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Proposed Changes in Techniques of U.K. Monetary Policy

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Summary of Proposed Reform of U.K. Monetary Policy

In a statement issued May 15 under the title, "Competition and Credit Control," the Bank of England indicated that several reforms to promote greater efficiency in the implementation of monetary policy and the operations of the banking system will be adopted at an as yet unspecified date.

The principal innovations proposed include elimination of specific quantitative limits on bank lending in sterling; extension of variable reserve requirements, now applicable only to the London clearing banks and Scottish banks, to the whole banking system; and termination of the fixing of interest rates, according to convention or agreements, charged and paid by the London clearing banks and the Scottish banks (hereafter referred to as the clearing banks).

Ceilings on sterling loans by U.K. banks -- which have been in effect almost continuously since 1965 -- combined, in the case of the clearing banks, with interest rates tightly linked to Bank rate have led to credit rationing and have prevented individual banks from gaining business at the expense of their less efficient or enterprising competitors. More indirect control over bank lending coupled with greater interbank competition is expected to eliminate these inefficiencies.

The Bank of England described its May 15 statement as a series of "proposals" intended to serve as a "basis for discussion," but the statement announced the introduction, effective immediately, of several changes in the Bank's mode of operations in the government bond market, designed to increase the Bank's flexibility in these operations. The key element in the new arrangement is that the Bank will no longer purchase government bonds with more than a year to run upon request but will make such purchases only upon its own "discretion and initiative." The assumption by the Bank of complete freedom to abstain from purchases of government bonds would appear to be an extension of the policy introduced two years ago of more sparing intervention by the Bank in the bond market. The new arrangements would thus seem significant mainly as a declaration of the Bank's intent not to permit its concern over what happens to the market for long-term government securities (those with an initial maturity of at least a year) to undermine its monetary policy.

Though the forthcoming reforms will apply to the entire banking system, the main impact will be on the clearing banks. This is true mainly because, first, the nonclearing banks -- for the most part, banks that operate chiefly in the Euro-dollar market[1/] -- already compete with respect to interest rates and, second, the reserve requirements will be calculated as a proportion not of total deposits but only of sterling

1/ The nonclearing banks include the British merchant banks and the overseas banks. The latter include foreign banks and British-owned banks engaged primarily in overseas business. American banks account for over half of the deposits of the overseas banks. The merchant banks account for about a quarter of total nonclearing bank deposits.

deposits and, apparently, net foreign currency liabilities.[2] Consequently, while virtually all clearing bank deposits will be subject to the requirements, required reserves of the nonclearing banks will be computed on the basis of a magnitude equal to only about a fourth of their total deposits.[3] (Because of their large-scale Euro-dollar business, the nonclearing banks account for over 60 per cent of all deposits of U.K. banks -- not counting interbank deposits -- but no more than 30 per cent of total sterling deposits.)

The proposed reforms are not designed to affect the capacity of the nonclearing banks to attract foreign currency deposits or to lend in foreign currencies, at least to nonresidents. (The authorities could of course impose reserve requirements on foreign currency deposits but such action would run the risk of driving the center of the Euro-dollar business out of London to more permissive climes.) But it seems certain that the Bank of England will retain its exchange control powers to regulate borrowing in foreign currencies by British residents. Since

2/ The assumption that net foreign currency liabilities will be subject to reserve requirements is based on the statement in the document that "The amount of reserve assets to be held by banks would be calculated by reference to their sterling deposits obtained outside the banking system including sterling resources acquired by switching foreign currencies into sterling."

3/ In December 1970, for example, total deposit liabilities of the nonclearing banks -- excluding interbank deposits -- totalled £20.5 billion. Their total sterling deposit liabilities -- including certificates of deposit denominated in sterling -- plus the difference between their foreign currency liabilities and assets equalled about £5.2 billion. The latter figure is approximately 25 per cent of the former.

January, foreign currency borrowing by British firms, except where the maturity of the loan is at least five years, has been prohibited. The ban was imposed because such borrowing posed a serious threat to the implementation of the tight money policy of the British government last year, as British firms sought to circumvent restrictions on clearing bank lending by obtaining funds in the Euro-dollar market.

The Bank of England's statement is discussed in more detail below.

