

Overdrafts and Monetary Policy

It has been known for some time that the overdraft system of bank lending can hamper monetary policy (1). In both the 1955 and 1960 booms in Australia, advances continued to rise while the trading banks, under central bank direction, were cutting back new lending. In 1961 and 1962, while the authorities were effectively encouraging the banks to pursue freer lending policies, advances first continued to decline and then stagnated; by February 1964, advances, though much above recession level and continuing to rise, accounted for little more than one-half of total overdraft limits, a situation which gave rise to fears of an uncontrollable "explosion of advances" in a new boom.

So erratic has been the behaviour of the system in recent years in Australia that there have been suggestions for its abandonment or at least for reform (2). To decide whether anything needs to be done, and what can or should be done, has not been easy because of our ignorance of the working of the system. "Nobody has made a study of the nature and habits of the animal" (3). To remedy this omission is the object of this article (4).

(1) Cf. H. C. COOMBS, *The Development of Monetary Policy in Australia*, E. S. & A. Bank Research Lecture 1954, University of Queensland Press, 1955, p. 15; H.W. ARNDT, *The Australian Trading Banks*, 1st edition, Cheshire, 1957, pp. 62f., 194f. A fairly extensive search of the literature of money and banking outside Australia and New Zealand has uncovered more than passing references to the subject of this article only in LAVINGTON'S *The English Capital Market* (Methuen, 1921, p. 136), KEYNES'S *Treatise on Money* (Macmillan, 1930, vol. i, pp. 41f., 236, vol. ii, p. 35), and in the *Report of the Irish Commission of Inquiry into Banking, Currency and Credit* (Dublin, 1938, p. 159).

(2) H.W. ARNDT, *loc. cit.*; Financial Editor, *Sydney Morning Herald*, 15 January 1961; *Australian Financial Review*, 17 January 1964, 2 March 1964.

(3) *Sydney Morning Herald*, 12 November 1960.

(4) I should like to thank several colleagues, including especially Dr. A. R. HALL, Mr. C. P. HARRIS and Professors BRIAN TEW, R. S. SAYERS and B. H. BECKHART, for helpful comments on an earlier draft of this paper. None of these has any responsibility for opinions expressed or for any remaining errors of fact.

The overdraft is a Scottish invention (5). In the countries of the British Commonwealth (except Canada) it has for long been the main form of bank lending, in contrast to the fixed loan which is normal in North America and predominates in most other parts of the world (6). The main differences between the two methods are familiar.

In the case of the fixed loan, the customer applies for, and the bank grants, a loan of a fixed amount which is at once credited to the customer's current account and debited to his loan account, and on which interest is due from that moment. Whether the loan is repayable over an agreed period or not, once repaid the loan (or any part of it) dies and cannot be revived without new approval by the bank. With the overdraft method, the customer in the first instance merely seeks the bank's approval to overdraw his account, usually subject to an agreed "limit". Actual borrowing takes place only as the customer draws against the approved limit, and interest is payable only on the daily debit balance, the "advance outstanding".

The overdraft has obvious advantages to the customer. One is its flexibility. So long as the limit is not exceeded, the debit balance can be varied up and down without the need for renewed approval. Although the bank will normally require security and carefully investigate the applicant's credit worthiness, the overdraft

(5) Cf. ADAM SMITH'S account: "The commerce of Scotland, which at present is not very great, was still more inconsiderable when the two first banking companies were established; and those companies would have had but little trade, had they confined their business to the discounting of bills of exchange. They invented, therefore, another method of issuing promissory notes; by granting, what they called, cash accounts, that is by giving credit to the extent of a certain sum (two or three thousand pounds, for example), to any individual who could procure two persons of undoubted credit and good landed estate to become surety for him, that whatever money should be advanced to him, within the sum for which the credit had been given, should be repaid upon demand, together with the legal interest" (*Wealth of Nations*, ed E. CANNAN, book ii, ch. ii). See also, W. T. C. KING, *History of the London Discount Market*, London, 1936; T. BALOGH, *Studies in Financial Organisation*, C.U.P., 1947, p. 74.

(6) In the American banking system, a number of variants of the overdraft are in use, including revolving credits subject to a commitment fee and confirmed lines of credit but their share in total bank credit is insignificant (cf. B. H. BECKHART (ed.), *Banking Systems*, Columbia U.P., 1954, p. 871, and *Business Loans of Commercial Banks*, Ronald Press, 1959). In some western European countries overdrafts are used under a variety of names but, except in the Netherlands and in Italy, they account for a small or negligible part of bank lending (cf. R. S. SAYERS (ed.), *Banking in Western Europe*, Oxford, 1962, pp. 18, 206, 276, 327, 366, 390).

method lends itself to more informal arrangements — from a nod to a closed eye.

The other advantage is that in the unused part of his limit the customer obtains an addition to his liquidity which is as good as cash but which is free of charge. This of course does not mean that bank credit is necessarily cheaper under the overdraft method; the average cost depends on the rate of interest and other terms and charges (7). Most of the Australian trading banks, moreover, some years ago introduced two types of charge related to the overdraft limit: an "establishment fee" and an "overdraft management (or service) charge" (8). But these were specifically designed merely to reimburse the bank in part for the administrative costs of an overdraft limit, the costs of investigation and valuation on establishment in the case of the former charge, the costs of running a loan account in the case of the latter. The charges are a small fraction of the overdraft rate of interest and moreover graduated so as to be negligible for large accounts. The fact remains, therefore, that while the full rate of interest is payable on the used part of an overdraft, the unused part is almost a free good.

