

# Cartels and Competition in British Banking: a Background Study

## 1. Introduction

For almost two decades a continuing debate over competition in financial markets has accompanied striking developments in borrowing and lending arrangements in several leading countries. Four considerations make it desirable to examine the state of these matters in Britain. First, the publication in May 1967 of the Prices and Incomes Board's report on Bank Charges (1) has stimulated rethinking about the banks' public service character, their efficiency as business concerns, and their competitiveness. Second, the Monopolies Commission's report in July 1968 on the proposed merger of three leading banks (2) further emphasised these questions. Third, the advent in autumn 1968 of the National Giro could foreshadow the strongest challenge to the private sector banking system for over a century (that is, since the establishment of the Post Office Savings Bank in 1861 to provide the government with finance outside existing financial institutions) (3). Finally, both the balance of payments and the public sector may be moving into sustainable surplus. This would reduce the upward pressure on interest rates, and diminish the temptation to the monetary authorities to seek lower, sub-optimal rates.

This article concerns itself largely with the issues involved in, and the origins of, existing constraints upon banking competition. It is concerned less to propound specific solutions than to argue that

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(1) *Bank Charges*: Report No. 34 of the National Board for Prices and Incomes ("P.I.B."), London 1967.

(2) *Barclays Bank Ltd., Lloyds Bank Ltd., and Martins Bank Ltd.: a report on the proposed merger*, *The Monopolies Commission*, London 1968.

(3) JOHN MORLEY (Lord Morley), *The Life of William Ewart Gladstone*, 3 vols. (London 1903), I, 650-1 and II, 52.

the problem is much wider than the relatively narrow one of banks' restrictiveness. In particular, it is urged that Britain's banking problems should be viewed in the context of financial markets, especially the long-term capital market, as a whole.

## 2. The relative Decline of Commercial Banks

During recent years, the clearing banks have faced problems that can be stated more simply than their possible solutions. Their debt (deposits) has tended to fall as a ratio both to the total volume of debt instruments and to money national income, compared with the period before the second world war. The ratios of their lending to total private sector finance and to national income have also fallen, but by not so much. Other intermediaries, new and old, have supplied the public with debt of varying degrees of liquidity, and have competed with the banks as suppliers of finance. The outstanding consequences have been twofold. First, the banks have experienced slower growth in their business, and possibly in profits, than the maintenance of earlier conditions (if such maintenance had been possible) might have assured to them; the fact that their profits have risen strikingly in recent years does not necessarily affect this point, since high profits may be a sign of market imperfections. To have struck out competitively to recover their share of debt and lending, assuming that this could have happened, would not only have embodied a possible threat to profits through increased costs: it would also have implied drastic changes in banking attitudes and in the role of the banks. Banks did not regard such changes as necessarily advantageous to them. In this sense, the reluctance of bankers to defend their business verged on defeatism, and was almost a recognition that their traditional dominance in financial arrangements had disappeared permanently.

The second consequence of the banks' relative decline has been in the field of official monetary policy. On the one hand, and no doubt to the partial satisfaction of the banks' desire for fair dealing all round, credit controls have been extended to virtually the whole range of financial institutions. On the other hand, the banks continue to operate under special restraints which further weaken their essential characteristics as competitive private enterprises; this has arguably been to the public detriment. Here we can cite in particular the compulsory lending to the public sector of a substantial

proportion (much higher before the recent shrinkage in Treasury bills and expansion of their commercial bill holdings) of their resources at preferential rates, indeed at zero interest on the cash element. These rates are related to the banks' agreements on deposit rates. In lending to the private sector there are also preferential rates for exporters, and preferential treatment generally for those borrowers deemed by government rather than by market mechanisms to represent the country's best economic interests. The upshot for the banks of the recent operation of the monetary system can be summarised in starkly simple terms: they have experienced serious competition, but have been restrained by their own and by official policies, especially in the endemic contemporary credit squeezes, from vigorous counter-competition.

Should banks become more competitive? Are existing market arrangements helpful or unhelpful to the best use of resources? In what follows, experience outside Britain will be cited to illustrate influences upon competitiveness amongst financial institutions; and some attention to Britain's long banking history may help to explain the origin and persistence of existing banking arrangements.

## 3. Traditional and structural Influences against Competitiveness

The traditional reluctance of British banks to compete across the board for deposits has its roots in the nature of the means of payment, the oligopolistic structure of the banking system, and the existence of a developed capital market.

For over one hundred years, cheques have been the principal means of payment other than currency in Britain. Earlier, privately issued notes outside the London area, commercial bills and bank drafts provided much of the country's means of payment. This predominance of bank liabilities (or, in the case of commercial bills, liabilities whose liquidity derived from banks' willingness to discount them) provided banks more or less automatically with a substantial part of their resources in line with the growth of the economy. As oligopolistic suppliers of means of payment, they have therefore been able to obtain deposits cheaply. This has applied directly to current accounts; it has also helped banks to obtain deposit accounts (i.e., « time » and « savings » deposits) cheaply, since these are the interest bearing assets closest in monetary terms to a current account, and thus closest to immediately available cash.

In this perspective, the nonpayment of interest reflects the apparently disadvantageous position of the current account holder, although it is far from clear whether he suffers significant net disadvantages. A current account holder receives an implicit return in the facilities provided by an account, such as convenience in making or receiving payments, the reasonably easy acquisition of currency, safe deposit facilities, etc.. Not least, he has a degree of claim, depending on the general credit situation, to financial help from his banker. Alternatively or additionally, it is arguable that a system of allowing interest and of charging for specific services rendered on current accounts might yield little or no net benefit to customers, and would involve considerable accounting costs. This is an area where further information is badly needed. In practice, British banks do set an implicit rate of return on current accounts against their gross charges, but do not explicitly credit it to accounts (4). In the present context, the relevant point is that banking procedures do recognise that a current account merits a return, albeit implicitly. This is not the same, however, as saying that the supply of deposits is interest elastic; within the zone of rates at which banks might be urged to compete, it may be that competition might not increase deposits significantly. In that case, some might conclude that therefore the banks could pay *lower* rates, whether implicitly on current accounts or explicitly on deposit accounts or even eliminate interest allowances entirely (5).

Is there in fact a significant elasticity of demand for bank deposits? Keynes's *General Theory* long encouraged us to think that the "transactions motives" for holding balances, being strongly influenced by the level of income, were virtually inelastic towards the rate of interest. Perhaps here Keynes was less general and more specific than both the title *General Theory* and indeed his own earlier writings warranted. He had himself noted earlier in his *Treatise on Money* (1930) that business firms in the nineteen-twenties (when interest rates were high) held some liquid resources in bills and money market loans rather than in deposits (6). By

(4) P.I.B., paras. 101, 123, 129.

(5) See, e.g., F.W. PAISH, "Deposit Rates after Mr. Jones", *The Banker*, Oct. 1967, reprinted in his *How the Economy Works* (London, 1970); W.A. MORTON, "A Zero Deposit Rate", *Am. Ec. Review*, Sept. 1940; and P.I.B., para. 58.

(6) J.M. KEYNES, *A Treatise on Money*, 2 vols. (London 1930), I, p. 42 and II, pp. 44-45.

the time of *The General Theory* (1935-6), matters had changed: bill and market rates were historically low, indeed they were virtually nominal, and meant that, when transaction costs were considered, there was little point in holding them rather than cash. These empirical considerations apart, Keynes was abundantly aware, first that the definition of "money" was essentially arbitrary, so that the demand for money is part of the demand for assets in general; and, second, that we ought perhaps to "consider the individual's aggregate demand for money... as a single decision" (7). Unfortunately, the attractions of analytical simplicity led to an identification of distinct *motives* with distinct *demands* for money (8). Thus, Keynes himself seems to have helped to create monetary error, and to slip into economic mythology a misleading version of his own insights.