Proposal for Reserve Requirements

The Bank of England has recommended that the basic reserve requirement be set at 12-1/2 per cent of the sterling deposits[4/] of each individual bank, clearing bank or nonclearing bank, with eligible reserve assets to include cash on deposit with the Bank of England (exclusive of special deposits), Treasury bills, call loans to the money market, British government securities within a year of maturity, "local authority bills eligible for rediscount at the Bank of England and, up to a proportion to be specified, commercial bills eligible for rediscount at the Bank of England." The reserve requirements will, in effect, be made variable through the mechanism of "special deposits." Introduced in 1958 (though not actually used until 1960), special deposits are deposits, paying interest 1/16 of a percentage point

4/ Specifically, "sterling deposits obtained outside the banking system." (See footnote 2.)

below the rate on Treasury bills, which the Bank of England can require the clearing banks to maintain at the Bank.[5] The special deposits must equal a prescribed proportion -- which the Bank of England can vary -- of each clearing bank's own deposits, and do not count as "liquid assets."[6] Under the new system special deposits will not be eligible to meet "reserve requirements"; in effect, therefore, they are additional reserve requirements.

The 12-1/2 per cent figure was chosen because it reportedly represents the average proportion of sterling deposits for all banks constituted by the assets which the Bank of England would classify as reserve assets. However, there are wide deviations from this average, and the Bank acknowledges that "special provisions" will be needed to deal with the problems this will create.

In general, the nonclearing banks will have to acquire eligible assets in large amounts to reach the 12-1/2 per cent minimum. As a rough estimate, their aggregate holdings of what would count as reserve assets now amount, at most, to 7 or 8 per cent of their aggregate sterling

5/ From May 1969 to April 1970, the rate on special deposits was reduced to half the rate on Treasury bills to penalize the clearing banks for not reducing their loans as directed by the Bank of England in the ceiling on lending it imposed in November 1968.
6/ The special deposits requirement for the Scottish banks has always been half of the requirement for the London clearing banks, for reasons that have never been explained. Professor Sayers suggests that the lower requirement for the Scottish banks relates to their serving the function of savings banks far more than the London clearing banks do and also the higher proportion of government bonds in their portfolios.

deposits. Interbank deposits and local authority deposits constitute the bulk of their sterling assets, and neither of these categories is eligible.

On the other hand, the reserve ratio of the clearing banks, unless reduced by a large initial increase in special deposits, will far exceed 12-1/2 per cent. The current requirement is that each clearing bank hold (a) cash -- which includes deposits with the Bank of England (other than special deposits) and till cash -- equal to 8 per cent of gross deposits; and (b) other specified liquid assets -- which may include Treasury bills, call and short-term loans to the money market, commercial bills, and certain loans for export purposes -- equal to at least 20 per cent of gross deposits.[7/] In fact, since mid-1969, the liquidity ratio (the ratio of cash and other specified liquid assets actually held to gross deposits) has consistently remained well in excess of 28 per cent. In April, for example, the ratio was 32.3 per cent. If the new reserve ratio were in effect, along with the new regulations regarding eligible reserve assets, it is likely that the excess would still be considerable.

The Bank of England omits mention of special export loans as a qualifying reserve asset in the future. It also indicates that

7/ Gross deposits of the clearing banks are defined to include "balances with, and cheques in the course of collection on, other banks in the United Kingdom and the Republic of Ireland and items in transit between offices of the same bank." (See Bank of England Quarterly Bulletin, 11:1 (March 1971), p. 138.

not all call money with the London money market will be considered eligible and that commercial bills will be acceptable only up to a specified proportion of deposits. By thus excluding or restricting the use as eligible reserve assets of several loans and investments it has had little power to influence, the Bank should enhance its ability to control the required liquid reserves of the clearing banks. However, even if one deducts all bills other than Treasury bills, refinancable credits (these are essentially the special export loans which qualify as liquid assets), all loans to the money market other than call loans to the discount market, and till cash (which will also be excluded as an eligible reserve asset), the liquidity ratio in April would have been 13.8 per cent. But this figure greatly understates what the liquidity ratio would be under the new rules, since it excludes bank holdings of government securities with less than a year to maturity -- which the Bank of England will now consider a reserve asset -- and since it is not the Bank's intention to exclude all commercial bills from the category of eligible asset. To reduce the clearing banks' liquidity ratio to 12-1/2 per cent, a sharp increase in the special deposits requirement would probably be necessary.

The Bank of England statement does not indicate whether there will continue to be a fixed cash ratio corresponding to the current 8 per cent requirement for the clearing banks or whether the mix of reserve assets will be left entirely to the banks' discretion.