From the point of view of the economy as a whole, and for the purposes of monetary policy, three features characterise a banking system which uses the overdraft, as contrasted with the fixed-loan, method of lending. First, a different significance attaches to "money supply" as an indicator of liquidity. Secondly, a different

(7) The customer under the fixed-loan system can reduce the net interest cost of the loan by placing on time deposit or reinvesting in the money market any temporary surplus funds. In Australia the banks usually compensate customers who have to borrow by fixed loan (such as some local authorities) or by the somewhat similar overdraft "subject to reduction arrangement" by granting an interest set-off, at or somewhat below overdraft rate, on the customer's daily credit balance on current account, up to the debit balance on loan account. In the United States, on the other hand, it is still general practice for banks to require borrowers to keep on deposit with the lending bank a sum equal usually to not less than 20 per cent of the loan. The effective cost of borrowing is thereby raised above the nominal rate of interest.

(8) See Commercial Banking Company of Sydney, *Annual Report 1962*; also *Australian Financial Review*, 11 May 1961. The A.N.Z. Bank's service charge was in 1961 reported to range from £2 p.a. on limits up to £500 to a maximum of £10 p.a. on limits above £50,000 (*Melbourne Herald*, 14 April 1961). No official information on these charges has ever been published in Australia. In New Zealand, the overdraft service fee, introduced in November 1961, "is based on the limit or the highest actual advance recorded (whichever is the higher) during the year ended 31 October and it rises in steps from £1 for limits up to £100, to £50 for limits over £50,000" (*Money and Banking in New Zealand*, Reserve Bank of New Zealand, Wellington, 1963, p. 5).

significance attaches to bank advances as an indicator of the volume of bank credit and of its effects on the level of spending. Finally, and most important, the monetary authorities face an additional difficulty in their efforts to keep the economy on an even keel. We will examine each of these features in turn.

Money Supply and Liquidity

The difference here is that, under the fixed-loan method, an increase in bank credit granted is at once fully reflected in an equal increase in money supply in the form of bank deposits, while under the overdraft method bank deposits come into existence only as and when customers draw against their limits. Since a customer to whom his bank has granted an overdraft limit is just as free to draw a cheque whether his account happens to be in credit or (up to his limit) in debit, unused overdrafts are clearly ready spending power no less than deposits (9). It has therefore often been suggested that countries which use the overdraft method should include the volume of unused overdrafts in their statistics of money supply.

The New Zealand Royal Commission of 1956 forthrightly defined the money supply in this way: "Money is anything which is immediately available and generally acceptable in payment for goods and services or in settlement of a debt. In New Zealand, there are three things which appear to us to satisfy these criteria of immediate availability and general acceptability:

- (a) The coin and notes in circulation;
- (b) The deposits on current account standing to the credit of the customers of the trading banks...;
- (c) The unexercised portion of overdraft authorities granted to customers by the trading banks" (10).

One practical reason why this definition has nowhere been officially adopted is that, until recently, statistics of unused overdrafts have not been available. But even in New Zealand, where

(9) "Thus it is not in the least essential to the efficient working of the cheque-money system that any of those who have cheque books should also have deposits" (J. M. KEYNES, *op. cit.*, vol. i, p. 42).

(10) Royal Commission on Monetary, Banking, and Credit Systems, *Report*, Government Printer, Wellington, 1956, para. 151; cf. also para. 160.

such statistics have been collected and published for many years, the Reserve Bank has hitherto resisted the advice of the Royal Commission. It explained in its evidence to the Royal Commission: "Unexercised overdraft authorities are not included in the volume of money for several reasons. They are not freely transferable from one person to another; some of them are merely nominal and may never be used; and finally many bank customers could obtain unexercised overdraft authorities if they desired, but this fact is not recorded in the statistics" (11).

These may not be entirely convincing arguments for excluding unused overdrafts from the money supply. But they draw attention to a point which has since then been much more emphatically stressed by the Radcliffe Committee: that money supply, however defined, is an inadequate measure of the liquidity of the public. The liquidity of the public is important as a determinant of the current and prospective level of aggregate effective demand. From this point of view, what matters is not merely the money supply in the public's hands but all factors affecting its "general liquidity position", including its holdings of highly liquid and near-money assets, and its current and expected borrowing facilities. Whether unused overdrafts are included in the money supply, or taken into account among the no less important other aspects of the public's general liquidity position, does not therefore matter very much.

