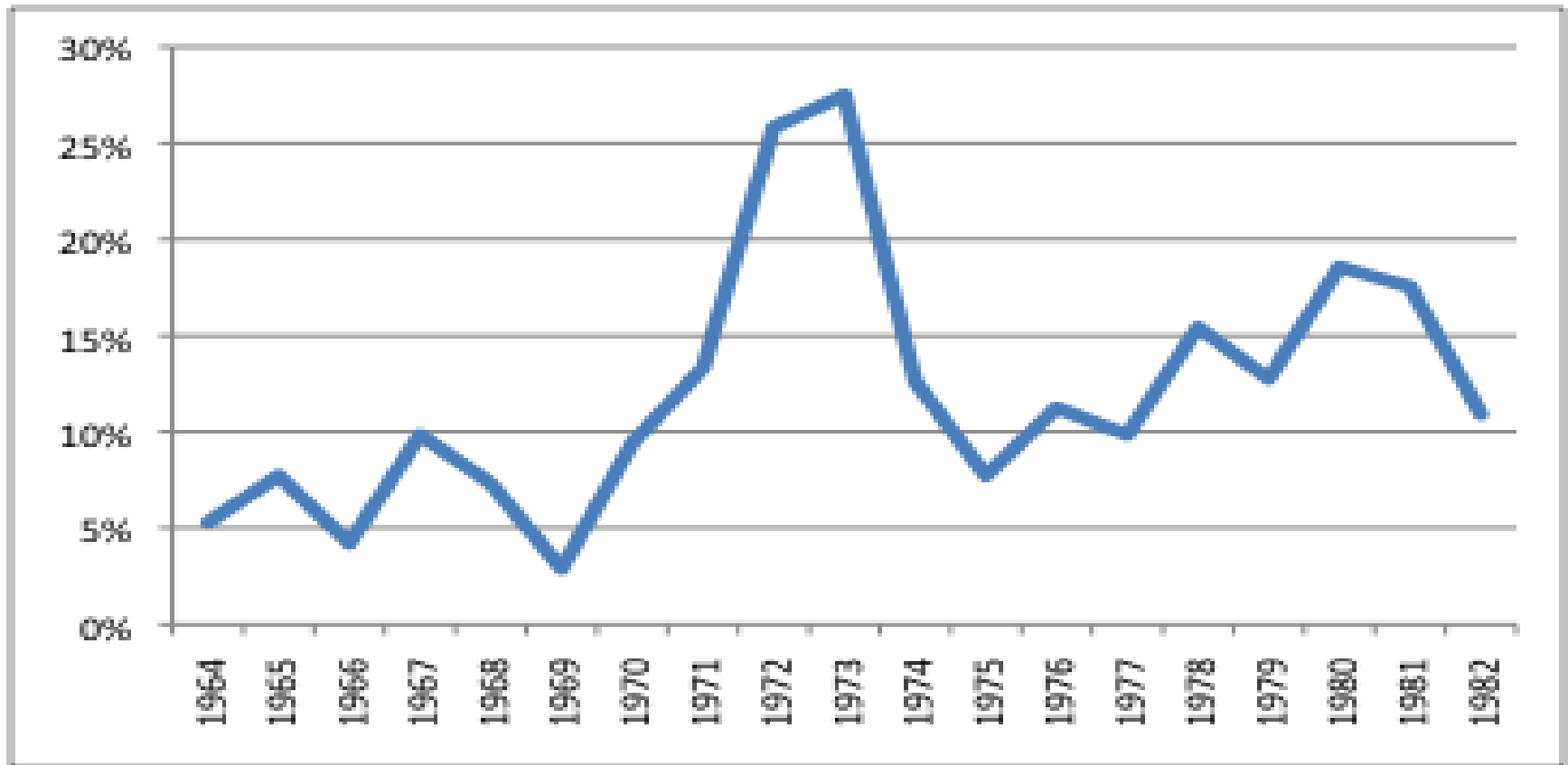


Financial Deregulation in the early 1970s: Competition & Credit Control, the Secondary Banking Crisis and 'Practical Monetarism' in Britain

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M3 growth

Agenda

- Competition and Credit Control was a ‘practical monetarism’ solution to the problem of imposing post-devaluation credit controls within the existing regulatory framework.
- The Bank’s demand-for-money equations were spectacularly wrong in 1972. This fuelled the monetary explosion that accompanied Heath’s dash-for-growth and precipitated the Secondary Banking Crisis.
- The Lifeboat operation was shaped by the need to ‘recycle’ rather than ‘inject’ liquidity in order to keep M3 under control.