As noted above, the reserve requirements will be altered by varying the special deposits requirement, to which all banks will now be subject.[8/] The range over which and the frequency with which the authorities are willing to vary the requirement will thus be crucial in determining the extent to which reserve requirements can influence the volume of lending. To date, special deposits have had only a very marginal direct effect on the ability of the clearing banks to lend: the requirement has been kept low -- the current level of 3-1/2 per cent, set last October, is the highest it has ever been -- and changes have been infrequent and small.[9/] Calls for special

8/ The nonclearing banks have been subject to a variant of special deposits known as cash deposits since 1967, though a call for such deposits has never been issued. In much the same manner that it can call for special deposits from the clearing banks, the Bank of England may require the nonclearing banks to make deposits with it equal to a designated proportion of their deposits. However, under the cash deposit scheme, the Bank may vary the proportion required as between types of banks or even individual banks. The authorities have been quite frank to acknowledge that cash deposits would be used not as a form of "ratio control" but to penalize banks that failed to follow the guidelines and directives of the monetary authorities. Chancellor Jenkins commented in April 1970, "Clear guidance will be given from time to time to these banks [the nonclearing banks] and a call for cash deposits would be the result of this guidance not being followed."

9/ In the past, the banks have been able to meet increases in special deposits by the relatively costless method of selling government securities close to maturity. This may have been an important reason for including government securities with less than a year to maturity among the eligible required reserve assets. The banks may now find they cannot part with such securities if they are to satisfy reserve requirements. They may thus have to sell off other, longer-term assets -- possibly at a substantial capital loss -- thereby raising interest rates (and hence decreasing demand for loans) and/or restrict lending (thereby raising interest rates) in order to observe the higher special deposits requirement. (Presumably, the banks can no longer expect the Bank of England to bail them out in such a situation through open market purchases of long-term government bonds.)

deposits have been utilized mainly as a signal of the lending policies the authorities wished the banks to follow. Presumably, under the new system, the authorities will employ special deposits more boldly, changing the requirements more often and by greater amounts than in the past.

The May 15 statement indicates that the special deposits requirement, while it will be uniform with respect to all individual banks, may be applied selectively or differentially to different classes of deposit. Specifically, the Bank suggests that separate special deposits requirements may be established for resident and nonresident sterling deposits. Sterling deposits held by nonresidents represented about 8 or 9 per cent of total sterling deposits in all U.K. banks (excluding interbank deposits) in 1970.[10/]

Special deposits differentiated in this manner could be put to many uses. For example, raising the requirement on nonresident deposits could offset or reduce the expansionary effects on bank lending capacity resulting from a hot money inflow without simultaneously reducing bank lending capacity based on domestic (resident-owned) deposits. Boosting the special deposit rate on net foreign currency liabilities[11/] could be used to discourage banks from switching into sterling assets.

10/ Virtually all nonresident deposits in sterling are in the nonclearing banks. Consequently, differential special deposits requirements would not have the same effect on the clearing banks as on other banks, even though the requirement for any one type of deposit was uniform.
11/ Net foreign currency liabilities plus sterling deposits of nonresidents equalled about 11 per cent of total sterling deposits in U.K. banks in 1970.

Introduction of Interest Rate Competition

Slightly over half of the deposits of the clearing banks are demand deposits (called "current account deposits") on which no interest is paid. The May 15 statement gives no suggestion that the banks will be allowed to pay interest on these deposits.

The remainder of the deposits of the clearing banks, however -- those in the so-called "deposit accounts" category -- will be freed from current restrictions. These deposits, on which checks cannot be written and which, technically, are withdrawable only on seven days notice, now pay interest rigidly set 2 percentage points below Bank rate. Under the new arrangements, the yield on deposit accounts will no longer be tied to Bank rate, allowing the clearers considerably more scope in competing for funds against each other and other financial institutions. However, the May 15 statement indicates that the clearers will not enjoy unrestricted freedom in setting and changing interest rates on deposit accounts, principally because of the impact the authorities fear such freedom would have on other institutions.[12/] In particular, the Bank of England is concerned that under the new system the clearing banks might divert funds from government savings institutions and the building societies (the equivalent of U.S. savings

12/ The statement says nothing of how interest rates on deposit accounts might be regulated, noting only that it might be necessary to "observe some limits on the terms offered for savings deposits."

and loan associations) in unacceptably large amounts. Apparently, interest rates on deposits in these latter institutions will continue to be set by law (in the case of government savings institutions) or will remain sticky with the blessing of the government (in the case of the building societies).

Interest rates charged by the clearing banks will be freed from restrictions when the reforms take effect. Under the present system, the prime rate is set a fixed number of percentage points above Bank rate. The margin was half a percentage point until the autumn of 1969, when it was raised to a full percentage point because of the emergence of a marked disparity between bank lending rates and other short-term rates.