For those, however, who continue to attach special importance to changes in the money supply, the case for including unused overdrafts remains powerful. It is worth noting in this connection that the familiar "money formation table" — like its more sophisticated cousin, the flow-of-funds account — inevitably neglects unused overdrafts because they do not appear as liabilities in the accounts of the trading banks. Paradoxically, the Australian trading banks meticulously record their "contingent liabilities" under confirmed letters of credit, guarantees, etc. (12), but never so much as mention their much larger and very real demand liabilities in the form of unused overdraft limits. Nor do these *de facto* liabilities ever seem to have been brought into the reckoning in the rules of thumb of British deposit banking, all of which have traditionally

(11) *Monetary and Fiscal Policy in New Zealand*, Reserve Bank of New Zealand, Wellington, 1955, p. 32.

(12) Cf. H.W. ARNDT, *The Australian Trading Banks*, Cheshire, 1961, p. 113.

run in terms of ratios of cash or liquid assets to *deposits*, rather than to *deposits-plus-unused-limits* (13). The explanation no doubt is that overdraft limits are nominally revocable at will. No doubt also the trading banks, in the practical management of their affairs, pay due regard to their commitments under unused limits (14).

Limits and Advances

More important than the difference in the significance of money supply under the two systems of bank lending is the difference in the significance of bank advances.

Where bank advances take the form of fixed loans of the American type, a rise in "advances outstanding" over a period reflects the excess of new loan approvals over repayments of old loans. This is not so under the overdraft system. Here we have two distinct series, each reflecting the net balance of two opposing forces: (a) *limits* (outstanding), a rise in which reflects an excess of new overdraft *approvals* over *reductions* or cancellations of existing limits; and (b) *advances* (outstanding), a rise in which reflects an excess of *drawings* (normally against existing limits) over *repay-*

(13) A notable exception, as so often, is Lavington who observed in 1921: "The English banks make their advances partly by way of loan, partly by way of overdraft. A simple statement of the ratio between their reserves and their lodgments, therefore, will give an accurate idea of their ability to meet contingencies only if it is supplemented by information as to the extent to which they have lent in one way or the other" (*The English Capital Market*, Methuen, 1921, p. 136). The Irish Commission of Inquiry of 1938 put it more bluntly: "Where the overdraft system prevails... the quick assets of the banking system should be contrasted, not merely with the current volume of liabilities revealed by the balance sheet, but with the total volume of liabilities really outstanding so long as the existing overdraft facilities are maintained" (*op. cit.*, p. 159). Keynes noted the point but then proceeded to ignore it throughout his subsequent analysis, on the thin excuse that he was also ignoring "the fixed minimum deposits retained by customers by agreement with their banks to remunerate the latter" (a practice common in the United States but surely not in the countries which use overdrafts) and that "perhaps these two sources of error may be regarded as roughly cancelling one another out" (*op. cit.*, vol. ii, p. 35). Another excuse sometimes advanced for ignoring unused limits among the liabilities of trading banks, that it is "highly unlikely that the whole would be used at one and the same time" (Mr. McKenna in evidence before the Macmillan Committee, quoted T. BALOGH, *op. cit.*, p. 75), is no more convincing since it would, after all, apply equally to deposits.

(14) The A.N.Z. Bank went further and took the view in 1962 that the large volume of unused limits also imposed an obligation on the monetary authorities "to ensure that the trading banks are provided with sufficient resources to meet their commitments legitimately entered into in accordance with official policy" (*Annual Report 1962*, p. 18).

ments of old loans. (In the rest of this article we shall use the italicised words for brevity as here defined.)

"The relationship between loan approvals and drawings against them" — and therefore between limits and advances — "is complex and varies with circumstances" (15). The complexity of possible relationships, the obverse of the overdraft's flexibility, is best illustrated by listing the main types of overdraft transaction.

Type I. *The customer secures an overdraft limit which may remain unchanged from year to year and against which he draws from time to time.* The customer "operates on an overdraft". All his cheque payments represent borrowing and increase the volume of bank advances, all his receipts represent repayments and reduce the volume of advances (except in periods when his account is in credit). This type of overdraft is particularly convenient for primary producers and others with seasonal credit requirements. But it is also commonly used by importers and others to finance fluctuating holdings of stocks. If all overdrafts were of this kind, limits would change little, rising secularly with gradual growth in the number of customers, and perhaps in their average limits. Short-term changes would be confined to advances.

Type II. *The customer secures an overdraft limit "subject to reduction arrangement",* that is to say, subject to repayment (usually coupled with corresponding reduction in the limit) in regular instalments. This type of overdraft, normal for housing loans but used also for other purposes, often involves drawing of the full amount of the loan in one lump sum, probably with little if any lag behind the establishment of the limit. Sometimes, for instance where there is a series of progress payments, the lag will be longer and distributed over a period. On average, there is likely to be a fairly short and fairly stable lag of drawings behind approvals. The other characteristic feature of this type of overdraft, which makes it most like the fixed loan, is that the limit, in effect, dies away with each repayment instalment, not to be revived; reductions coincide with repayments or follow them more or less closely.