Conceivably, the Keynesian simplification of "the transactions demand" for money might have been less readily used in respect of bank deposits if the payments system in Britain had resembled that of Continental countries. The public's use of giro and postal cheque services causes Continental banks to depend much more than their British counterparts on attracting time and savings deposits. They are therefore much more likely to have to offer competitive rates; further, to the extent that this imposes significant costs (compared with British banks' access to "interest-free" current accounts), the banks' lending and other charges may be higher than they would otherwise have been (9). Not least of relevance in the present context is the consequent involvement of Continental banks in profitable and possibly riskier lending outside the fields regarded as traditional by British bankers. This brings overlaps, e.g., in mortgage finance, with "non-bank" financial intermediaries, to a degree that emphasises their similarities rather than their differences on both the assets side and the liabilities side of balance sheets. These similarities are broadly acknowledged in some countries by the grouping of the various financial institutions under a single controlling authority. In contrast, and notwithstanding the recent extension of the Bank of England's influence, there has been greater

(7) J.M. KEYNES, *The General Theory of Employment, Interest, and Money* (London 1936), p. 167, n. 1, and p. 195.

(8) *Ibid.*, p. 199.

(9) J.S.G. WILSON, *French Banking Structure and Credit Policy* (London 1957), p. 95.

separation in Britain between substantial segments of financial markets, and between the types of official control exercised: the official supervisors of banks, of hire-purchase companies, and of building societies have continued to be respectively the Bank of England, a government department (Board of Trade), and a public official (the Chief Registrar of Friendly Societies). This differentiation, with specific legislation (10) for various credit activities (as well as more general legislation) has helped to sustain an exaggerated distinction between the credit creating capacities of institutions which have been slowly moving closer to each other, both in assets and in liabilities.

It would be over-hasty to conclude from this comparison between British and Continental practices that the creation of more competitive conditions in banking would impel British banks to lengthen and to increase the risk of their lending. Three reasons can be offered. First, this would impute a scarcely credible degree of passivity to banks in their choice of assets, although it must be admitted that the conventional reaction of British bankers has been an assertion that competition, bringing increased deposit costs, would in fact drive them in the direction of riskier lending. Second, it seems scarcely illuminating to proceed from deposits to assets. Banks are not mere intermediaries, but are, distinctively, creators of means of payment; hence, the platitude, albeit neglected in bankers' conventional reactions, that advances create deposits. The third reason for questioning the view that the taking of more time/savings deposits would compel banks to lengthen and to reduce the quality of their lending is that this argument runs contrary to experience. Here, we can extend the remarks above about the more or less automatic accrual of current account deposits to banks, as the main providers of the means of payments. A sudden withdrawal of working balances, given the existing institutional structure and public preferences, is improbable unless the national income shrinks with disastrous suddenness; nor, if we accept for the moment the bankers' conventional assertions that current accounts are virtually inelastic to interest rates, would they be much affected

(10) See J. S. G. WILSON, "Regulation and Control of the United Kingdom Banking and Financial Structure", in this Review, No. 89, June 1969, pp. 128-145.

by deposit competition. In contrast, the most volatile deposits of banks have been precisely those which bankers' comments have suggested to be the more stable — whether as a force propelling them to longer term investment, or as a requirement before they could happily undertake that. In practice, it has been precisely the "non-active" time and savings deposits which have tended to drain banks in runs: in nineteenth century Britain no less than in modern Hongkong and in the Lebanon in their bank runs during the 1960's.

Here, indeed, help comes from history. Stress on the supposed volatility of demand deposits, and thence on the supposed necessity for a deposit banker to restrict himself to short-term assets, stems from too generous an application of past experience to quite different twentieth century conditions. During the eighteenth and nineteenth centuries, many commercial banks in Britain issued their own notes. These proved to be "quick" liabilities in a panic because they circulated widely amongst non-account holders, who lacked the loyalty of regular users of a bank's facilities. Moreover, deposits in early banks tended to be predominantly savings deposits, and the holders of these were just as likely as note holders to seek to encash their claims on a bank when confidence in it was shaken. A further hazard arose from the pre-1914 system of unit banks of differing sizes. Individual banks were liable to experience serious fluctuations in deposits and in liquidity that are unlikely to arise in a four- or five-bank oligopoly system, in which liabilities and assets are more or less evenly distributed.

This was not all. Three further and closely associated historical influences have left their marks on habits of thought, long after they ceased to have any justification. The first two were the existence before 1914 of a domestic gold circulation and the strict limit, by the 1844 Bank Charter Act, upon the supply of Bank of England notes. This situation sustained widely held fears that an external drain on sterling, particularly if it were accompanied by a domestic drain reflecting lack of confidence in banks, could drive the monetary system into illiquidity and bankruptcy. Third, although the Bank of England had repeatedly, in the eighteenth and nineteenth centuries, resolved financial crises by classical central banking action, bankers professed uncertainty right up to 1914 about whether and when and how the Bank might so act to check a crisis; indeed, influential voices urged that the banking system should seek to do

without such help (and such uncertainty) by building up their own liquid resources (11).

None of these considerations should have weight nowadays. We have an oligopolistic, not a unit, banking system; the note issue has not been rigidly limited to the supply of international means of payment since 1928-31 (12); and the central banking role of the Bank of England is unquestioned — a domestic crash because of some international financial crisis is unthinkable, for the exchange rate would not be defended at that price (13).

#### 4. Bank Lending, the Capital Market, and official Constraints

The traditional banking explanations for non-competition for deposits seem, therefore, to lead into a maze of blind alleys. On the one hand the liquid character of demand deposits is not necessarily a barrier to longer and possibly riskier lending. On the other hand, increased time deposits would not necessarily offer a firmer basis for longer term lending. These conclusions inevitably switch emphasis away from competition and preference for particular types of banking *liabilities* to competition and preference for particular types of *assets*. This is the third element in British banks' reluctance to compete across the board, the nature of the capital market (the first two are the means of payment and the structure of the banking system).

In Britain, internally generated funds have long been a major source of business finance. Externally raised funds have been derived from or through non-banking intermediaries, as well as directly through personal shareholdings. In consequence, particularly since the development of financial markets in the inter-war years, there has not as a general rule been a clear case for the direct acquisition by banks of equity or of relatively long-term fixed interest claims; the exceptions have been special cases, such as the finance of the Industrial and Commercial Finance Corporation, and, more recently,

(11) See, L. S. PRESSNELL, "Gold Reserves, Banking Reserves, and the Baring Crisis of 1890", in C. R. Whittlesey and J. S. G. Wilson (eds), *Essays in Money and Banking in Honour of R. S. Sayers* (Oxford, 1968), pp. 183-4.

(12) By the Currency and Bank Notes Act of 1928 and the suspension of the gold standard in 1931.

(13) Cf. my "1931 and 1968: Repeat Performance?", in *Three Banks Review*, June 1968.

the acquisition of ownership or shareholdings in hire-purchase finance companies. Banks have in general stressed the short-term character of their lending. Where it has been longer term, it has tended to be for special cases and for stated terms; it has been at rates that if not fixed, have been variable with Bank Rate and not with the borrowers' profits (i.e., not on an equity basis). The significance of British banks' finance of industry should not on these accounts be under-estimated. If they have formally insisted on the short-term character of their lending (an insistence in any case less pronounced in recent years), much of it is in fact not of that character. Indeed, the repeated credit squeezes may produce the seemingly paradoxical result of encouraging lending at longer, but fixed, terms; then, in contrast with the nominally short-term, recallable, but in reality very flexible overdraft system with its borrowers' cushion of unused limits, there would be definite dates of repayment, giving greater certainty to banker and customer alike (14). It is in practice the case that overdraft facilities are expected to be and frequently are repeatedly renewable. The regular annual "clean-up" of customers' indebtedness required by some American banks (recalling and perhaps more relevant to more primitive economies) (15) is unfamiliar in Britain. Banks recognise that many of their customers simply could not in fact repay quickly their nominally short-term borrowings, except at great damage to and beyond their own interests (16).