With bank lending rates no longer tied to it, Bank rate will presumably lose virtually all of its importance as a tool of monetary policy. Bank rate can be expected, as a rule, to follow changes in other short-term rates and therefore be changed more frequently.[13/] Its remaining function in implementing monetary policy will be almost exclusively limited to communicating signals. For example, a change in the discount rate could, on occasion, still be used to herald a change in monetary policy. Requiring the discount houses (the

13/ The May 15 statement makes no mention of any change in the arrangement whereby the Treasury bill rate is linked to Bank rate, with the yield on the weekly tender allowed to fluctuate only within a narrow range under it. Consequently, with virtually all other short-term rates allowed to move freely, flexibility in Bank rate would be required if the government wishes to keep the Treasury bill rate in line with these other rates.

institutions with which the Bank of England deals in its role of lender of last resort) to borrow at Bank rate (a penalty rate in the British system) could still serve as a method of expressing official displeasure with actions of the banking system (and might also exert marginal upward pressure on short-term interest rates).

The clearing banks will not be completely free to determine the terms on which they lend. The May 15 document states that the Bank of England will continue to give "qualitative guidance," specifying, by way of an example, that it would continue to forbid the banks to extend personal loans for the purchase of goods subject to hire purchase regulations on more favorable terms than those permitted in hire purchase contracts.[14/] For several years, the authorities have stipulated minimum downpayments and maximum repayment periods on hire purchase sales of a variety of consumer durables, most notably automobiles.

14/ In-mid June, however, several finance houses, though no clearing banks, indicated that they had ceased to observe this restriction on personal loans, apparently with the tacit acceptance of the government. This suggests that limitations on hire purchase sales will soon be relaxed or eliminated. Incidentally, as deposit taking institutions, the finance houses -- the principal providers of installment credit in the U.K. -- apparently will also be subject to variable reserve requirements, which, however, are likely to differ from those applied to the banks.

Concluding Comments

Though the details of the reforms remain to be worked out with the banks before they go into effect (probably no later than next autumn, though a definite date has not been disclosed), the proposals in their present general form suggest that major innovations in the techniques of British monetary policy and in the control and operations of the British banking system are envisioned. Discarding quantitative limits on bank lending and allowing clearing bank interest rates to reflect the play of supply and demand are expected to put an end to credit-rationing and to spur competition among the banks, developments which will augment efficiency. At the same time, though the authorities may sacrifice much of their capacity to influence the direction and composition of bank lending (for instance, by exempting certain classes of loans from ceilings), their ability to control the overall volume of bank credit -- through market operations in government securities of more than a year's maturity and manipulation of special deposits requirements -- should not be diminished.[15/]

In fact, the role of market operations in such securities in conducting British monetary policy may substantially increase. The emphasis in the May 15 statement is on how the Bank of England has restricted its self-imposed obligation to purchase bonds more than

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15/ Bank of England operations in short-term securities are discussed in the Annex.

a year from maturity. However, freedom to abstain implies freedom to intervene directly, by buying or selling, heavily if necessary. Thus, in the future the authorities may heavily depend on official market intervention to affect the banks' reserve position and to regulate the size of such monetary aggregates as the money supply. The British authorities have assigned a much higher priority to managing monetary aggregates in the last two years than ever before.

However, though the reforms in broad outline appparently foreshadow a major renovation of British banking practices and of the execution of monetary policy, the actual extent of the changes depends on how vigorously they are implemented. Indeed, the projected alterations in the conduct of monetary policy, at least with respect to the clearing banks, depend, primarily, not on the creation of new machinery, but on both increasing and changing the use of machinery which the authorities have long had at their disposal. Variable reserve requirements become effective only if the authorities vary the requirements by significant amounts -- something they have not done in the past even though their powers to alter the special deposits requirement for the clearing banks allowed them to do so. Furthermore, the greater discretion the Bank of England will now exercise in the government bond market becomes meaningful only if the authorities no longer give overriding priority to interest rate stabilization. The central government may again be running large deficits, with a borrowing requirement of £683 million foreseen for the fiscal year which began April 1. This could rekindle the pre-occupation with maintaining "orderly markets" -- that is, moderating interest rate fluctuations -- to assure a ready market for government bonds.

It appears that the authorities are somewhat apprehensive about the reduced control over bank lending that the forthcoming reforms will entail, and it is clear that they have chosen the present period to introduce the new arrangements because it is one in which stimulative measures are called for and can be taken with little risk to the balance of payments. With unemployment at exceptionally high levels by British standards and with aggregate output apparently declining -- industrial production fell by about 1 per cent from November-January to February-April -- a rise in bank lending is certainly desirable.[16]

But how willing the authorities will be to stick with the new system should the situation turn less favorable to expansion -- when, say, balance-of-payments difficulties may be encountered and aggregate demand may be growing rapidly -- remains to be seen. With a highly centralized domestic banking system -- there are only six London clearing banks, all headquartered within a stone's throw of the Bank of England -- the possibility of making great use of moral suasion backed up by relatively easily enforced direct controls remains in reserve.