Type III. *The customer secures a new or increased overdraft limit linked to some specific planned expenditure.* Here again the object may be the traditional use of bank credit to finance investment

(15) Reserve Bank of Australia, *Annual Report 1962*, p. 19.

in working capital (stocks). But the expenditure may also be of a seasonal nature (e.g. a primary producer's shortfall of receipts in the off-season); or it may be the purchase of a car or the payment of doctors' bills; or a major business investment in fixed capital, such as the purchase of equipment or the construction of a building. The new or increased limit may be for the whole or part of the planned expenditure. Approval will usually (though not necessarily) be secured before the decision is taken to go ahead with the spending plan. Drawings will usually lag behind approvals, the lag depending partly on the interval between the granting of the overdraft and the placing of the order or orders (or letting of the contract), but primarily on the interval between the placing of the order and the presentation of the bill or account for payment. In this case, the limit is not necessarily reduced *pari passu* with repayments. Frequently, however, such overdrafts are subject to a more or less formal understanding that they will be repaid over a period and that no substantial new drawings are made without renewed approval by the bank. Reductions, therefore, will tend to be closely related to repayments. On the other hand, there is here in the nature of the case scope for great variety as regards the period for which such advances are outstanding, i.e. the interval between drawings and repayments.

Type IV. *The customer secures an overdraft limit without any firm or immediate intention to use it.* Whether or not banks knowingly grant such overdrafts is not clear. But it is generally believed to be common practice for firms to secure limits, as a kind of nest-egg of liquidity, especially when credit is temporarily easy after a squeeze and "the going is good" or in anticipation of a squeeze. To the extent that overdrafts are of this type, approvals and limits may rise, with drawings and advances following only much later if at all.

Type V. *Customers may secure overdraft limits solely as security against trade credit.* This is commonly done in Australia by importers, in connection with documentary letters of credit. The overdraft limit here serves much the same purpose as a bank acceptance of a trade bill (16).

(16) In Australia, it is common for woolbuyers, in anticipation of credits from their overseas principals which may arrive through any one of several banks, to establish temporary overdraft limits with all these banks. These multiple limits have little significance and are excluded from the Australian statistics for limits (but the temporary wool advances are included in the statistics for advances).

Type Va. A variant of the preceding type became common practice in Australia in 1963 in connection with so-called "inter-company lending". Company A would borrow short-term funds from company B at a rate of interest substantially below bank overdraft rate, using an unused overdraft limit as backing. In this case, unlike the preceding one, the individual transactions occurred without the knowledge of the banks concerned, and against existing rather than specially established limits (17).

Type VI. *The customer secures no formal limit, knowing that he can rely on the bank to allow him to overdraw his account, within reason, as and when required.* This appears to be very common in the case of the large company whose custom is so valuable that the bank cannot easily afford to say No. Here limits are, in effect, zero; all changes are in advances.

Type VII. *The customer overdraws his account without an approved limit, or in excess of his limit.* Here, as in the preceding type, advances are quite independent of limits, but this case which probably involves a great mass of small accounts is much less important. At any time, some part of total advances outstanding will be of this type, but the amount will not fluctuate greatly (although it may have a tendency to rise when credit is tight) (18).

Finally, we must take account of two ways in which limits or advances may change at the initiative of the bank rather than the customer:

Type VIII. Advances will be increased whenever banks debit interest to accounts. If half the banks (accounting for one-half of advances) do so annually in a given month, and overdraft rate is 6 per cent, this can bring about a 3 per cent rise in advances in that month quite independent of drawings and repayments (19).

(17) For information about this inter-company lending, see *Australian Financial Review*, 3 October 1963, 17 January 1964, 2 March 1964; also Bank of New South Wales, *Annual Report 1963*, pp. 19f.

(18) In New Zealand, the published statistics for total credit limits are compiled by adding statistics for unused limits to total advances; they therefore include advances of this and the preceding type. In Australia, the banks are requested to include only formal limits in their returns of new approvals and limits outstanding; overdrawn current accounts and advances in excess of limits will therefore generally be excluded. The difference is quite significant. It means, for example, that the New Zealand statistics for limits reflect the substantial seasonal drawings without or in excess of formal limits for tax payments, while the corresponding Australian statistics would not generally do so.

(19) Cf. Financial Editor, *Sydney Morning Herald*, 15 November 1960.

Type IX. Banks may reduce limits and even recall advances at their own initiative. It is customary for banks in Australia to review most customers' limits once a year. Such review may lead to a request to the customer to reduce his limit. In addition, the central bank has once or twice in recent years directed the trading banks to take steps to reduce limits, and banks have undoubtedly done so. Whether banks ever nowadays call in advances (i.e. demand repayment) on any significant scale is more doubtful, though it is said that they did so in Australia in the weeks following the November 1960 emergency measures (20).

When one surveys this list, and allows for the fact that the relative importance of the various types of overdraft may change from time to time, one is tempted to conclude that no valid generalisations about the relations between limits and advances under the overdraft system are possible, that anything can happen. As we shall see later, the position is probably not quite so bad in practice. Meanwhile, it may help to pursue taxonomy a little further.

In the first place, we can summarise the likely main influences on the four determinants of net changes in *limits* and *advances*. Changes in *approvals* will reflect mainly changes in the public's spending plans and liquidity, but may also reflect changes in the degree of severity of credit rationing by the banks. Changes in the rate of *reductions* of limits will mainly reflect repayments, but may also be influenced by bank policy. Changes in the rate of *drawings* will reflect chiefly payments by customers which, in turn, will be related in various ways to their spending plans. Finally, changes in *repayments* will partly reflect changes in current cash receipts by customers (which in turn will vary not only with their incomes, but also with their rate of borrowing from other sources, such as overseas capital inflow or company raisings in the capital market); in part also they will echo past rates of approval to the extent that advances are subject to more or less regular repayment arrangements.