Monetary Tools

- Bank Rate — no longer that ‘most delicate and beautiful instrument for the management of a monetary system’ following the growth of the wholesale markets
- Liquidity Ratio (28%) — easy to ‘window dress’
- Special Deposits — a blunt and counter-productive instrument
- Open market operations — ‘lean into the wind’ or control M?
- Lending ceilings — often at the behest of the IMF
- (Hire purchase controls)

The clearing bank cartel's tariff

Type of Customer	Rate Charges	Details
Nationalised Industries (with a Treasury guarantee)	Bank Rate with minimum 4%	Some lending is at 0.5% above Bank Rate reflecting the use of funds in hire purchase business
Local Authorities Building Societies Insurance Companies Other First Class Industrial and Commercial Borrowers	Bank Rate + 0.5% with minimum 4.5%	The 'blue chip' rate
Hire Purchase Companies	Bank Rate + 1% with minimum 6%	Minimum rate
Export Loans (guaranteed by Export Credit Guarantee Department)	i) Bank Rate with minimum 4.5 % ii) Fixed Rate of 5.5 %	For loans up to 2 years For loans for 2-15 years (subject to 1% commitment fee to cover the whole term)
Other Industrial and Commercial Business and all private customers	At discretion, but above the 'blue chip' rate	
Medium term shipbuilding finance (guaranteed by Ministry of Technology)	Fixed Rate of 5.5 %	For loans up to 8 years (10 in exceptional circumstances. Overall limit of £200mn outstanding at any one time.

Source: 'The clearing banks' collective agreements', 20 August 1968, TNA, T326/861.

Lending ceilings (and the IMF)

	Clearing banks	Other banks	Larger Finance Houses
Jul-61	100% of Jun 1961	100% of Jun 1961	100% of Jun 1961
Oct-62	Ceiling removed	Ceiling removed	Ceiling removed
May-65	105% of March 1965	105% of March 1965	105% of March 1965
Apr-67	Ceiling removed	No change	No change
Nov-67	100% of Nov 67	100% of Nov 67	100% of Oct 67
May-68	104% of Nov 67	104% of Nov 67	No change
Nov-68	98% of Nov 67	102% of Nov 67	98% of Oct 67
Apr-70	105% of Mar 70	107% of Mar 70	105% of Mar70
Mar-71	107.5% of Mar 70	109.5% of Mar 70	107.5% of Mar 70

Source: J.H.B. Tew, 'Monetary Policy Part I', in F.T. Blackaby et al., *British economic policy, 1960-75*, (Cambridge, 1978), pp. 224-226 and *BEQB*, various

Bank of England ‘ladder of recognitions’

Box 1 STATUS OF A BANKING INSTITUTION (PRE-1979)

The status of a banking institution was based in practice on what became known as “ladder of recognitions”, depending on its position under various statutes.

- 1 Authorised status under the Exchange Control Act 1947 — the Bank and the Treasury were responsible for establishing a list of banks authorised to deal in foreign exchange. This was regarded as the highest accolade a bank could attain.
- 2 Companies Act 1948 exemption from disclosure of certain information in company accounts.
- 3 Exemptions from the Protection of Depositors Act 1963 restrictions on advertising for deposits.
- 4 Companies Act 1967, section 123 certificate — issued by the Board of Trade to institutions it considered to be *bona fide* carrying on the business of banking. This certificate secured exemption from the Moneylenders Acts.
- 5 Recognition under Income and Corporation Taxes Act 1970 — granted by the Inland Revenue to bona fide banking businesses allowing them to pay and receive interest gross of tax.

Some of the “lesser” recognitions only required decisions about the type of business carried on (eg section 123 certificates) rather than fitness and properness and soundness of the institution.

- ‘The Bank may, if they think it necessary in the public interest, request information from and make recommendations to bankers and may, if so authorized by the Treasury, issue directions to any banker for the purpose of securing that effect is given to any such request or recommendation’ Section 4(3), Bank of England Act, 1946.

Source: V. Robb, ‘The genesis of regulation’, Bank of England, *Financial Stability Review*, (Autumn, 1997), p. 30.