A somewhat different set of considerations is that British banks' preference for nominally short-term lending at more or less fixed interest rates helps industry in ways not always recognised. There are two aspects. First, the deliberate limitation of such finance encourages business firms to depend more upon equity capital. In periods of declining profit, when equity dividends can be cut, this is less burdensome than substantial fixed interest finance which must continue to be serviced (the example in the 1960's of the burden

(14) The case for this approach to lending was aired as long ago as 1959 by Mr W. R. Ballantyne, then General Manager of the Royal Bank of Scotland, in his presidential address to the Institute of Bankers in Scotland, reprinted in *Scottish Bankers' Magazine*, Aug. 1959.

(15) E.g., at the Chinese New Year it was customary to repay loans: F. H. H. KING, *Money and Monetary policy in China, 1845-1895*, (Cambridge, Mass., 1965), pp. 58, 97.

(16) Cf. Sir OLIVER FRANKS (Lord Franks), "Bank Advances as an Object of Policy", *Lloyds Bank Review*, Jan. 1961.

to Krupps' of heavy fixed interest indebtedness to German banks illustrates the point). Second, when profits are rising, such lending as banks do undertake at fairly steady rates gives the equity holder in the borrowing firm the advantage of gearing; this raises his share in rising profits, because the firm is paying no more than before to the bank whose lending has none the less helped to increase profitability. These aspects of bank lending, involving at once a deterrent to business from running up too heavy a load of external debt, and the advantage of gearing, deserve more stress than they normally receive.

Where, in contrast with Britain and other Anglo-Saxon countries, capital markets are less developed, banks face a greater demand and greater opportunities for longer-term financing, including the acquisition of equity interests. To the extent that banks and other financial institutions dominate the market in "primary securities", such a situation may be self-perpetuating; the personal sector may have little choice but to hold "indirect securities" such as time and savings deposits, or perhaps bank shares. This situation may be desirable, or at least largely inevitable, in a developing country where individual savings are likely to be too small to warrant personal holdings of primary securities, the supply of which may also be quite small in the early stages of economic development. It is less clear that such a situation ought to persist indefinitely, and even less clear that it should be encouraged to evolve in countries with hitherto elaborate capital markets. In Britain and the U.S.A., where personal shareholdings are still quite high, there has recently been a significant switch towards the "indirect securities" of financial institutions. This re-channelling within the financial sector raises the question of its consequences for the allocation of resources within the "productive" sectors. It thus draws attention to the fundamental problem that must dominate the background to any discussion of increasing banks' competitiveness: should deficiencies in the capital market be corrected by first trying to improve the capital market itself?

If we leave that question aside for the present, and take existing capital markets for granted, the reluctance of British bankers to diversify their assets, as the essential counterpart of diversification of their deposits, is thoroughly understandable. Historically, the conservative traditions of British banking principles and practice derived from much painful experience. Some of this, during the

eighteenth and nineteenth centuries, arose from deliberate and unfortunate involvement in industry, which taught banks to observe the dictum "mind your own business". Some misfortunes, like those of the 1920s and 1930s, were attributable to wider economic calamities, which quite unpredictably transformed erstwhile short-term and safe advances into illiquid and loss-making millstones. From a different aspect, the banks' virtual monopoly of short-term finance diminished the temptation to extend their lending. They could expect, at the least, to maintain their share in this part of the economy's business, given the assured flow of current accounts stemming from their oligopoly in payments facilities. Historically, they had been able to minimise their dependence upon time and savings deposits and leave longer term lending to others. Trustee savings banks in the early nineteenth century, and later the Post Office Savings Banks and Building Societies, offered deposit facilities; only building societies offered limited competition on the other side of the account, with specialised borrowing facilities for the personal sector. Further, the business sector's demand for short-term interest-bearing assets could be satisfied outside the banking sector by commercial bills, railway and government securities, and time deposits with British overseas banks.

After the wave of amalgamations from which the "Big Five" banks emerged in 1917-18 sheer size induced cautiousness. In difficult economic circumstances after the first world war, the banking giants needed time to digest small and not so small banks, and to assimilate staffs inflated in numbers and perhaps diluted in quality, not only by amalgamation but also by bankers' generosity in the re-employment of returning ex-servicemen. In any case, the possibly inhibiting effect of size upon innovation must be considered. The point was drily recognised in the response of the chairman of a leading bank to advice to lead his bank boldly along new paths. "You may be right", he said, "but if you are wrong, we shall be wrong for millions".

Official conservatism in various channels has, until recent years, reinforced and perhaps exceeded that of the banks. Amalgamations bred new fears and reinforced old fears about monopoly and of undercapitalisation in banking; the resultant official ban of 1918 on further large scale mergers endured almost half a century, and the ban extended broadly to the mixing of domestic with overseas banking (this did not necessarily preclude a domestic bank from

holding shares in an overseas bank or from having an affiliated overseas bank). A few years later, in 1926, Treasury anxiety (or that of the Chancellor of the Exchequer, Mr. Winston S. Churchill) to conserve revenue thwarted Midland Bank's attempt to spread the banking habit to wage earners by avoiding stamp duties (17); indeed, it may be that the existence of a stamp duty on cheques has been a continuing official disincentive to the spread of banking (18). Not long after, in 1928, the government accepted the adverse report of an inquiry into the possibility of a postal cheque system, with the incidental result of protecting the banks from potential competition as suppliers of payments facilities (19). The Bank of England strengthened the resistance to change through the predilection of Montagu Norman, its Governor during most of the inter-war years, for the maintenance of the traditional specialisation of the country's financial institutions. Further, the preoccupation of the monetary authorities with easing the government's financing problems impelled them to support cartelised interest rates in banking and in the money market in the 1930s. During the preceding decade, the overvaluation of the pound and the enormous volume of the national debt had made high interest rates virtually inescapable. Anxiety over the regular financing of the short-term debt (Treasury Bills) at rates the authorities were willing to accept particularly plagued Treasury and Bank (20). The abandonment of the gold standard in 1931 and the establishment of the Exchange Equalisation Account in 1932 at last provided a degree of insulation for domestic interest rates. Greater control over rates brought the corollary of less control over the supply of liquid assets. In the Treasury bill market, funding was a partial answer but the crucial move was towards the use of the discount market, from the mid-1930s, as an agency to ensure that the regular tender of Treasury bills would always be fully subscribed. This exorcised the long postwar nightmare that the Exchequer might be driven to

(17) On Midland Bank's abortive chequelets, see J. M. MILNES HOLDEN, *The History of Negotiable Instruments in English Law*, (London 1955), pp. 287-90.

(18) It was announced in the 1970 Budget that the cheque stamp duty would be abolished in February 1971 (on decimalisation of the currency).

(19) *Postal Cheque-System. Report of a Committee of the Post Office Advisory Council*, Brit. Parl. Papers, 1928 (3151) XII.

(20) See, e.g., Sir HENRY CLAY, *Lord Norman* (London 1957), pp. 221, 230, 253, 275-6, 297, 395, 460-2, 464-5.

borrow directly from the Bank of England instead of through the market (21).

The discount houses recognised and grasped a life-line in these arrangements. Prolonged world recession had threatened their traditional business; dealing in short-dated government bonds, later to be a major activity, was as yet neither substantial nor approved by the Bank of England; and the clearing banks in the early 1930s were competing fiercely for Treasury bills, the remaining liquid asset, driving historically low short-term rates even lower. Between 1933 and 1935 these conditions produced the money market agreements which in broad details continue to govern short-term rates. The discount houses formed a loose cartel (eventually tautened into "the discount market syndicate") to bid at agreed rates for sufficient Treasury bills to ensure that the whole of the weekly tender would be subscribed; in return, they could rely upon the Bank of England's lender-of-last-resort facilities to meet any shortfall in their funds. This assured the authorities that Treasury bills would always be taken up, whatever other tenderers offered, at rates under their direct influence. To help the discount houses to survive, the banks agreed to lend to them on call at low rates; they would not tender for bills; and they would not buy bills at less than the call rate, thus guaranteeing the discount houses against a recurrence of irresistible competition (22).

The banks regarded these arrangements as an emergency measure (23), but they have survived for one-third of a century so far. This is perhaps not surprising when the advantages to all three parties directly involved (though not necessarily to the general public) are considered. The discount market secured a guaranteed survival; the authorities conquered their Treasury bill neurosis; and the banks, since their own deposit rates had clearly to be non-competitive with discount house funds, gained a powerful anchor for their long traditions of cartelisation and of distaste for competition. It is now time to look closely at those traditions and that distaste.