Secondly, while it is true that "changes in policy operate in the first instance upon the rate at which new loans are being approved and tend to be in the opposite direction to the current pressures of bank borrowing as manifested in movements in

(20) *Ibid.*, 21 December 1960.

advances" (21), one cannot identify limits as reflecting influences from the supply side and advances as reflecting influences from the demand side in the market for bank credit. The banks, as suppliers, can refuse to increase and perhaps marginally even reduce limits; to the extent to which there is excess demand for overdrafts, they can stimulate an increase in limits by relaxing credit rationing; in theory, though hardly in practice, they can recall advances. But what happens to advances and even to limits is much more dependent on demand than on supply. For, as is well known, banks "can take the horse to the water but cannot make it drink" and, in practice, they find it difficult to resist strong pressures of demand for credit (22).

Thirdly, the ratio of advances to limits (i.e. the proportion of limits used) will fluctuate with advances where overdrafts are of types I, VI, VII and VIII distinguished above. It will fluctuate with limits where overdrafts are of types IV, V and IX. In the case of type II, the advances/limits ratio will tend to stay close to 100 per cent. In the case of type III, the ratio may fluctuate widely with changes in both limits and advances. It may therefore be possible to discover something about the relative prevalence of the various types of overdraft by examining the behaviour of the advances/limits ratio.

But, fourthly, care is needed in interpreting movements in the advances/limits ratio. Even in the simple case where advances follow quite regular fluctuations in limits with a stable three months' lag the movement in the ratio is by no means simple. In particular, even in the months in which advances and limits are rising or falling by the same amount, the ratio changes for obvious arithmetic reasons.

Limits, Advances and Spending

So far we have discussed the relationships between limits and advances under the overdraft system without enquiring in which of the two series we are more interested and why.

Until a few years ago, this question would have sounded odd. It was taken for granted that changes in bank credit — actual

(21) Reserve Bank of Australia, *Annual Report 1962*, p. 19.

(22) Cf. H.W. ARNDT, *The Australian Trading Banks*, 1961, p. 62.

lending by banks and actual borrowing by customers — are properly measured by statistics of advances outstanding; and that, if we are interested in what is happening to (bank-financed) spending, it is again to the trend in advances that we must look. This view still prevails in countries like the United Kingdom where it has not yet been thought worthwhile to publish statistics of overdraft limits.

In Australia and New Zealand, statistics of limits have in recent years been collected and published. But even here, except to the extent that limits (and approvals) have been treated as indicators of trading bank *policy*, changes in limits have been thought interesting only because they precede changes in advances and may therefore be useful for short-term forecasting if — but only if — it is safe to assume a fairly stable lag of advances behind limits.

In the light of recent developments in monetary theory, these assumptions need to be reconsidered.

Presumably we are interested in what is happening to the level of (bank-financed) spending because, in the short run, it is the level of spending or effective demand that determines the level of economic activity, production and employment. But, as the Radcliffe Report has stressed, what matters for the level of effective demand is not the volume of money paid out in a period, but the volume of orders placed; “decisions to spend”, not “acts of spending” (23). The events that will cause more labour to be employed and more output to be produced are the decisions to place an order for goods or to let a tender for a construction project, not the acts of writing out cheques when the bills finally come in.

If this view is accepted it ceases to be obvious whether advances or limits are the more significant indicator of trends in (bank-financed) effective demand. The answer now depends largely on which types of overdraft predominate.

If all overdrafts were of types II or III, where the bank's loan approval normally triggers the decision to spend, the series for limits would certainly be the decisive indicator of trends in effective demand; the subsequent change in advances would reflect merely the economically relatively uninteresting rate at which drawings were made to pay bills. In the case of overdrafts of types I, VI

(23) Cf. H.W. ARNDT, “Radcliffe Monetary Theory”, *Economic Record*, September 1962, pp. 341ff.

and VII, on the other hand, where the change is only in advances (whether because limits remain unchanged or because they are dispensed with), it is obviously the series for advances that measures trends in spending in both senses.

It seems likely that in Australia types II and III — overdrafts of the housing-loan type and overdrafts granted to finance some specific planned expenditure — account for a considerable part of total bank credit, and for an even larger part of the cyclical changes in bank credit in which we are most interested. But the other three major categories — spending by primary producers and others operating on an overdraft with a virtually unchanging limit, by large companies operating without a formal limit, and in some circumstances by customers overdrawing their accounts without or in excess of limits — are by no means negligible.

To this division into two broad classes of overdrafts secured at the initiative of customers corresponds a parallel division of cases where banks take the initiative in tightening or relaxing credit rationing. Although banks can directly influence only approvals, not drawings (and therefore limits, not advances), it may be the rate of approvals which matters most for their customers' decisions to spend (as contrasted with their acts of spending). “Notwithstanding the time lags between the approval of loans and their drawing, a stimulus can be given to the economy when approvals are high and rising by providing assurances of financial accommodation; when approvals are low or falling, expenditure can be dampened by the lack of such assurances” (24).

