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Exchequer Financing and the National Savings Movement

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The important role now played by nonmarketable securities[1] in Exchequer finance in the United Kingdom is an outgrowth of the Treasury's difficulties since 1955 in selling marketable Treasury securities to the gilt-edged market when the domestic economy was expanding and when securities yields were rising. In the 1955-1957 boom and again in the 1959-1960, the Bank of England was on balance a net buyer of bonds from the gilt-edged market in its debt-management operations.

Because of the Treasury's difficulties in selling bonds to the market in the 1955-1957 boom, the Radcliffe Committee was led to consider the question at length in its hearings. In fact, the question of how to sell marketable securities in periods of rising interest rates proved to be one of the principal points of controversy in the Committee hearings between members of the Committee and representatives of the British Treasury and the Bank of England.

In an attempt to obtain cash from private sources outside the gilt-edged market, the Chancellor decided in his 1958-59 budget materially to improve the attractiveness of these various types of nonmarketable securities. The success which he achieved with this policy in 1958-59 encouraged him to take further steps along the same line in the April 1960 budget.

These changes in Treasury policy chiefly account for the primary role now occupied by nonmarketable securities in Exchequer finance in Britain. In 1959-60, for example, the Chancellor reported to Parliament that the inflow from nonmarketable securities of £344 million was adequate to cover the Exchequer's new capital spending during the year. In commenting on the Bank of England's difficulties in selling marketable bonds to the gilt-edged market, the Chancellor stated that there had been "no long periods of sustained demand for gilt-edged stocks . . . " with the result that ". . . over the year as a whole we [the Treasury] paid out more to the gilt-edged market than we were able to take in by new issues and official sales."[2]

1/ The principal types of nonmarketable securities in the United Kingdom are National Savings Certificates, Defense bonds, Premium bonds and deposits in the Post Office Saving Banks and the Ordinary Department of the Trustee Saving Banks, whereas the marketable securities consist of bonds which are traded on the gilt-edged market of the London Stock Exchange and Treasury bills which are traded in the Treasury bill market.

2/ Parliamentary Debates (Hansard), April 4, 1960, columns 34 and 35.

The emergence of nonmarketable securities as the principal source of Exchequer new cash inflow represents a major development in Treasury finance in the United Kingdom. Before 1958, for example, receipts from sales of nonmarketable instruments were only a minor source of supply of cash to the Treasury. In fact, there were 5 years (1951-52 to 1955-56 and 1957-58) when withdrawals exceeded new cash receipts.

Principal types of nonmarketable securities

The principal types of nonmarketable securities (which are included in Britain under the general heading of the National Savings Movement) are National Savings Certificates, Defense bonds, Premium bonds and deposits at the Post Office Savings Banks and Trustee Savings Bank.

National Savings Certificates are available to individuals in denominations (or multiples) of 15 shillings ($2.10) and are wholly exempt from income tax and surtax. The certificates earn the full rate of interest only if held to maturity; if encashed within the first year after purchase, they earn no interest. Individual holdings of National Savings Certificates are limited. Defense bonds are available in denominations of £5 with income, which is paid half yearly, subject to income tax but with a maturity bonus not subject to such taxation. The bond is principally attractive to investors paying little or no tax. The current issue can be encashed at six months' notice (or immediately subject to a deduction of six months' interest). There are limits to the total number of Defense bonds that any one individual may hold. The Premium bond was introduced in 1956 as a purely experimental type of bond but its success seems to have insured a permanent place for it in the National Savings Movement. Instead of earning interest, the bonds are eligible for inclusion in a draw for tax-free prizes. The prize fund is based on a rate of interest on the total outstanding amount of the bonds.

The Post Office and Trustee Saving Banks both accept deposits. The Trustee Saving Banks are divided into the Ordinary and the Special Departments. Although only the Ordinary Department lends its deposits directly to the Exchequer, both departments must be considered since there are no separate statistics during the period 1950-1956. Through the whole decade, the rate of interest in the Post Office Saving Banks and the Ordinary Department of the Trustee Saving Banks remained the same at 2.5 per cent with the first £15 of interest tax-free. The advantage to deposits in these savings banks is their liquidity.