(21) Radcliffe Report (Report of Committee on the Working of the Monetary System, Cmnd. 827 of 1959), para. 167.

(22) This paragraph is based on R. S. SAYERS, *Gillett's in the London Money Market, 1867-1967* (Oxford 1968), esp. pp. 89-95.

(23) In 1936 the then Chairman of Barclays Bank described the arrangements as "a temporary measure to meet an abnormal situation" (SAYERS, *Op. cit.*, p. 93, n.).

### 5. The History of Restrictions upon Interest Rate Competition

As far back as one need go in Britain's banking history, there has been a strong bias towards stability or standardisation in interest rates. This was particularly true outside London. Local monopolies or oligopolies reflecting geographical limitations were characteristic, and until the 1820s there were legal restrictions on the size and therefore on the competitive power of banks. There was considerable cohesion despite keen rivalry in some spheres amongst bankers generally, not only through their routine clearing arrangements, but also in the *ad hoc* solidarity called up by financial crises and by the urge for collective action against unpopular governmental measures. In London, clearing arrangements existed before the clearing house acquired a permanent home in the 1770s; and in the nineteenth century, London bankers safeguarded their interests through the Committee which ran the clearing and did so, for a period, in an exclusive manner to protect the old private banks from the new joint-stocks (24). Nationally, bankers came together with the establishment of the Institute of Bankers in 1879. Five years earlier, in 1874, an Association of English Country Bankers had been formed. It appears to have had an active existence until amalgamation of its members into a few branch banks based on London led to its absorption into the Central Association of Bankers; this, in turn, became in 1919 the present British Bankers' Association.

Competition on other than a restricted basis has never been popular with British banks. It is true that, as the P.I.B. report noted with disapproval, there has been vigorous competition in opening new branches, but this was the wasteful competition characteristic of oligopoly. The older tradition was for banks to maintain monopolies or cartels within local or regional "circles". The joint-stock banks of the mid-nineteenth century and later only partly broke with this tradition. Thus (25), in the 1880s the threatened intrusion of a new branch of an "outside" bank provoked the

(24) The London private banks for some years excluded the new joint stock banks of the 1830's from the Clearing House: T. E. GREGORY, *The Westminster Bank*, 2 vols. (London 1936), I, 167-77, 255, 257.

(25) "Mr. Rae's Private Letters on Banking Questions", 23 March 1881 and also 11 Feb. 1885. I am indebted to the Midland Bank for permission to consult this.

local (and national) leader of bankers in north-west England to organise successful retaliatory threats to open in the would-be invader's own territory. As late as 1909, a particular district could be regarded as the preserve of a given banker (26). The "live-and-let-live" cosiness of established banking was admirably described to the Macmillan Committee in 1930, by the then Chairman of Lloyds Bank, who came from an old Yorkshire banking family:

"... the partners of the different firms used to dine at each other's houses, they were on friendly terms and there was a feeling that it was not quite fair to take away accounts. I think competition was certainly less in those days than it is now" (27).

In the days of private banking there were recognised traditions about deposit interest. In London, deposits were mainly "demand deposits" on current account, and attracted neither interest nor charges for routine business. In the country, deposits were mainly time and savings deposits (deposit accounts) and bore interest rates that tended to be stable locally, although the levels varied between districts. On current accounts, interest might be allowed in the case of bill drawing accounts, for example, but charges would be imposed correspondingly.

The establishment of joint-stock banks, in the country from 1826 and in the London region from 1833, significantly changed this situation (28). The new banks used competitive rates on both current and deposit accounts to attract business. Moreover, as was reflected in the proliferation of other financial intermediaries, the economic expansion of the middle decades of the century offered opportunities for profitable intermediation. In respect of rates on current and deposit accounts, the situation can be simply sketched. A newly-formed joint-stock bank or branch would initially offer competitive rates for deposits. When competition became uncom-

(26) See, L. S. PRESSNELL, "Joseph Barnard: Westminster's Predecessor in Bedford", *Westminster Bank Review*, Feb. 1960.

(27) J. W. Beaumont Pease in evidence to the Committee on Finance and Industry (The Macmillan Report), London 1931, Q. 2054. See also W. LBAF, *Banking*, (London 1926 and later printings), p. 115. Leaf, chairman of Westminster Bank 1918 to 1927, recalled "that sense of friendliness which impelled the smaller banks... to abstain from poaching on territories which were marked out by tradition as 'belonging' to particular houses".

(28) This paragraph is based on R. S. SAYERS, *Lloyds Banks in the History of English Banking* (Oxford 1957), pp. 161-7.



fortable, there would be a local agreement between banks. Later in the nineteenth century, competition from the Trustee and Post Office Savings Banks, with their unvarying rates, tended to put a floor to bank deposit rates.

Competition was being modified in London from the mid-nineteenth century. This owed something to a settling down of the joint-stock banks and something, in the 1870s, to very low market rates of interest; most of all, it reflected the banks' realisation of their dependence upon the Bank of England. Although competitive elements remained, deposit rates became partly administered rates attached to the key Bank Rate.

There had been inconclusive stirrings amongst London banks to limit competition in 1847, when an historically high Bank Rate of 8 percent imposed severe strains upon banks paying rates 1 percent below Bank Rate (29). When the crisis of 1857 brought an even higher Bank Rate of 10 percent, there was a move amongst London bankers to avoid chasing deposit rates up in line with it, as part of an effort to reduce competition among themselves. The differential for deposit rate of 1 percent below Bank Rate came to be regarded as applying to "normal times" only. On current accounts some banks appear to have continued to pay interest, but the practice had ended by 1877. One reason for this was probably the very low level of market rates of interest; this same reason, in a period when Bank Rate was out of true with market rate, produced acute discontent over the linking of deposit rate with it, although there appeared to be no question about banks keeping broadly in step on interest rates. Events, notably the severe financial pressure of 1878, intermittently reminded banks of their possible dependence on the Bank of England, and the link was preserved. In 1886, however, the differential was widened to 1½ percent, where it remained until, claiming higher costs, banks raised it to 2 percent during the first world war. The abnormally low Bank and market rates of the 1930s caused a reversion to 1½ percent; but the revival of monetary policy, with a higher Bank Rate, in the 1950s brought back the differential of 2 percent (30).

(29) This paragraph is based on GREGORY, *Westminster Bank*, I, 261-2; II, 194-8.

(30) The history of agreements on deposit rates is discussed in D. A. ALHADEFF, *Competition and Controls in Banking* (Univ. of California Press, 1968), esp. pp. 251-4 and Chapter XVI.

These statements, it must be stressed, refer to standard terms for deposits left on standard conditions in the London area, which in practice meant a good deal of the south and south-east of England. Any departure from standard conditions, e.g., where money was left for longer than the minimum seven days' notice, might attract a higher rate (31).

Outside London, the shake-up by the joint-stock banks had tended to lead to local agreements on rates as early as the 1830s and 1840s. Later in the nineteenth century, there was a movement of country to London rates as the metropolis attracted the larger country deposits. Amalgamations also fostered the assimilation of rates in the larger towns to London-based levels. This trend continued in the first world war. Nevertheless, the old tendency for greater rigidity in the country persisted: whereas in the inter-war years London deposit rates varied with Bank Rate, in the country a steady 2½ percent was common until the low rates of the 1930s enforced greater uniformity. Moreover, on current account it was common country practice to pay interest (and to charge for routine transactions that were "free" in the London region), until the banks agreed in 1945 to abolish the practice (32).