The picture is further complicated by the fact that, as we saw, both limits and advances may be influenced by factors which have nothing to do with the current level of spending (in either sense), such as the two types of overdraft limit IV and V which are not intended to lead to drawings, and the factors listed under VIII and IX above (reductions of limits and debiting of interest by the banks).

In all the circumstances it is clearly impossible to say *a priori* which of the two series, limits or advances, is the more significant indicator of trends in (bank-financed) spending. But there can be little doubt that limits are important in their own right, not merely as heralds of advances.

(24) Reserve Bank of Australia, *Annual Report 1962*, pp. 19f; cf. also A. G. HART, *Money, Debt and Economic Activity*, Prentice Hall, 1948, p. 75.

Statistical Evidence

For the first time in the long history of the overdraft system we now have, for two countries, some statistical evidence of the working of the system.

The Reserve Bank of New Zealand has for some years published monthly statistics of unused or total overdraft limits and in recent years also a classification of limits by classes of borrowers (25). In Australia, the Reserve Bank has, since February 1962, published two new series of statistics (26). One is a monthly series of "new and increased lending commitments" (approvals) (27); the other a series (monthly from September 1961) for "overdraft limits" (limits). Both series relate to the major trading banks and both exclude temporary advances to woolbuyers and term loans (28).

Graph I shows the series for limits, together with two series for advances (one excluding temporary advances to woolbuyers and term loans but seasonally unadjusted, the other seasonally adjusted but including the two components) for the period July 1961-March 1964 (29). It also shows the two corresponding series for the advances/limits ratio. Unfortunately, the monthly series for limits does not go back far enough to indicate what might have been a normal cyclical relationship between advances and limits before 1961; and since 1961 conditions in Australia have been highly abnormal. But until more time has elapsed, we must make do with what evidence we have.

There is a suggestion that limits turned down before (seasonally adjusted) advances late in 1960 (30). Limits declined faster than

(25) Reserve Bank of New Zealand, *Bulletin*. See also footnote 18 above.

(26) Reserve Bank of Australia, *Statistical Bulletin*; for both series up to July 1963, see Financial Supplement, September 1963.

(27) The Reserve Bank has been collecting statistics of approvals since the mid-fifties; the first reference to these data appears in its *Annual Report 1957*, p. 13.

(28) See also footnotes 6 and 8; the Reserve Bank also publishes term loan approvals and a series for total approvals including term loans; but there is no comparable series for limits.

(29) No seasonally adjusted series for advances excluding temporary advances to woolbuyers and term loans is as yet available.

(30) The position is not entirely clear. A note in the *Statistical Bulletin*, February 1962 (p. 103) says that approvals "dropped sharply in the second half of that year" (1960). The *Annual Report 1961* at one point (p. 20) implies that approvals began to fall between August and October 1960, at another (p. 21) says merely that "before the end of 1960 the rate of new lending by banks began to fall".

LIMITS AND ADVANCES, AUSTRALIA
(Major Trading Banks)