From ceiling controls to money supply targets

- A non-regulatory solution to deal with the breakdown of ceiling controls
- The joint Bank/Treasury Monetary Policy Group
- ‘*The Importance of Money*’, February 1970
 - An exercise in practical monetarism.
- The IMF and Domestic Credit Expansion
- M3 from ‘indicator’ to ‘intermediate variable’
- The March 1972 Budget and the ‘dash for growth’

The Bank's demand-for-money equations in 1972

$$MP_t = -4.129 + 0.457Q_t + 0.396Q_{t-1} + 0.336P_t - 1.686RL_{t-1} + 0.628MP_{t-1}$$

$R_2 = 0.997$, Long run elasticities **Q, 2.29**: P, 0.9: RL, -0.3

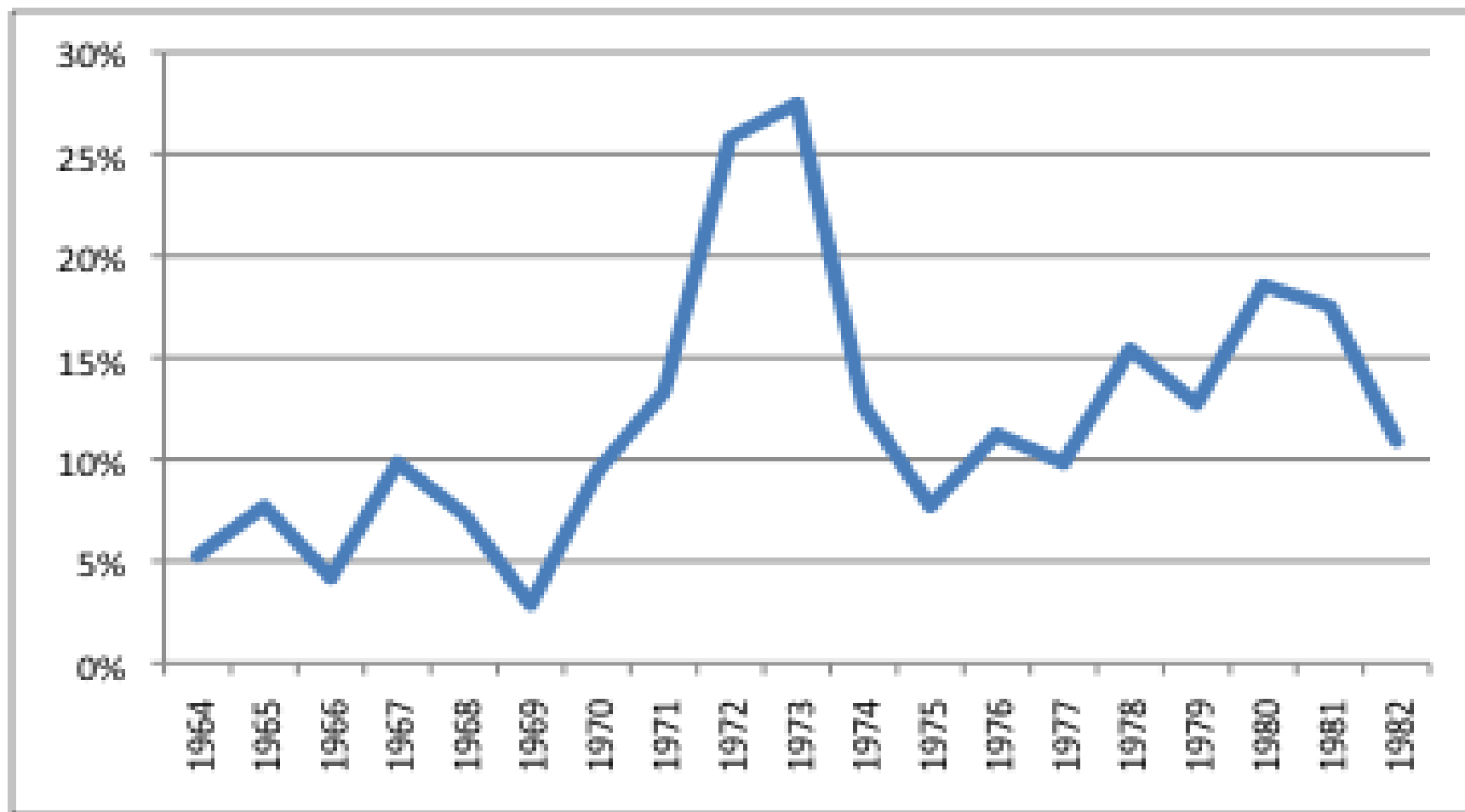
$$MC_t = 1.936Q_t + 0.833Q_{t-1} + 0.406P_t - 4.327RS_t + 0.630RS_{t-1} - 0.008RS_{t-2} - 1.934RS_{t-3} - 4.574$$

$R_2 = 0.983$, Long run elasticities Q, 1.3: P, 0.41: RS, -0.36

Where, MP = personal sector demand for money, MC = corporate sector demand for money, Q = real income, P = prices, RL = (1+Consol yield), RS = (1+ local authority debt yield). The Bank estimated that the personal sector held 65% of M3, the corporate sector 25% with the rest held by finance companies and the public sector.