Competition to the National Savings Movement comes principally from the building societies, finance houses and clearing banks although the local authorities and unit trusts are continuing to increase their competition for private savings. Throughout the whole decade, the rate of interest on building societies shares has been below that on National Savings Certificates, but the societies have had two compensating advantages: (a) the full rate of interest accrues immediately; and (b) there are no maximum permissible holdings per individual. These advantages also apply to deposits in finance houses and clearing banks.

The principal small savings media, with details of their yields, are summarized in Table I. Because of tax considerations, the yields are shown at the standard rate of income tax (37-1/2 per cent or 7s 9d in the pound) to facilitate comparison. Tax concessions, of course, become a greater attraction for higher incomes than they are for incomes in the standard category.

Table I

United Kingdom: Comparative Yields on Principal Small Savings Media

Security	Yield	Maximum holding
Savings certificates	4.2 per cent. free of income-tax and surtax; 6.85 per cent. less income-tax at 7s 9d	1,200 units of 15s each
Defense bonds	5 per cent. subject to tax, plus £3 tax free at end of seventh year	£5,000
P.O. and Trustee Savings Banks deposits	2-1/2 per cent. free of income-tax on first £15 of interest	£5,000
Premium bonds	4 per cent. tax free prize fund	£800
Building society shares	3-1/2 per cent. tax paid; 5.7 per cent. less income-tax at 7s 9d	£5,000 per society
Building society deposits	3 per cent. tax paid; 4.9 per cent. less income-tax at 7s 9d	£5,000 per society
Local authority loans	5-3/4 to 6 per cent. subject to tax	No limit
Finance house deposits	From 4 per cent. at 3 months' notice; from 5 per cent. at 6 months' notice	No limit
Unit trusts	2.5 to 5.8 per cent	No limit
War Loan 3-1/2 %	5-7/8 per cent.	No limit

Source: *Financial Times*, (London), September 24, 1960, page 6.

National Savings, 1950-51 to 1955-56

In April 1956, the Chancellor presented what he termed a "savings budget" in which he inaugurated a campaign to make nonmarketable securities more attractive to private investors. For this reason, a review of Britain's experience with these nonmarketable savings instruments over the past decade finds April 1956 as a natural dividing line.

From April 1950 to April 1956, there were only limited changes in the yields on various small savings media, and the Exchequer obtained little cash from these sources. Between 1950-51 and 1955-56, in fact, there were four years when withdrawals exceeded the new cash inflow and only one year of significant cash receipts. For these six years as a whole, withdrawals exceeded total receipts by £188 million, as may be seen in Table II.3/

During this period, the cash inflow came from National Savings Certificates and from Trustee Savings Bank deposits; there were net withdrawals from Defense bonds and Post Office Savings Banks. The cash inflow from Savings Certificates, which commenced in 1951, followed changes in terms introduced in early 1950. The rate of return (gross redemption yield at the standard rate) was increased from 4.9 per cent to 5.3 per cent; each investor was allowed to hold up to £450.

This pick up in purchases of Savings Certificates was accompanied by substantial withdrawals from Defense bonds (see Table II). To discourage withdrawals, the coupon on Defense bonds was raised in early 1951 from 2.5 per cent to 3.0 per cent, but the 1 per cent tax-free bonus (when the bonds were held for 10 years to maturity) was removed (see Table III). As funds continued to be shifted from Defense bonds to Savings Certificates, the coupon was raised from 3 per cent to 2-1/2 per cent in September 1952; in addition, a 3 per cent tax-free bonus was introduced. In November 1955, the yield was increased from 3.5 per cent to 4 per cent. Despite these changes, these bonds produced a cash inflow only in 1954-55.

During the period, there were continuous net withdrawals from the Post Office Savings Banks, some of these funds probably being switched into more attractive media. Because of better facilities for handling the small savers funds, the Trustee Savings Banks have shown a better performance than the Post Office Savings Banks. Within the Trustee Savings Banks, the Special Department is in direct competition with the Ordinary Department. The total deposits in both departments have increased continuously over the decade, amounting to £178 million over the period, compared to withdrawals of £259 million from the Post Office (see Table II).