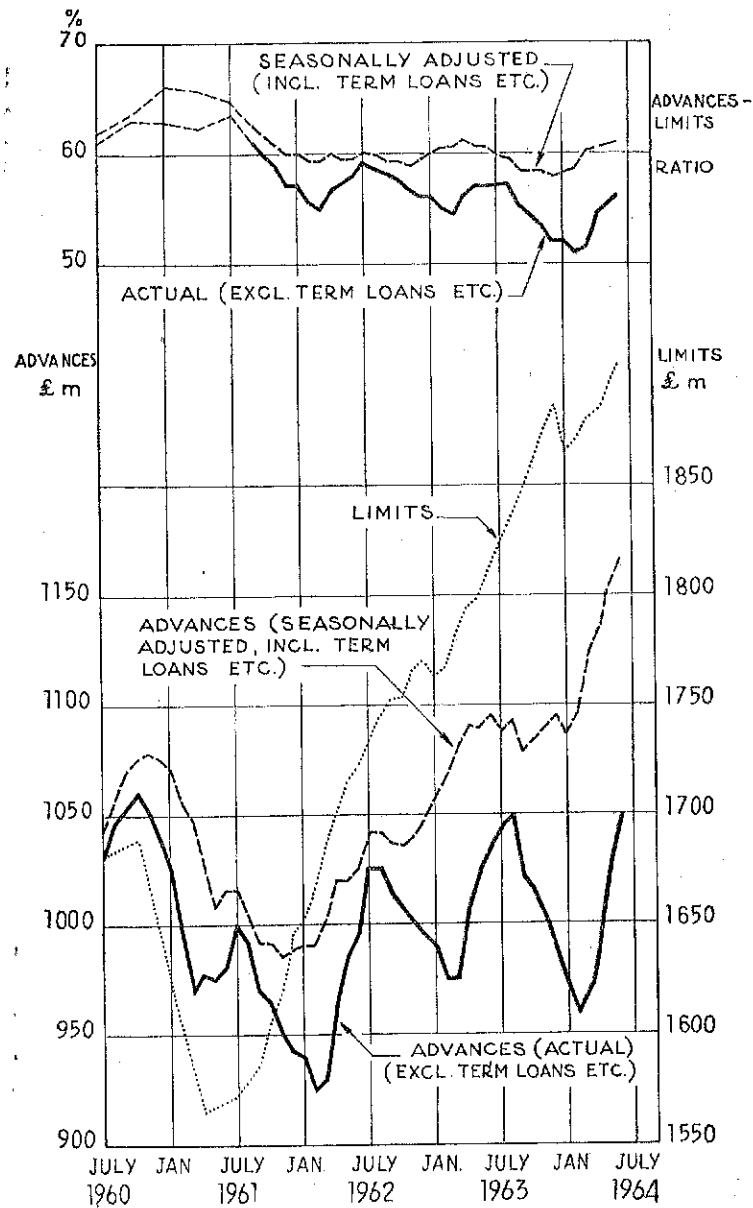
TABLE I

| Second Wednesday in | Limits (a) | Advances | | Ratio of Advances to Limits | |
|---------------------------|---------------|---------------|-------------------------------|-----------------------------------|--------------|
| | | Actual (a) | Seasonally Adjusted (b) | | |
| | | (1) £m. | (2) £m. | (2) (1) % | (3) (1) % |
| 1960 July | 1,682 | 1,030 | 1,041 | 61.1 | 62.0 |
| Aug. | | 1,046 | 1,056 | | |
| Sept. | | 1,053 | 1,068 | | |
| Oct. | 1,688 | 1,060 | 1,076 | 62.8 | 63.6 |
| Nov. | | 1,052 | 1,078 | | |
| Dec. | | 1,040 | 1,076 | | |
| 1961 Jan. | 1,624 | 1,025 | 1,072 | 63.0 | 66.0 |
| Feb. | | 996 | 1,056 | | |
| Mar. | | 970 | 1,042 | | |
| Apr. | 1,565 | 977 | 1,027 | 62.3 | 65.8 |
| May | | 975 | 1,008 | | |
| June | | 981 | 1,014 | | |
| July | 1,572 | 999 | 1,016 | 63.6 | 64.6 |
| Aug. | | 993 | 1,005 | | |
| Sept. | 1,587 | 971 | 992 | 61.0 | 62.3 |
| Oct. | 1,606 | 966 | 992 | 60.0 | 61.8 |
| Nov. | 1,620 | 951 | 986 | 58.8 | 60.7 |
| Dec. | 1,647 | 943 | 988 | 57.1 | 60.0 |
| 1962 Jan. | 1,651 | 939 | 990 | 57.0 | 60.0 |
| Feb. | 1,665 | 924 | 990 | 55.5 | 59.2 |
| Mar. | 1,683 | 928 | 1,002 | 55.0 | 59.2 |
| Apr. | 1,701 | 964 | 1,019 | 56.7 | 59.9 |
| May | 1,714 | 984 | 1,020 | 57.2 | 59.6 |
| June | 1,722 | 994 | 1,025 | 57.8 | 59.6 |
| July | 1,733 | 1,026 | 1,042 | 59.1 | 60.0 |
| Aug. | 1,744 | 1,025 | 1,042 | 58.6 | 59.8 |
| Sept. | 1,752 | 1,013 | 1,037 | 58.3 | 59.1 |
| Oct. | 1,753 | 1,007 | 1,036 | 57.7 | 59.1 |
| Nov. | 1,767 | 1,001 | 1,040 | 56.7 | 58.8 |
| Dec. | 1,771 | 996 | 1,048 | 56.1 | 59.2 |
| 1963 Jan. | 1,763 | 990 | 1,058 | 56.0 | 59.9 |
| Feb. | 1,767 | 975 | 1,067 | 55.0 | 60.3 |
| Mar. | 1,783 | 976 | 1,080 | 54.6 | 60.4 |
| Apr. | 1,794 | 1,007 | 1,090 | 56.2 | 61.0 |
| May | 1,798 | 1,024 | 1,089 | 57.0 | 60.6 |
| June | 1,812 | 1,034 | 1,094 | 56.9 | 60.5 |
| July | 1,824 | 1,043 | 1,088 | 57.1 | 59.7 |
| Aug. | 1,836 | 1,048 | 1,093 | 57.2 | 59.5 |
| Sept. | 1,846 | 1,022 | 1,078 | 55.2 | 58.2 |
| Oct. | 1,862 | 1,015 | 1,084 | 54.4 | 58.2 |
| Nov. | 1,874 | 1,004 | 1,090 | 53.6 | 58.2 |
| Dec. | 1,884 | 986 | 1,094 | 52.1 | 57.9 |
| 1964 Jan. | 1,865 | 973 | 1,085 | 52.1 | 58.1 |
| Feb. | 1,870 | 958 | 1,096 | 51.1 | 58.6 |
| Mar. | 1,879 | 969 | 1,123 | 51.6 | 60.0 |
| Apr. | 1,883 | 1,010 | 1,138 | 53.6 | 60.1 |
| May | 1,897 | 1,034 | 1,150 | 54.5 | 60.6 |
| June | 1,907 | 1,049 | 1,160 | 55.0 | 60.7 |

(a) Excluding } temporary advances to woolbuyers and term loans.
(b) Including }

Source: Reserve Bank of Australia, *Statistical Bulletin*; seasonally adjusted advances: *Australian Financial Review*.