16/ Governor O'Brien himself, in the text of a speech delivered May 28 at the International Banking Conference in Munich, said, "We judge the present situation of low international interest rates, relatively slack demand for loans and a strong balance of payments to be a propitious moment in which to introduce these changes."

ANNEX

The Bank of England conducts open market operations in short-term securities -- mainly three-month Treasury bills -- that are classified as reserve assets. These bill operations, however, cannot affect the reserve position of the clearing banks, which must hold cash equal to 8 per cent of deposits plus other liquid assets, including Treasury bills, equal to at least 20 per cent of deposits. This does not weaken the ability of the Bank of England to control the reserve position through its other market operations, the purpose of its dealings in short-term securities being to enable the discount houses to balance their books each day.[17/]

Buying Treasury bills (or, on occasion, other assets) is a non-punitive way of assisting the discount houses, in contrast to lending to them at Bank rate, a penalty rate in that it is higher than the rates the houses earn on at least one of their key investments, Treasury bills, for which the houses are obliged to submit a bid at the weekly tender. Lending at Bank rate serves as a signal of dissatisfaction with the behavior of the banking system and can also push up short-term rates to a limited degree. (Under the present system, substantial increases in short-term rates depend on changes in Bank rate.)

17/ Assets of the discount houses averaged about £1.85 billion ($4.44 billion) in 1970. This was equal to about 18 per cent of the average value of the assets of the London clearing banks in the same period. Loans from the latter account for about two-thirds of the discount houses' liabilities.

As a general rule, the Bank of England aims at forcing the discount houses to obtain assistance from it more or less constantly. It seeks to accomplish this by maintaining an excess of receipts over disbursements in its capacity as manager of the Treasury's accounts and through its operations in the bond and foreign exchange markets. Specifically, the Bank undertakes to achieve this excess by "over-issuing" Treasury bills, a practice whose initial effect is to compel the clearing banks to acquire cash to meet their 8 per cent cash reserve requirement.18/ The banks generally do this by requiring the discount houses to repay their call loans, a prime source of funds for the latter institutions. The discount houses then turn to the Bank of England for the funds needed to balance their books. The Bank can provide the funds in various ways: by lending at Bank rate, lending at non-punitive "market rates," or buying short-term securities, generally three-month Treasury bills but in recent years --

18/ See R. S. Sayers, Modern Banking, Seventh Edition, Oxford: Clarendon Press, 1967, p. 114. See also "The Management of Money Day by Day," Bank of England Quarterly Bulletin, III:1 (March 1963), p. 16, where it is stated, "If the Bank [of England] are [sic] to operate effectively, therefore, it suits them if there is an initial shortage of funds in the market which they may at their discretion relieve with or without the penalty of forcing [discount] houses to borrow at the Bank....In practice the normal operation of the weekly Treasury Bill tender will usually create such an initial shortage of funds. This is because the number of Bills which is put on offer at the tender each Friday, to be paid for day by day in the following week, is calculated so as to cover the Exchequer's estimated needs with, if anything, a small margin to spare...."

when, in connection with central government surpluses, holdings of Treasury bills have decreased -- other assets as well, such as commercial or local authority bills. Occasionally, the Bank of England may relieve a cash shortage by buying bills from the clearing banks rather than from the discount houses. However, Bank of England loans are made only to the discount houses.

On relatively infrequent occasions, the discount houses will find themselves with surplus cash at the end of the day, which the Bank of England must mop up with sales of Treasury bills.

The discount houses are not classified as banks and will not be subject to the new reserve requirements. The May 15 statement says only that "separate proposals are therefore being made to the [London Discount Market Association] to ensure that their operations do not undermine the authorities' arrangements with the banks." There will apparently be no change, at least for a while, in the principal public duty of the discount houses, that of assuring that all of the government's weekly tender of Treasury bills will be bought. The discount houses submit a unified bid each week for the entire tender. Rarely will they receive all of the bills, since bids at higher prices for some portion of the issue will generally be received from other prospective buyers.

The principal assets of the discount houses, in addition to Treasury bills,[19] are commercial bills, local authority securities, sterling certificates of deposit and government bonds, mostly in the one- to five-year maturity range. As noted, call loans from the London clearing banks are their main liability.

19/ The discount houses seldom keep Treasury bills to maturity selling them, instead, to the clearing banks and other buyers.