice provided by the Citizens Advice Bureaux, and money advice centres. The report of the Money Advice Working Party, set up by the Finance Houses Association, proposed that a charitable trust should be set up and to coordinate the provision of money advice services and to encourage industry donations. The Association has now agreed to set up this trust.

The report of the Working Party outlined a three year plan for the funding of Money Advice Services. It estimated that an extra £9.5 million was needed over three years. It suggested that the majority of these extra funds - £2 million a year - should be provided by the credit industry itself. (The DTI will already provide some £11 million towards Citizens Advice Bureaux in 1990-91).

ANNEX 6

Minimum reserve arrangements in selected countries

Country	Calculation basis		Maintenance of reserves		
	Reserve-carrying items	Period or date for which required reserves are calculated	Bank assets eligible for meeting reserve requirements	Period within which reserve requirements must be met	Reserve ratios
Austria	Sight, time and savings deposits in Schillings, certain securities issues, net foreign exchange position	One month	Central bank balances, balances with central institutions and Post Office, cash balances, some "Bundesschatzscheine"	A four-week average, with the calculation period for the actual reserves lagging behind the calculation period for the required reserves	Between 9 % and 4½ %
Canada 1	Sight and time deposits	One month	Central bank balances, cash balances	The average of two fourteen-day periods which lag behind the calculation period for the required reserves	Between 10 % and 1 %
Federal Republic of Germany	Deposits and borrowed funds (sight, time and savings deposits for less than four years, bearer bonds for less than two years, net foreign exchange position vis-à-vis non-residents)	One month	Central bank balances, cash balances	A four-week average, with the calculation period for the actual reserves lagging two weeks behind the calculation period for the required reserves	Between 12.1 % and 4.15 %
France	Sight deposits, liquid savings deposits, time deposits and the like for up to two years	End of month	Central bank balances	The average of a four-week period stretching beyond the end of month in question	5.5 % for sight deposits 3 % for the rest, for foreign currency deposits the current ratio is 0 %
Italy	Changes in sight and time deposits in Italian lira and in the net foreign exchange position	End of month, partly also one month	Central bank balances	The balances must be immobilised at the Banca d'Italia not later than two weeks after the calculation of the required reserves	25 % of the increment until 22.5 % of the level is reached (interest-bearing)
Japan	Time deposits and other deposits, securities issues, liabilities to offshore centres	One month	Central bank balances	A four-week average lagging two weeks behind the calculation period for the required reserves	Between 2.5 % and 0.125 %
Netherlands	a) Changes in net credit expansion (after deduction of monetary capital formation), if it exceeds a specified rate	Three months	Central bank balances	The maintenance of reserves is fictitious only; banks are charged their cost equivalent	10 %
	b) Bank liabilities		Central bank balances	During a period of four weeks	Varies with conditions in the money market (interest-bearing)
Spain	Sight, time and savings deposits, plus securitised bank liabilities held by domestic non-banks in peseta	Ten days	Central bank balances	A ten-day average lagging two days behind the calculation period for the required reserves	17 % (9.5 % of which interest-bearing). A reduction in the non-interest-bearing reserves to 5 % and an abolition of the interest-bearing reserves comes into effect in March 1990, when it will be phased in.
Switzerland 2	Sight deposits, time deposits for up to three months, 20 % of savings deposits	Three months	Central bank balances, balances with central institutions and the Post Office, cash balances	A four-week average (from the 20th of the current month to the 19th of the following month)	2.5 %
United Kingdom 3	Bank liabilities with maturities of up to two years in pound sterling	Six months	Central bank balances	The balances are immobilised at the Bank of England over a six-month period	0.45 %
United States	Sight deposits and similar funds; time deposits other than those held by individuals with maturities of under one and a half years, Euro-market liabilities	Two weeks	Central bank balances, cash balances	A two-week average, for sight deposits the calculation period for the actual reserves lags two days behind the calculation period for the required reserves; for the other reserve-carrying liabilities, the calculation period for the actual reserves lags two weeks behind the calculation period for the required reserves	12 % for sight deposits and the like, 3 % for the rest

1 In Canada there is currently, on competitive grounds within the domestic financial system, a debate on the possibility of abolishing minimum reserve requirements. — 2 In Switzerland the data refer to the regulations governing cash liquidity — 3 In the United Kingdom the minimum reserve instrument does not serve monetary policy purposes.

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ANNEX 7

Reinvigorating National Savings products

1. **Fixed interest savings certificates**

The current (34th) issue has been on sale since July 1988. About £1.5 billion is now invested. The maximum investments in this issue are now £1,000 (for new money) and £10,000 (for reinvestment of matured older issue certificates). This issue offers 7.5 per cent a year tax free if held for 5 years. The interest is "raked" to give lower returns on certificates cashed early. It is not now an attractive investment, even to higher rate taxpayers. At present, sales are running at £40 million a month, nearly all of it reinvestment.

2. It is difficult to know how much higher yields would have to be in order to attract significantly larger amounts. With 5 year gilt yields currently at about 13½ per cent, a relatively small increase to about 8-8½ per cent would restore the attractiveness of certificates to higher rate taxpayers. For basic rate taxpayers, however, a larger increase would be required: perhaps to 10-10¼ per cent. On one basis of calculation a rate of 11 per cent or more would still provide funding as cheap for the Government as a five year gilt.