3/ If the substantial receipts of the Trustee Savings Banks Ordinary Department were available, this deficit would probably be much lower (see Table II).

Table II

United Kingdom: Changes in Holdings of Various Media

	1950-51	1951-52	1952-53	1953-54	1954-55	1955-56	1956-57	1957-58	1958-59				1959-60				1960-61	
									I	II	III	IV	I	II	III	IV	I	II
National Savings Certificates																		
Principal	- 4	+16	+23	+19	+46	+19	+77	-19	+15	+43	+42	+29	+26	+25	+13	+11	+21	+15
Accrued interest	+28	+26	+21	+22	+22	+13	+30	-18	- 8	- 6	- 7	- 2	- 1	+ 2	+ 5	+ 2	+ 1	n.a.
Defense bonds	-21	-58	-57	-38	+22	-28	-35	-40	+11	+27	+31	+38	+39	+33	+39	+35	+26	+28
Premium bonds	--	--	--	--	--	--	+67	+81	+16	+19	+18	+16	+12	+12	+ 9	+ 5	+10	+11
Post Office Savings Bank	-36	-53	-71	-46	-17	-36	+ 1	-24	-14	-13	-11	+25	+ 6	+ 6	+ 1	+30	+ 3	-22
Trustee Savings Bank	+37	+27	+ 9	+32	+48	+25	+54	+42	+10	- 3	+ 4	+34	+22	+10	+11	+42	+18	n.a.
Ordinary Dept.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	+ 7	+14	+ 5	- 9	- 4	+25	+14	0	0	+25	+ 7	+ 6
Special Dept.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	+47	+28	+ 5	+ 5	+ 8	+10	+ 9	+10	+11	+16	+12	n.a.
Total	+ 4	-42	-75	-11	+121	- 7	+194	+22	+309				+390					

Source: Monthly Digest of Statistics, Central Statistical Office (Table 148).
n.a. -- Not available.

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Over this period, there were general increases in interest rates in the competitive media to the National Savings Movement -- that is, building societies, finance houses and clearing banks. While the latter two are tied more or less to Bank rate, building societies adjust their rates independently as the mortgage market permits. Many finance houses give Bank rate on one-month call deposits, one per cent over Bank rate on 3-month call deposits and 1.5 per cent over Bank rate on 6-month call deposits, with a minimum of 4.5 per cent. Saving deposits in clearing banks generally receive 2 per cent below Bank rate (except when Bank rate is unusually low).

Growth of nonmarketable savings, 1956 to 1960

Since April 1956, there has been a marked expansion in the public's holdings of various small savings media (see Table II). In the past four years (1956-57 to 1959-60), for example, the Treasury obtained £718 million of new cash from these sources compared with a net withdrawal of £188 million in the preceding six years. The cash accruals from each of these media were (in millions of pounds):

	1950-51 to 1955-56 (6 years)	1956-57 to 1959-60 (4 years)
National Savings Certificates	+ 119	+ 236
Accrued interest	+ 132	- 3
Defense bonds	- 180	+ 143
Premium bonds	--	+ 255
Post Office	- 259	+ 7
Trustee Savings Banks		
Ordinary Department only	n.a.	+ 77
	1/ - 188	+ 718

1/ Excludes the substantial receipts of Trustee Savings Banks Ordinary Department which are not available.
Source: See Table II.

This general expansion can be attributed to aggressive attempts by the Treasury to make these investments attractive to the private investor. The first step came in the "saving budget" of 1956-57 when the Chancellor of the Exchequer made several proposals designed to stimulate interest in the National Savings Movement. These changes included: (a) the gross redemption yield on National Savings Certificates was increased from 5.3 per cent to 6.9 per cent; (b) the yield on Defense bonds was increased from 3 per cent to 5 per cent; and (c) the Premium bond was introduced. (The holder of a Premium bond does not earn interest as such

Table III

United Kingdom: Yields on Various Small Savings Media
(As of March 31 of each year)