Lending rates are naturally linked with deposit rates, and here also standardisation and mutual understandings have been characteristic. Originally, the Usury Laws of 1714-1854, with their legal maximum of 5 percent, had long accustomed the public to relative stability in basic interest rates in banking. This was the standard rate for bill discounts and bank advances during the formative period of English banking, although market transactions that escaped the Usury Laws frequently involved rates beyond 5 percent; thus, a degree of disregard of market equilibrium rates has been bred into the British banking atmosphere. Within the legal/traditional ceiling, rates proved quite flexible when market rates fell, and the development of a more active Bank Rate policy from 1833 (when the Usury Laws were relaxed) introduced a fresh element of variability in London rates. In the country, however, especially outside the main towns, lending rates were very slow to lose their rigidity until amalgamation brought them, like deposit rates, closer to London practice.

(31) See, e.g., LEAF, *Banking*, p. 217.

(32) See SAYERS, *Lloyds Bank*, pp. 270-1 and ALHADEFF, *loc. cit.*

Like their deposit rates, the banks' lending rates have largely been linked to Bank Rate, at least until recently, although there has been less precise information about them (33). The normal pattern has been for the major lending rates to fall within a narrow range between Bank Rate and  $1\frac{1}{2}$  percent above it, with provisos for minimum levels. There were four main categories of borrowers under the arrangements that the banks agreed in 1951-2, on the revival of monetary policy: nationalised industries at Bank Rate; top-class "blue chip" borrowers at "I.C.I. terms" of  $\frac{1}{2}$  percent above Bank Rate; the rank and file business borrower at 1 percent above Bank Rate; and the group of personal and small-scale business borrowers paying 1 or  $1\frac{1}{2}$  percent above Bank Rate. During 1964-5, borrowers were reclassified into five groups. The first two existing groups were retained; the third and fourth were amalgamated; a new group comprised hire purchase companies; and a fifth covered special arrangements for export credits. This last group encompasses two types of lending: short-term up to two years, at Bank Rate with a minimum of  $4\frac{1}{2}$  percent; and longer term at a fixed rate of  $5\frac{1}{2}$  percent. The fixed rate was chosen in 1962 by the banks under persuasion from the Bank of England, as a reasonable average of expected future rates; in 1967 the arrangement was extended to domestic orders for shipbuilding (34). The substantial rise in other interest rates has made the fixed rate a concessionary rate. Partially offsetting this subsidy element are, first, the charging of commitment fees by the banks; second, the reduction of risk in export credits guaranteed by the Government's Export Credit Guarantee Department; and third, the rather complex arrangements by which the Bank of England may treat certain export credits as liquid assets that it is prepared to re-finance (i.e., to take over from the banks). The banks, it should be noted, have grown increasingly restless over the growth of this subsidised category, and seek to eliminate it (35).

(33) This account is based largely on the useful summary in ALHADEFE, *Op. cit.*, pp. 254-9 and Chapter XVII.

(34) See First Report from the Select Committee on Nationalised Industries ("S.C. N. 1.") Session 1969-70, *Bank of England* (London 1970), QQ. 397, 1186. See also *Bank of England Quarterly Bulletin*, March and June 1961; March 1962, March 1965, June 1966, June 1967, June 1968, December 1969.

(35) S.C.N.I., *Bank of England*, QQ. 397, 399, and report in *The Financial Times*, 11 July 1970, p. 15. Since the above was written, the Bank of England has approved

Did British banks in 1969 at last move towards more market-oriented lending rates? Apart from their grumbling over the subsidies to exports and shipbuilding, the clearing banks in October 1969 moved their lending rates up by  $\frac{1}{2}$  percent although there had been no change in Bank Rate. Indeed, Mr. John Thomson, Chairman of Barclays Bank, expressed his preference (36) "to have as a benchmark some 'basic' rate not invariably tied to Bank Rate...".

This has been a collective, non-competitive move which can scarcely — yet — be regarded as an edging towards a more vigorous lending policy. Rather, it might be prudent to regard it as an adjustment to a situation, comparable with that of about a century ago, discussed above (37), in which Bank Rate has become more remote from day to day market rates, and has therefore lost relevance as an anchor. Since the development of the local authority short-loan market in the 1950s, and of the Euro-dollar market in the 1960s, rates in the former, reflecting the influence of those in the latter, have become a more significant market indicator than Treasury Bill rate. Correspondingly, therefore, Bank Rate has lessened in significance since its level is traditionally related to Treasury Bill rate. In sum, the relevant change has been in the status of Bank Rate, not in the banks' policies. Indeed, Mr. Thomson has specifically stressed the aim of reasonable stability in lending rates in the interests of goodwill with customers.

Would there be undesirable consequences if more variable lending rates accompanied deposit competition? It is often argued that there might well be; that historical experience shows that high deposit rates encourage banks to undertake riskier lending, to their own danger and to that of the economy as a whole; and that the Federal Reserve System's Regulation Q, which since 1933 has been used to restrict banks' deposit rates, is a sound device to prevent such excesses (38). These arguments have little strength. Indeed,

increases in rates from 1 October 1970: to  $\frac{1}{2}$  percent above Bank Rate for short-term credits, and to 7 percent for medium- and long-term credits. These changes do not entirely eliminate the element of subsidy.

(36) Barclays Bank Briefing - 10. "Interest Rates: Competition or Cartel?", in *Investors Chronicle*, 26 June 1970.

(37) Above, p. 388.

(38) For a recent British view see Sir Cuthbert B. Clegg's Presidential Address to the Institute of Bankers, 21 May 1969, reprinted in *Journal of the Institute of Bankers*, June 1969, "Competing for Deposits".

the historical record, as contrasted with the prevailing "received truth", recalls the essence of a great historian's dictum: good history may make only a modest contribution to society, but bad history can do incredible harm (39).

It is unquestionably true that since at least the middle of the 19th century there has been concern in Britain and the U.S.A. lest competitive rates on deposits, and especially the payment of interest on demand deposits, should drive banks into unsound lending (40). Undeniably, a good deal of bad banking in the 19th century was associated with non-standard rates, but what was the nature of that association? Did banks scramble for deposits and then scramble for the most profitable-looking lending to offset their recklessly incurred costs, or did the character of their lending largely determine their behaviour over deposit rates? Given the relatively undeveloped character of 19th century capital markets the second seems the more plausible possibility (George J. Benston has usefully described the two approaches as "the profit target hypothesis" and "the profit maximisation hypothesis" respectively) (41). Further, in general, one suspects that it was bad banking that led to reckless competition rather than the reverse. Moreover, reckless competition has been only one of a number of causes of bad banking. Many of these have been beyond the immediate control of bankers. They have included inadequate payments systems, unsatisfactory company and banking laws, non-existent or limited central banking, unregulated cyclical fluctuations, narrow and weak capital markets, shortages of skilled banking personnel, poor statistics, lack of publicity, to name only the most obvious.

Was there not, however, "destructive competition" in the 1920's in the U.S.A., which justified the imposition in 1933 of Regulation Q in the Federal Reserve System? Regulation Q forbade the payment of interest on demand deposits and authorised the Federal Reserve to prescribe maximum rates on time and savings deposits.

(39) The late Richard Pares, quoted by L. S. Sutherland in her Introduction to R. PARES, *The Historian's Business* (Oxford 1961), p. ix.

(40) See ALBERT H. COX, JR., "Regulation of Interest on Deposits: An Historical Review", *Journal of Finance*, May 1968, and his fuller discussion in his *Regulation of Interest Rates on Bank Deposits*, (Ann Arbor, Michigan 1966).

(41) GEORGE J. BENSTON, "Interest Payments on Demand Deposits and Bank Investment Behaviour", *Journal of Political Economy*, Oct. 1964.

Hitherto, regulation had been local and spasmodic (42). It has usually been assumed that the rationale of Regulation Q rested in "destructive competition" by banks in the 1920's, but there is reasonable doubt over this on two counts. First, the banking legislation of 1933-35 was directed not only against the recurrence of the banking weaknesses that immediately preceded the banking crises of 1929-33, but also, more generally, to those things left undone by the original Federal Reserve legislation of 1913. Second, careful quantitative analysis does not show that there was widespread, "destructive competition" before 1929, nor does it support the view that the payment of interest on demand deposits significantly influenced the choice of banks' earning assets (43).