Source, 'The demand for money in the United Kingdom: a further investigation', *BEQB*, March 1972, pp. 53-4.

M3 Growth



Source: Financial Statistics, CSO, various.

The Bank on the demand-for-money equations

- ‘Equations of the types described provide a sufficiently accurate statistical explanation of past movements in the stock of money to be a useful guide for monetary policy’ BEQB (12), 1972, p. 43.
- ‘The relationships that appeared to be established in the past have not held good more recently’, J.Q. Hollom, Apr. 1973 in BEQB (13), 1973, p. 183
- ‘This study points to a recent significant, and somewhat sudden, though not surprising shift in certain demand-for-money equations’ BEQB (14), 1974, p.285
- ‘The monetarist edifice rests largely on the stability, and predictability, of the demand-for-money function...subsequent experience has revealed weakness in this foundation’ C.A.E. Goodhart, *Problems of monetary management*, 1975
- ‘There is no obvious simple, single equation, demand for M3 balances’ R.T. Coghlan and L.M. Smith ‘*A preliminary note on the demand from M3*’, 15 Sep 1977 (Bank archive, 6A50/22).

Lending by sector to UK residents, May 1971 to August 1973.

	May-71 (£bn)	Aug-73 (£bn)	Nominal change (£bn)	Percentage change
Manufacturing	3.8	5.7	1.9	49%
Other Production	1.2	2.4	1.2	104%
Financial	1.3	4.9	3.6	280%
Services	2.1	4.5	2.4	117%
Personal	1.1	3.4	2.3	209%
Total £ advances to UK residents	9.4	20.9	11.4	121%

Source, *BEQB*, 1971-74.