	1950-1951	1951-1952	1952-1953	1953-1954	1954-1955	1955-1956	1956-1957	1957-1958	1958-1959	1959-1960
National Savings Certificates 1/	5.3	5.3	5.3	5.3	5.3	5.3	6.9	6.9	6.9	6.9
Defense bonds 2/	2.5	3.0	3.5	3.5	3.5	4.0	4.5	4.5	5.0	5.0
Maturity bonus 3/	1.0	--	3.0	3.0	3.0	3.0	5.0	5.0	3.0	3.0
Premium bonds	--	--	--	--	--	--	4.0	4.0	4.0	4.0
Building society shares 4/	2.3	2.5	2.5	2.5	2.5	3.0	3.5	3.5	3.5	3.5
Finance house deposits 5/	4.5-6	4.5-6	4.5-6	4.5-6	4.5-6	5.5-7	5-6.5	7-8.5	4.5-6	4.5-6
Clearing bank savings deposits 5/	0.5	2.0	2.0	1.8	2.5	3.5	3.0	5.0		

1/ Gross redemption yield at the standard rate of tax.
2/ Yield on bond subject to income tax.
3/ Tax-free bonus when kept to maturity (for 10 years up to 1957-58, and for 7 years thereafter).
4/ Tax-free yield on shares (tax paid by society).
5/ Yield on deposits subject to tax.

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but is eligible to receive various cash prizes which are financed by the yield from the bonds. Initially the prizes represented a yield of 4 per cent.)

In response to these changes, there was a substantial growth in savings in 1956-57; only Defense bonds continued to show a decline (see Table II). However, by the next year, 1957-58, Britain experienced substantial foreign exchange and domestic economic difficulties; the National Savings Movement was hard hit.

With this depressing result fresh in his mind, the Chancellor proposed in his Budget for 1958-59 several more stimulants to these types of saving. The total permissible holdings per person of National Savings Certificates was raised from £450 to £750 and the yield on Defense bonds increased from 4.5 per cent to 5 per cent. The tax-free bonus on these bonds was reduced from 5 per cent to 3 per cent, but the maturity of the bonds was also cut from 10 years to 7 years, which in effect increased the gross redemption yield on the bonds from 4.8 per cent to 5.4 per cent.

With the declining rates of interest during 1958-59 in most sectors of the economy, the continued high level of the yields on National Savings Movement media moved these instruments out of line with their competitors, thus explaining their significant increases (see Table II). Sales of National Savings Certificates rose sharply and, for the first time in the period, sales of Defense bonds were not only positive but very substantial. Only the Post Office Savings Bank remained with net withdrawals during the year (see Table II). Although the Budget speech of 1959-60 hinted at a lowering on yields of the National Savings Movement, these lowerings did not materialize, possibly because of the urgent need of the Exchequer to find funds at a time when the Bank of England was making purchases of gilt-edged securities from the market.

Sales of National Savings Movement media in 1959-60 reached new peaks; there were net sales in every category, but with some slowing down in the rate of sales of Premium bonds and National Savings Certificates. As somewhat higher interest rates were forecast generally for the economy, the Chancellor made several moves in the Budget for 1960-61 to insure continued sales of these media. The first of these stimulants was to increase the total permissible holdings of National Savings Certificates from £750 to £900 per person. A new series of Defense bonds was introduced with the same yield as the previous issue of 1958 but with the maximum permissible holding increased from £2,000 to £5,000 in addition to any holdings of the previous issues. The yield on the Premium bond was increased from 4 per cent to 4.5 per cent and the waiting time until the first draw was reduced from six to three months. The higher rate of interest contributed to more and larger prizes and the betting odds were stabilized. The final change was in the formerly unchangeable Post Office Savings Banks and Trustee Savings Banks. In these institutions the total permissible deposits per person were increased from £3,000 to £5,000.

The results of these measures are still not completely known but some analysis of the first two quarters of the year 1960-61 may be ventured. With a Bank rate 2 per cent higher than the comparable period in 1959-60, competition from other forms of investment has been stronger and there has been a consequent fall in the rate of increase from £140.6 million (excluding interest) in the first two quarters of 1959-60 to £100.3 million this year. Only Premium bonds have succeeded in surpassing their record of last year. Higher interest rates on competitive media, the desire of investors to remain liquid until the investment outlook in the United Kingdom becomes clearer and the increased hire-purchase and mortgage obligations assumed recently by potential small investors may have contributed to the slowing down of bond sales this year.