The fear of "destructive competition" seems to imply that bankers would pay extravagant deposit rates and would extract extravagant rates on their lending: in other words, that they would operate in competitive markets for deposits and in monopolistic markets for lending. The solution to this problem lies in increased competitiveness in both markets. Interest rates on company deposits have risen in the more competitive atmosphere of recent years in Germany and the U.S.A.; the availability of alternative outlets for surplus funds has reduced the banks' *monopsonistic* influences over deposit rates. Correspondingly, the existence of other sources of finance limits the banks' *monopolistic* influences over lending rates, which have risen less or have even fallen. In short, increased competitiveness all round involves stronger market positions for both depositors and borrowers, bringing upward pressures on deposit rates and opposite pressures on lending rates.

In Britain a highly developed capital market offers would-be borrowers a wide range of financing methods. This limits the oligopolistic character of banks' lending and therefore of their charges. Moreover, the capital market could be much more competitive if, for instance, company taxation encouraged rather than discouraged the distribution of profits, so that investible funds became

(42) Cox, *loc. cit.*

(43) Cox, *loc. cit.*, and BENSTON, *loc. cit.* Recent discussion has stressed the role of Regulation Q as a controller of the flow of funds between the banks and other institutions: see, e.g., CHARLOTTE E. RUEBLING, "The Administration of Regulation Q", in Fed. Res. Bank of St. Louis *Monthly Review*, Feb. 1970, and JIMMIE MONHOLLON, "Regulation Q: an instrument of Monetary Policy", in Fed. Res. Bank of Richmond, *Monthly Review*, July 1970.

more widely available. Modifications in Britain's clumsy capital gains tax might also improve the market, and there are some less striking reforms, such as improved accounting requirements and the abolition of unequal voting rights in equity shareholdings which could contribute to a more efficient allocation of resources (44). If the fear lingered that higher deposit rates might drive the sober British banker to toy with high yielding but risky assets, then there could be reserve controls in the liquidity ratio, lending ceilings, moral suasion, and even conceivably in the bank inspection found in many overseas countries; these could scotch that surely unreal fear.

### 6. Bank Competitiveness and the Monetary Authorities

Apart from any innate proclivity towards cartelisation, the acquiescence of British banks in restraint of competition is scarcely surprising. For years after 1918, general economic conditions and official policies discouraged innovation in a calling in which, as Adam Smith long ago remarked (45) with some exaggeration, "the operations are capable of being reduced to... a Routine, or to such a uniformity of method as admits of little or no variation". It has not been easy for the enterprising banker to break free. An evident constraint has been the oligopolistic environment, in which the movement of one bank provokes counter-responses from others. For long, another constraint was the undeniable tawdriness (46) associated with consumer credit, which would otherwise have attracted bankers much earlier as an obvious fresh field to cultivate. The major restraints, however, were official. First, there was long hostility to modification of the traditional compartmentalisation of financial activity. Second, official preoccupation with financing the

(44) The Minority Report of the Royal Commission on the Taxation of Profits and Income, 1955-56 (Cmd. 9474), proposed that taxes on capital should bear the main burden of the redistribution of wealth, but that company taxation would have to take a good deal of the burden until capital taxes were sufficiently high. It appears to have escaped attention that the Labour Governments of 1964-70, whose adviser on taxation had been the inspirer of the Minority Report, imposed both high capital taxes and high company taxation.

(45) ADAM SMITH, *Wealth of Nations*, 5th Cannan edition (2 vols., London 1939), II, 246.

(46) It was formerly common for goods purchased from shops known to deal in hire purchase to be delivered in plain vans to conceal the shop's identity.

public sector and with repeated credit restraint on the private sector restricted the volume and character and profitability of banks' assets. It oriented them towards a higher ratio of public sector to private sector debt than they might otherwise have come to prefer (47); and official concern for a stable Treasury bill rate underpinned the relative inflexibility of banks' lending rates, with their narrow range that scarcely recognised the disparate qualities of borrowers' credit or ability to pay. It is by no means clear, however, that interest rates could become controllers of lending. Even if in theory they could be, in practice exchange rate policy may raise a formidable obstacle. In an open economy like Britain's are more or less completely flexible short-term interest rates possible without flexible exchange rates? How close, in fact, is it possible to approach to interest rate flexibility under the contemporary fixed exchange rate system, which provides the broad rationale for stabilisation of the Treasury bill rate (though not necessarily in its present questionable form)? To what extent, on the other hand, will the continuance of the balance of payments and budgetary surpluses of 1969-70 weaken those arguments?

A further constraint on competitive rates is that the elasticity alike of supply and demand in bank credit within contemporary zones of *real* interest rates is probably considerable, so that banks impose rationing. This is the essence of Keynes's imaginative concept (48) of "the fringe of unsatisfied borrowers". In this context, it may be helpful to stress again that competition is as much a problem of assets as of deposits. If banks were willing (and permitted) to lend in a really competitive manner, they would in fact probably lend more; interest rates would presumably be more variable, and range more widely than at present in greater recognition of varying risks. Both quantities of lending and interest rates would tend to be more market-determined. Such a situation does not characterise British banking. Instead, the banks operate with interest rates distant from equilibrium levels, and with fewer assets and deposits respectively than the private sector would be willing to offer and to hold, were rates closer to equilibrium. In consequence, outside the banks there are pressures from suppliers and holders of assets to sell them for yields higher than banks'

(47) S.C.N.I., *Bank of England*, QQ. 660, 664-7.

(48) KEYNES, *Treatise on Money*, I, 212 and II, 364-7.

interest rates, and pressures from borrowers to pay higher rates to non-bank lenders. To control this situation, the monetary authorities extend "moral suasion" to restrain all types of financial institutions from reacting to market conditions. Such "moral suasion", vastly widened in recent years, may seriously impede the efficiency of banking itself and that of resource allocation in general. Further, the state's collaboration with private sector oligopoly to redistribute wealth between bank depositors on the one hand, and bank borrowers including the state on the other hand, may have welfare implications besides significance for the quality of political democracy.

This situation stems from the framework of economic policy as a whole, with its aims of "full employment" (the better and more realistic phrase would be that of the 1944 White Paper on *Employment Policy*, "a high and stable level of employment"). The monetary authorities have taken their views on a number of different desiderata: levels of employment, production, productivity; the balance of payments and the exchange rate; public and private sector expenditure; the rate of growth in productivity; and of tolerable rates of change in wages and prices. Politicians have further geared these elements to electoral calculations. The monetary situation has appeared as the consequence of rather than as an active influence upon the other magnitudes, and the existing supply of money, in these circumstances, must always therefore be "the right amount" of money to sustain them (it is too early yet to be sure that the greater attention to monetary constraints since late 1968 represents a major and lasting change). The outcome hitherto of this order of preference amongst economic aggregates has been a constant struggle, by such supererogatory exercises as prices and incomes policies, to minimise the disequilibrating threat of inflationary pressures to the desired goals.

It has indeed become traditional for the monetary authorities to depend on non-market controls to support a non-equilibrium structure of interest rates. Thus, the banks have been required to hold excess reserves (i.e., in excess of what market-oriented judgment would choose), instead of increasing their lending to the private sector. In effect, they have been prevented from operating up to the point of maximum profitability, where marginal costs would equal marginal revenue. Further, the imposition of similar "ceilings" for banks' lending weakens the incentive for competition amongst them; the justification is presumably that an overall

"ceiling", if sustainable, within which each could compete for a bigger share of the maximum, would risk upsetting the officially desired pattern of interest rates. In any case, given the banking oligopoly, such a redistribution of shares of lending and deposits is a doubtful outcome; more likely would be a maintenance (or restoration) of the original situation, with higher deposit rates and a mixture of somewhat increased lending rates and lower bank profit margins. Once again, therefore, official preference for controlled rates in the public sector has seemed to involve public sector underpinning of private sector oligopoly.

A more sweeping approach to greater competition in banking is to consider the possibility that banks could compete in extending their aggregate lending, by entering financial markets hitherto dominated by non-bank institutions. This, in fact, is the direction in which banks have moved since 1958, when they acquired interests in hire purchase finance companies. It is arguable that the public interest would have been better served if they had undertaken such business — not indirectly, as they have done, thus sustaining the inefficiencies — but directly as in the case of American banks.