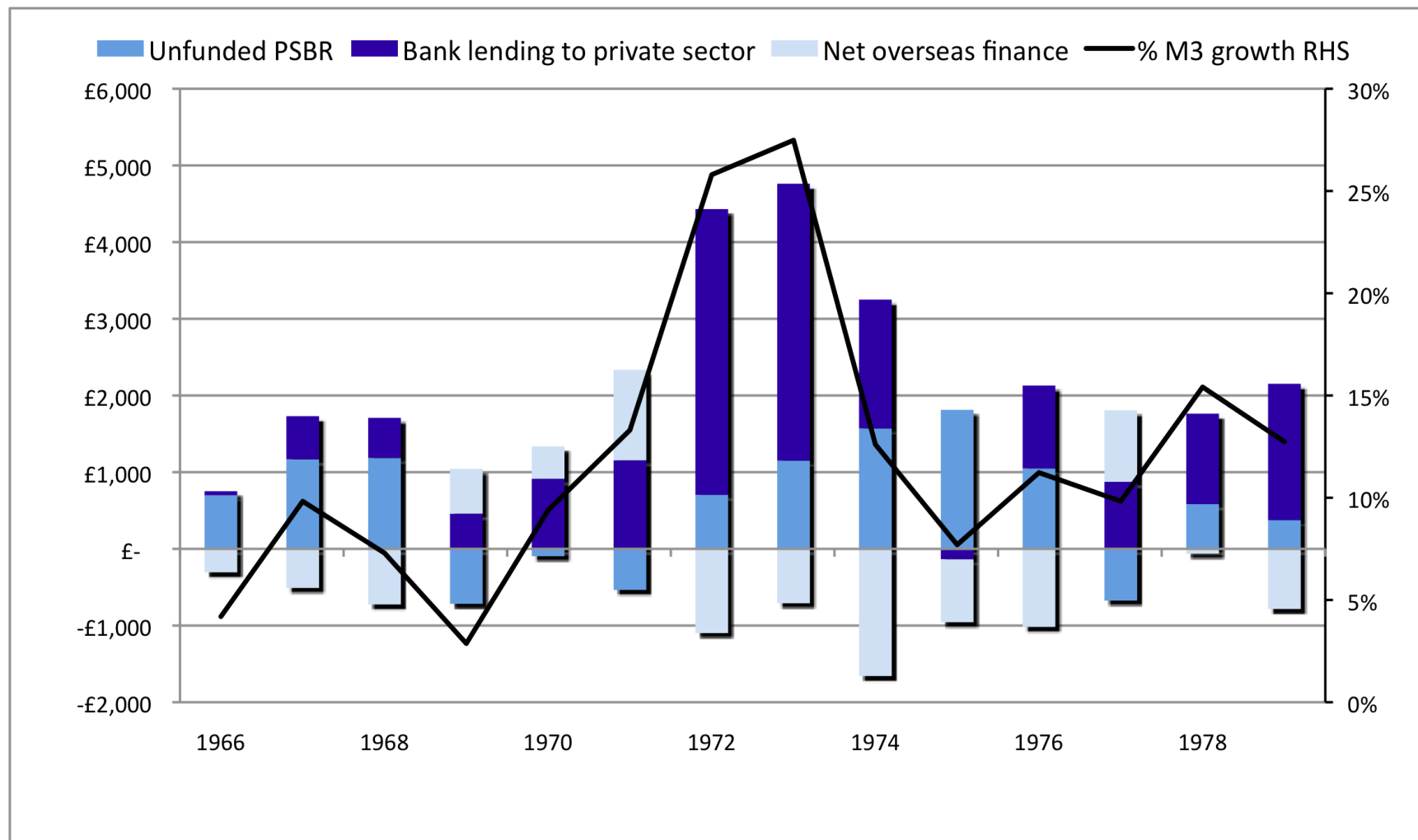
The Lifeboat

- Why did the Bank abandon the old approach?
 - An ‘authorised’ bank should not be allowed to fail?
 - Failures were mostly Section 123 companies
 - Insolvency (G.T. Whyte) and fraud (London and County)
 - Structural changes associated with CCC?
 - Counterparty prudence.
 - Loans not bills
 - The need to control M3
 - The Corset: ‘The prime objective of this device is, quite simply, to contain the growth of M3. A second objective is to avoid producing any perceptible further upthrust in the general level of interest rates’. *‘Controlling growth in M3’*, 29 Nov 1973, 6A50/12

Postscript: public M3 targets

- ‘Britain’s monetary regime was not built on the back of a stable equation or model of money, but on a conceit intended to shackle the state’s spending bureaucracies’. A.C. Hotson, *‘British monetary targets, 1976 to 1987: a view from the fourth floor of the Bank of England’*, March 2010
- ‘If we can establish internally, with the Treasury, the principle of keeping the growth in money supply down and taking any necessary measures to that end, we will in due course get an extra lever on the Chancellor to attack public expenditure itself...if we could get a public statement of a target for the growth of money supply, we should have a tighter rope around the Chancellor’s neck’. C.W. McMahon, ‘Monetary policy’, Jul 75, EID4/200.
- ‘Notwithstanding the pain a target could inflict on us later on, the confidence-raising value of the package could make all the difference between success and failure. Since we cannot afford failure we must have a target’. D. Wass, ‘The July 1976 economic package’, T 386/16.
- ‘In 1976, before the IMF negotiations, I decided to publish these monetary targets, largely to placate the financial markets. But I never accepted Friedman’s theories. Nor did I ever meet any private or central banker who took them seriously’, Healey, *The time of my life*, p. 491.

The counterparts of M3



Source: Financial Statistics, CSO, May 1980 – discounted to 1966 values.

The Medium Term Financial Strategy

- ‘Mr Griffiths explained two alternative views of the conduct of monetary policy since the introduction of Competition and Credit Control (CCC). The Bank of England’s view now was that both the demand for and supply of money are unstable, and that the monetary aggregates must be controlled by ceilings rather than interest rates. The alternative view was that the Bank of England had failed to control the money supply through the reserve asset system, that the demand for money was stable, and that many of the failings of CCC had been because of political pressures on interest rates’, Conservative Party, Economic Reconstruction Group, 1 Dec 1975.
- ‘it would now be right to announce clear targets for monetary expansion as one of the objectives of economic management’ *The Right Approach*, Oct 76
- ‘We should, perhaps, have done more work on monetary policy while in Opposition’, Nigel Lawson, ‘*The Thatcherite Revolution*’, (talk), Cambridge, 2010