The contribution of small saving to Exchequer financing

Over the past three financial years, the change in the contribution of the National Savings Movement to Exchequer finance has been noteworthy. In 1957-58, there were net withdrawals from the funds of the National Savings Movement that are available for loan to the Exchequer. During the 1957-58 year, the Exchequer depended entirely upon non-savings sources for new cash; borrowing from the clearing banks of £260 million and from the public in the form of an expanded note issue of £125 million enabled the Treasury to purchase £135 million of securities sold by nonbank investors and to finance the sterling cost of increased foreign exchange reserves as may be seen in Table IV.

In 1958-59, the tide turned. In 1958-59 and 1959-60, receipts from small savings provided £635 million and marketable bond sales to nonbank investors provided £420 million of cash to the Exchequer. With these two sources of cash inflow, the authorities were able to retire £617 million of bank-held marketable debt. These cash inflows not only facilitated the Treasury's financing of its capital needs from nonbank sources but they made it easier for the authorities to encourage the banks to expand private credit as a principal part of their expansionary economic policies after credit restriction was lifted in mid-1958.

Despite the success of this program, there has been some controversy about the interest rate policy in effect on these small savings instruments. On the one hand, the head of the National Savings Movement emphasized to the Radcliffe Committee the interest sensitivity of investors in these instruments in these words:

Table IV

United Kingdom: Sources of Exchequer Finance,
Fiscal Year April to March
(In millions of pounds)

	1957-58	1958-59	1959-60
Nonmarket borrowing:			
External transactions	- 139	- 250	- 81
Notes in circulation	+ 125	+ 50	+ 100
Tax reserve certificates	- 17	+ 44	- 35
Small savings1/	- 6	+ 281	+ 354
Total nonmarket borrowing	- 37	+ 125	+ 338
Market borrowing:			
Estimated from banks2/	+ 260	- 307	- 310
Estimated from nonbanks3/	- 135	+ 132	+ 288
Total market borrowing	+ 125	- 175	- 22
Total borrowing, all sources	+ 88	- 50	+ 316

1/ Excludes deposits in the Special Departments of Trustee Savings Banks since they are usually not loaned to the Exchequer.
2/ Rough calculation based on changes in call loans and holdings of Government securities of the London clearing banks.
3/ Residual. Very rough approximation.
Source: Monthly Digest of Statistics, Central Statistical Office (Table 145).

Lord Radcliffe: But if you throw the emphasis on the rates of interest being out of line with other things elsewhere, are you not telling us that your investors in national savings are greatly interest conscious?

Lord Mackintosh: Much more than they used to be.4/

On the other hand, a former senior Conservative Treasury official has questioned the usefulness of the National Savings Movement in a recent book.5/ He has suggested, in the words of The Economist, that the Movement

> collects small savings for the Government with the aid of artificial tax-free interest rates. Costs of collection are high. National savings certificates are easily encashable, and cannot be made to lose part of their value (as gilt-edged securities do) when the Government puts up interest rates to discourage new consumption out of past savings.6/

He also maintained in his book, according to the London Times, that the great increase over the last two years in the size of national savings is "largely because investors liable to tax at standard or higher rates" are switching from one form of investment to another rather than any change in the propensity to save of the small saver. However, this argument does not seem to maintain that the substantial quantity of funds that has been funneled into the Exchequer through national savings over the past two years would have found its way eventually to the Exchequer if rates on national saving media had not been so high. From the point of view of Treasury finance, the latter question has been an overriding consideration in the formulation of fiscal policy.

4/ Minutes of Evidence of Radcliffe Report, Paragraph 8005.

5/ Enoch Powell, Saving in a Free Society, Hutchinson, 1960. Mr. Powell who resigned with Chancellor Thornycroft in early 1958 is now Minister of Health.

6/ The Economist (London), October 8, 1960, page 125.