Direct involvement might have eased official problems in the control of the monetary system; it might also have avoided some of the confusion that blurred the public's comprehension of it. During the 1950's, the banks' shares in financial assets and liabilities were shrinking under credit restraints. Those of non-bank institutions rose, and this was widely regarded as a frustration of official policy. That interpretation is questionable. Unless it can be demonstrated, and it is not clear that it can be, that the intensified credit squeeze on the banks sufficiently offset the rise in the lending of other financial institutions, it implies that the authorities would really have liked to deflate the private sector, and presumably the economy as a whole, much more in fact than they succeeded in accomplishing, and that they were really willing to run the economy at a slower pace. Given the political and economic atmosphere of the decade, this view is scarcely plausible. In effect, non-bank intermediaries acted as convenient lightning conductors to carry away some of the credit expansion from traditionally controlled channels, though not out of the economy as a whole. To relate this argument more directly to that over deposit competition, the same point may be put rather differently. If the liabilities of the banks instead of their competitors had increased during the

1950's, the overall economic situation would have been broadly the same; but the commercial, balance-sheet position of the banks would have suffered much less, and the impact of credit squeezes might have been diffused more widely over borrowers as a whole.

How far in practice could competition go and what forms might it take? The Midland Bank has put the possibilities succinctly, so far as *areas* of new activity are concerned, in its critique of the P.I.B.'s advocacy of direct competition (49). There are three main ways in which banks might develop. First, in fields already cultivated, it might be prudent to operate, at least transitionally, by taking over existing enterprises; this was the method of entry into instalment credit in 1958. Second, a specialist company might be established for new, specialised activities; this has been the approach of bankers to Eurodollar dealings, for instance. Third, where the "product" is easily assimilable to the relative routine of local branches, with their non-specialised staff, it can readily be added to standard banking facilities; the "bank giro" system is an example.

This classification deals with the forms of competition, largely on the assets side of the balance sheet, but not with the vexed issue of deposit competition; indeed, the forms adopted permit the continued operation of discrimination against the ordinary bank customer. If banks were eventually to offer instalment credit directly as banks rather than indirectly through subsidiaries, they would need to consider more attractive rates for deposits. More precisely, such additional bank lending would create additional bank deposits (instead of increasing the liabilities of non-banks), so that they would need to pay people more to hold these instead of other types of debt; the rate on deposits would tend to be related to the yield — presumably higher than on normal bank lending — on the new lending.

Amongst the many facets of banks' concern over direct involvement in non-traditional forms of lending are two particular anxieties. The first anxiety is that higher deposit costs but only slightly higher deposits would result. This seems to reflect an attachment to discrimination rather than to paying the depositor what he is worth; there are fears that it would not be possible

(49) See Midland Bank, Chairman's Annual Statement, 1968.

to limit higher rates to restricted group of depositors, whereas indirect competition through subsidiaries permits discrimination. Is this position defensible in the public interest? And would competitive deposit-taking (as distinct from more detailed discrimination) be an unthinkable contrast with some prevailing practices? At present, there are gradations of treatment of current accounts according to size and turnover, etc., and also of small savings deposits. For a bank to take deposits on uniform terms is to invite some potential holders of deposit accounts instead to sell their current accounts in secondary financial markets in exchange for more highly remunerated claims. This is the essence of the relationship between banks and non-banks; this involves a double-intermediation process, which the banks perpetuate when operating through their own finance houses (although as the Midland Bank implied, such arrangements might be transitional), and appears to impose unnecessary costs on the public.

The banks' second anxiety has been the supposed deflationary implications of direct competition: minimal reserves are needed against non-banks' liabilities, whereas bank deposits must observe the authorities' substantial liquidity requirements. It might then appear that increased bank lending to offset the fall in non-bank lending would be dependent upon an expanded supply of liquid assets. Initially, successful competition for deposits would appear to produce no net change in total deposits, only a change in their composition; non-banks would run down their current accounts to enable their erstwhile depositors to switch to banks' deposit accounts. Non-banks' lending would diminish by roughly the amount of this switch. To enable the banks to replace this lending, their deposits would have to increase by about twice the switched deposits; this is because the banks' advances ratio to deposits is roughly 50 percent (50). Hence, on the foregoing assumptions, the authorities would have to contemplate, and might hesitate about, the creation of a substantial extra volume of liquid assets to support the extra deposits.

This concern about the supply of liquid assets seems to be exaggerated in two senses. First, the monetary authorities have shown their readiness to ease liquidity requirements. In recent years, the formal minimum has been reduced from 30 to 28 percent;

(50) PAISE, "Deposit Rates after Mr. Jones", *The Banker*, Oct. 1967, p. 849.

certain refinanceable credits may be included in the ratio; at one stage the expansion of commercial bills was permitted; and the Governor of the Bank has looked forward to being able to reduce the present liquidity ratio to a level more commensurate with the banks' commercial preferences (51).

The second consideration is that successful competition by banks would stimulate the holding of bank liabilities in preference to liquid assets such as government debt, and would also reduce the ability of non-banks to hold such assets. Thus, competition could be expected to release to the banks some at least of the extra liquid assets needed (ignoring for the moment the possibility of diminished official requirements) to permit expansion of their lending (52).

Would the demand for bank deposits and their substitutes in fact be responsive to more competitive interest rates? The short answer is to point to the substantial switching between assets in recent years that was first noticed on a big scale when the differential between the rates on Treasury bills and bank deposits widened in the 1950's; this switching recalled that of earlier generations (53). More specifically, we can point to the success of U.S. and German banks in attracting deposits, especially from the company sector. In the U.S.A., the previously magnetic margin in favour of personal saving deposits with Savings and Loan Associations has disappeared in the last decade. Banks have competed both for the deposits and for the type of lending done by the S.L.A.'s. At the same time, the widespread use of Certificates of Deposit, until the low ceiling applied to rates by regulation Q drove them down in 1969, attracted company sector funds by a marketable instrument which offered the holder much more liquidity but no less interest than an ordinary time deposit. In Germany, the liberalisation of interest rates in 1967 has produced comparable results in attracting large deposits from companies.

Three important points, at least, emerge from these American and German experiences. One is that, notably in the U.S.A.,

(51) S.C.N.I., *Bank of England*, Q. 359.

(52) The late W.T.C. King, then editor of *The Banker* hinted at this point in "Should the Banks Bid for Deposits?", *The Banker*, Dec. 1962, but I owe its elucidation to Professor R. S. Sayers, who must not be blamed if I have misunderstood or misused his explanation.

(53) L. S. PRESSNELL, "Switching - Past and Present", *Bankers' Magazine*, Sept. 1956.

banks have become much more enterprising and more willing to enter new lending fields. Second, the smaller rise in lending rates compared with deposit rates suggests that they have also been prepared to risk, or simply to accept, a reduction in profit margins. The possibility of such a reduction has been invoked by some other bankers against deposit competition but it does not appear to have inhibited German and American bankers (nor Canadian bankers, although Italian bankers may have over-reached themselves); nor is there any reason why it should be allowed to do so where banks have hitherto enjoyed oligopoly profits. The third point is that some of the success in deposit competition appears to have depended on large, growing surpluses in particular sectors (54). By their willingness to diversify their bids for deposits, American and German banks were therefore able to tap these surpluses; in contrast, it was *non-bank* institutions which attracted them in Britain and the U.S.A. during the 1950's. It is therefore arguable that by diversification banks can attract a wider range of resources. Certainly, there has by now been sufficient demonstration of this possibility to make it hard to regard as adequate the existing range of deposit facilities in British banks.