3. Another way of making a new issue more attractive and bringing in more money would be to increase the maximum investment. The current £1,000 limit compares with £3,000 in the first year and £9,000 in total for the new TESSA accounts, to be introduced next January (though National Savings investors can also save up to £2,400 a year in the regular savings scheme Yearly Plan, which offers the same tax-free return as certificates). A final option is to offer a new regular savings plan to allow savers to invest in a new issue by instalments over a five year period.

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2. **Index-linked certificates**

4. The current (4th) issue has been on sale since August 1986. About £2 billion is now invested. The investment limit is £5,000; there is no extra for reinvestment from matured certificates. These certificates are indexed by reference to the RPI and pay extra interest of 4.04 per cent a year tax free if held for 5 years. The extra interest is "raked", so that a lower rate is paid if certificates are cashed early. But the "rake" is very gentle, providing little incentive for locking the money in. Interest starts at 3 per cent after the first year, and rises by stages to 6 per cent in the final year, giving an overall average of 4.04 per cent over the 5 year period. Investors who bought 4IL a year ago can now cash them in and show an 11 per cent tax free return.

5. There is therefore a strong case for a steeper "rake", perhaps starting with no interest at all in addition to index-linking. This would increase the penalties on early withdrawal and improve the quality of our funding.

6. Hitherto, we have not envisaged improving the overall return on the certificate, and on this basis it would not be any more attractive to savers. However, those who already hold the maximum amount in index-linked certificates would be able to invest a further amount. Like a new certificate, this is a cheaper way for the Government to borrow than selling conventional gilts. On a cost comparison, the real return would need to be raised from 4.04 per cent to about 6.5 per cent before gilts were cheaper.

3. **Capital Bond**

7. The Capital Bond was introduced in January 1989. It offers 12 per cent (taxable) if held for 5 years. Nearly £500 million has so far been invested. When it was introduced, the return was very attractive - indeed, Capital Bond was then marketed with a strong hint that the generous terms then available would shortly be withdrawn. In the event, the terms have not been changed and

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are now not very attractive (even though unlike competing savings products, the Capital Bond rate is guaranteed for 5 years) because other rates have risen.

8. In assessing the cost of the Capital Bond, the correct comparison is with 5 year gilts. Like savings certificates, Capital Bond has a guaranteed interest rate and penalties for early withdrawal. A comparison with present gilt yields now suggest the interest rate on a new series could be raised to 14 per cent (after allowing for administrative costs and early withdrawal).

Annex 8

SAATCHI & SAATCHI COMPANY

BERKELEY SQUARE, LONDON W1X 5DH

12th April, 1990

The Rt. Hon. Mrs Margaret Thatcher, MP,
Prime Minister,
10 Downing Street,
LONDON SW1

Dear Prime Minister,

I visited the Treasury last week to present an advertising campaign aimed at following up the Budget initiative to encourage the British people to save. In that context, I thought you would be interested in the advertisement which appeared in today's edition of Le Figaro, (Page 5) and in most other French newspapers.

In the advertisement the French Ministry of Finance urges the French people to "put a little aside" to help the economy, and themselves.

According to our Model, such an initiative in the UK holds the prospect of cutting our inflation rate in 1992 by over 1%.

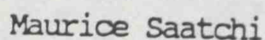
The campaign we have devised is, I think, a brilliant one (much better than the French effort, naturally) and I hope you will not mind my writing to you directly to urge you to consider it.

The campaign has been extensively researched among professionals and the public, and been generally judged "a good idea".

I hope it may be possible for you to look at it.

Have a lovely Easter.

Kindest regards,



Maurice Saatchi

METTRE DE L'ARGENT A GAUCHE C'EST ADROIT.

L'ECONOMIE FRANÇAISE SE REDRESSE.

DEPUIS TROIS ANS, LA CROISSANCE EST SUPERIEURE A 3%, L'INFLATION FAIBLE, LE FRANC RECONNU COMME UNE MONNAIE SOLIDE; L'INVESTISSEMENT INDUSTRIEL PROGRESSE AU RYTHME DE 10% PAR AN ET LES CREATIONS D'EMPLOIS ONT DEPASSE LES 550000 EN DEUX ANS.

TOUTEFOIS, MALGRE LES PROGRES ACCOMPLIS, NOUS N'AVONS PAS ENCORE REDUIT SUFFISAMMENT LE CHOMAGE, QUI EST LA PREMIERE DES INEGALITES SOCIALES.

POUR ATTEINDRE CET OBJECTIF, LA FRANCE DOIT EPARGNER PLUS.

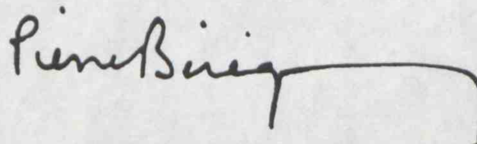
CELA DEPEND DE CHACUN D'ENTRE VOUS.

LE GOUVERNEMENT AIDE TOUS LES FRANÇAIS A EPARGNER, IL EST JUSTE QU'IL AIDE DAVANTAGE LES PLUS MODESTES.

EN METTANT UN PEU D'ARGENT DE COTE POUR ACQUERIR UN LOGEMENT OU AMELIORER VOTRE RETRAITE, VOUS PREPAREZ L'EMPLOI DE VOS ENFANTS ET L'AVENIR DU PAYS.

TOUT LE MONDE EN BENEFICIERA, VOUS LE PREMIER.

PIERRE BEREGOVOY



MINISTRE D'ETAT.

MINISTRE DE L'ECONOMIE, DES F...