At this point, it is time to stress again that the issues do not concern deposits only. Excessive stress on deposits has profound implications for monetary policy. Thus, the P.I.B. report sometimes calls up memories of the mid-19th century Currency School, which believed that money could be defined precisely, that its supply could be controlled rigorously, and that its control would ensure control of the economy. The P.I.B.'s arguments for liberalisation of interest rate policy imply that freely moving rates would cause the level of deposits to come out at more or less an equilibrium level. If necessary, the authorities could undertake open market operations to keep the system under control, and, as a long-stop, they could retain reserve power to fix maximum interest rates. In this P.I.B. world, interest rates might range more widely and reach higher average levels than at present. It is true that the Report believes (and reasons have already been given here for believing) that lending rates might fall through a reduction of

(54) See M. HETH "The C.D. in American Banking: Retrospect and Prospect", this *Review*, March 1968, pp. 48-74, and also Deutsche Bundesbank, *Monthly Report*, Oct. 1967, "First Results of the Inquiries on Bank Interest Rates".

margins; but this belief does not guarantee the achievement of equilibrium rates of interest if we have to allow for the limitations imposed by Britain's predilection for full employment/repressed inflation. If interest rates were intended significantly to influence the distribution and overall use of real resources, they might have to rise very high indeed in money terms, given inflationary expectations. If, by the use of the reserve control over rates, they were not allowed to rise sufficiently, this would bring the usual corollary of price control: quantities, in this case of bank assets and of deposits, would therefore slip out of control, though attempts would be made to prevent this by moral suasion. We should then be back in, if indeed we had ever been able to leave for long, the present world of non-market restraints.

To express unease about the P.I.B.'s failure to consider more fully the implications of deposit competition is not to doubt the need for variability. Rather, it is to ask how far it can in practice be a substitute for direct controls of bank lending and interest rates. It is worth remarking, and it is surely significant, that in the choice of control policies there is less difference in practice between the monetary policies of different countries than their publicly stressed objectives imply. Thus British policy traditionally stresses interest rate stability, but certain rates (notably those paid by local authorities in recent years) fluctuate markedly, and official policy leans on moral suasion and special deposits to influence the quantity of monetary assets. Conversely, Continental countries may stress their devotion to control, exercised by an "independent" central bank, of the money supply; but the variable interest rates that an effective money-supply policy might produce are missing, official interest rates are moved less frequently than in Britain, and specialised public sector institutions provide subsidised rates and preferential treatment for favoured categories of borrowers.

There have been two particular features in British official preference for the retention of the bank and discount market cartels and hence for continued constraint on competition. The first concerns the management of the public debt, the second the provision of cheap credit to industry.

Traditionally, a leading preoccupation of British monetary policy has been to ensure that government debt is held in firm hands. This inspired the close attention of the Bank to market rates in the 18th century (when it was a shareholders' bank chartered

expressly to finance the government), and led to the evolution of the classical central bank function of lender of last resort, to maintain orderly markets. This was primarily a policy of stabilisation and of smoothing operations to minimise the impact of temporary disturbances. The case for it was strengthened by Britain's continuing position as a world banker, and by the desire of other countries to restrict international competition in interest rates. But the argument for stabilisation is distinguishable from one for shielding official rates from adjustment to real factors; indeed, in 18th century wars, until the Revolutionary and Napoleonic wars at the end of the century, official interest rates were allowed to rise extremely high in real terms to divert resources from the private to the public sector, and the attraction of government debt reduced the deposits of London banks (55). With public expenditure nowadays absorbing in peace time a greater proportion of national income than in earlier war periods, and with full employment and with managed currencies, is the situation fundamentally different? It is obviously more complex, but it is arguable that official interest rates may need to be at levels sufficient to divert real resources from the private sector. Thus, although it stressed that "social priorities" must ultimately prevail, the Radcliffe Report recommended that public sector investment should have regard to interest rates intended to reflect the underlying capital situation (56). There is a similar message in the authoritative advocacy for nationalised industries of D.C.F. ("Discounted Cash Flow") test rates for investment that are compatible with those of the private sector. As a notable House of Commons report on nationalised industries has stressed, it is the duty of the public sector to ensure that resources are used as efficiently as in the rest of the economy (57). One may go farther, to argue that at the most fundamental political level, "No easy finance for government" is the ancient justification for parliamentary representation and supremacy. A decision to allow the government to spend and to borrow must be distinguished from allowing it to

(55) See L. S. PRESSNELL, "The Rate of Interest in the Eighteenth Century", and D. M. JOSLIN, "London Bankers in Wartime 1739-84", in L. S. PRESSNELL (ed.), *Studies in the Industrial Revolution* (London 1960).

(56) Radcliffe Report, paras. 502-3.

(57) See First Report from the Select Committee on Nationalised Industries, Session 1967-68, "Ministerial Control of the Nationalised Industries". (London 1968), *passim*.



borrow at sub-market rates, although of course the British government's traditionally high credit rating and the efficiency of the gilt-edged market enable it to borrow on securities with given terms more cheaply than the private sector. More generally, as the Radcliffe Report commented, it is no longer relevant to see in the rates at which governments borrow a measure of their prestige (58). Rather, a government that borrows at excessively cheap rates may be taxing the community; it needs to be explained why this is preferable to some other form of taxation.

The foregoing considerations apart, the British government's concern for controlled and relatively low rates on its own short-term borrowing has resulted in a degree of make-believe over the extent to which, in fact, the public sector is thereby protected. The decision of 1955, however motivated, to push the local authorities into the open market to seek funds causes them to borrow at rates that are significantly higher and more flexible than those enjoyed by the central government; yet both are part of the public sector. This arrangement — "oddest among the oddities in British policy since the war" (59) — certainly meets, probably fortuitously, a long and widely expressed yearning for a separation between internal rates and external rates, the former being relatively stable compared with the latter's greater liveliness. Against this apparent gain, however, must be set the accounting fact that the price of easing the citizen's burden as a taxpayer to the central government is to raise his burdens as a ratepayer to local government. In addition, the more stable official rates may involve distortions in resource allocation in the private sector, the outstanding feature of official preference for the bank cartel arrangements.

### 7. Cheap Finance for Business?

The banks declared to the Monopolies Commission that "without the agreements [on deposit rates], they would end up by paying more for the deposits they already receive and would therefore be unable to finance industry and commerce so cheaply". Their defence of cross-subsidisation was supported by the Governor

(58) Radcliffe Report, para. 564.

(59) R. S. SAYERS in a review in *Economic Journal*, September 1968, p. 692.

of the Bank of England and even more by the Treasury (60). None offered justification.

Two arguments are involved. One, already discussed, concerns the desirability or otherwise of cross-subsidisation. The other, linking with earlier comments upon the efficiency of the capital market, concerns the desirability or otherwise of providing cheap finance for business. As they have made clear over the now concessionary rates for export and shipbuilding credits, the banks do not see why they should shoulder the burden, at least not at a loss. If there is a real case for cheap finance (and it has not been made in that particular connection), is a distorted banking system the most appropriate mechanism to provide it? Would it be more sensible to treat the "cheap finance justification" as essentially an *ad hoc* and *post hoc* defence of restrictive arrangements that are not otherwise readily justifiable? Even so, the case for cheap finance for business is far from self-evident. The return on capital in Britain is notoriously lower than in most other industrial countries, and this might suggest higher rather than lower rates to encourage more efficient utilisation. Moreover, where is it possible to discern a systematic concern for industry's borrowing costs in the years of high Bank Rate since 1964? It is true that official policy appears to have kept Bank Rate rather lower than it might otherwise have been; none the less, banks' lending rates *have* markedly increased. Moreover, the cost of borrowing through debentures and loan stocks rose, and rose very sharply in 1968-9, to probably unprecedented levels.

### 8. Conclusion

It has been argued that British banks have a long tradition of restrictiveness over interest rates and over competition generally, based on (though not necessarily justified by) historical conditions that have largely passed away. Similarly, the very special conditions of the early 1930's led to the Discount Market's restrictive methods which, dreading a repeat of their nightmares of the 1920's, the monetary authorities underwrote. Considerations of the balance of payments, of the preferred exchange rate system, and of the oli-

(60) Monopolies Commission, paras. 205-6.

gopolistic banking structure itself, must undoubtedly limit the modifications that can be made. It is desirable, however, to try to understand just why and how we have reached the present unsatisfactory situation. It is scarcely less desirable for those who wish to retain present restrictions to offer a more satisfactory case than has yet been revealed (61).

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