GRAPH I - LIMITS AND ADVANCES, AUSTRALIA



advances in the early months of 1961 (31), but in the second half of the year rose rapidly while advances continued to decline or stagnate. Encouraged by the central bank, the trading banks had no difficulty in finding customers willing to take up new loan approvals, but advances failed to respond, partly because business confidence for long remained sluggish, partly because a combination of influences — expansionary monetary and budget policies, running down of accumulated stocks, and sustained capital inflow — added to the liquidity of the public, and thereby both increased the rate of repayments and kept down demand for bank credit (32).

In 1963 all these factors were unexpectedly but very greatly reinforced by an export boom which, between January 1963 and February 1964, added nearly £250 million to international reserves. By March 1962, the (unadjusted) advances/limits ratio had already fallen to 55 per cent. In the next two years limits rose by another £200 million, and the ratio fell to 51 per cent in February 1964. Unused limits reached the record total £912 million. Obviously, this could not be explained in terms of any normal lags of drawings behind approvals. A considerable part of the new or increased limits granted in those years must have been overdrafts of type IV — aimed at a “nest-egg of liquidity” — and meanwhile used in part as in type Va, as backing for inter-company credit. To that extent, it is arguable, undrawn limits were not really unused, but inter-company credit took the place of bank advances.

In any case the February 1964 figure is somewhat misleading since it was a seasonal low (33). A turning point may have been reached two months earlier. In relation to seasonally adjusted advances, the ratio reached its lowest point in December 1963. In the following months, under moderate central bank restraint, the rise in limits appeared to slow down while (seasonally adjusted) advances looked like staging the long-feared “explosion”.

(31) Between October 1960 and April 1961 limits fell by 7.3 per cent, advances (seasonally adjusted) by 4.6 per cent. It has been suggested that the rapid decline in limits is partly accounted for by the fact that “a considerable number of weekly new approvals are thought to be specifically for terms of three months or less”, in effect “tiding-over arrangements” (Financial Editor, *Sydney Morning Herald*, 15 March 1962).

(32) For another account of this episode, see *The Australian Economy 1963*, Government Printer, Canberra, p. 14.

(33) It should also be noted that the ratio as here defined excludes term loans which had risen to £50 million by March 1964. As Graph II shows, the shift towards term loans partly accounts for the relative stagnation of other advances and therefore for the abnormally low advance/limits ratio.

TABLE II

LIMITS AND ADVANCES, NEW ZEALAND

| Last balance day in | Limits | Advances | | Ratio of Advances to Limits |
|---------------------|------------|------------|---------------------|-----------------------------|
| | | Actual | Seasonally Adjusted | |
| | (1) £m. | (2) £m. | (3) £m. | (2) (1) % |
| 1959 July | 285.1 | 167.3 | | 58.5 |
| Aug. | 286.1 | 164.6 | | 57.5 |
| Sept. | 286.8 | 165.7 | | 57.6 |
| Oct. | 288.2 | 163.4 | | 56.8 |
| Nov. | 287.1 | 160.9 | | 56.0 |
| Dec. | 291.6 | 161.5 | | 55.2 |
| 1960 Jan. | 291.3 | 162.7 | 170.8 | 55.9 |
| Feb. | 293.1 | 160.5 | 170.6 | 54.9 |
| Mar. | 304.5 | 182.1 | 169.3 | 60.0 |
| Apr. | 304.1 | 177.1 | 170.6 | 58.3 |
| May | 303.0 | 173.8 | 173.0 | 57.3 |
| June | 304.5 | 173.5 | 175.6 | 57.0 |
| July | 307.9 | 173.7 | 177.1 | 56.5 |
| Aug. | 307.8 | 174.1 | 176.0 | 56.7 |
| Sept. | 312.5 | 178.8 | 181.8 | 57.2 |
| Oct. | 314.7 | 183.2 | 187.5 | 58.1 |
| Nov. | 319.1 | 185.1 | 190.7 | 58.0 |
| Dec. | 324.8 | 187.0 | 193.2 | 57.9 |
| 1961 Jan. | 324.3 | 190.3 | 199.6 | 59.0 |
| Feb. | 334.3 | 196.8 | 206.6 | 59.0 |
| Mar. | 349.0 | 233.3 | 212.5 | 66.8 |
| Apr. | 347.0 | 228.5 | 219.0 | 65.9 |
| May | 344.3 | 223.5 | 221.9 | 65.0 |
| June | 341.6 | 217.3 | 221.3 | 63.5 |
| July | 340.5 | 218.8 | 223.7 | 64.0 |
| Aug. | 338.2 | 217.5 | 224.2 | 64.5 |
| Sept. | 336.1 | 217.8 | 224.2 | 65.0 |
| Oct. | 335.1 | 213.8 | 223.2 | 63.6 |
| Nov. | 332.5 | 208.4 | 217.3 | 62.7 |
| Dec. | 327.8 | 205.0 | 213.9 | 62.6 |

(Cont'd.)

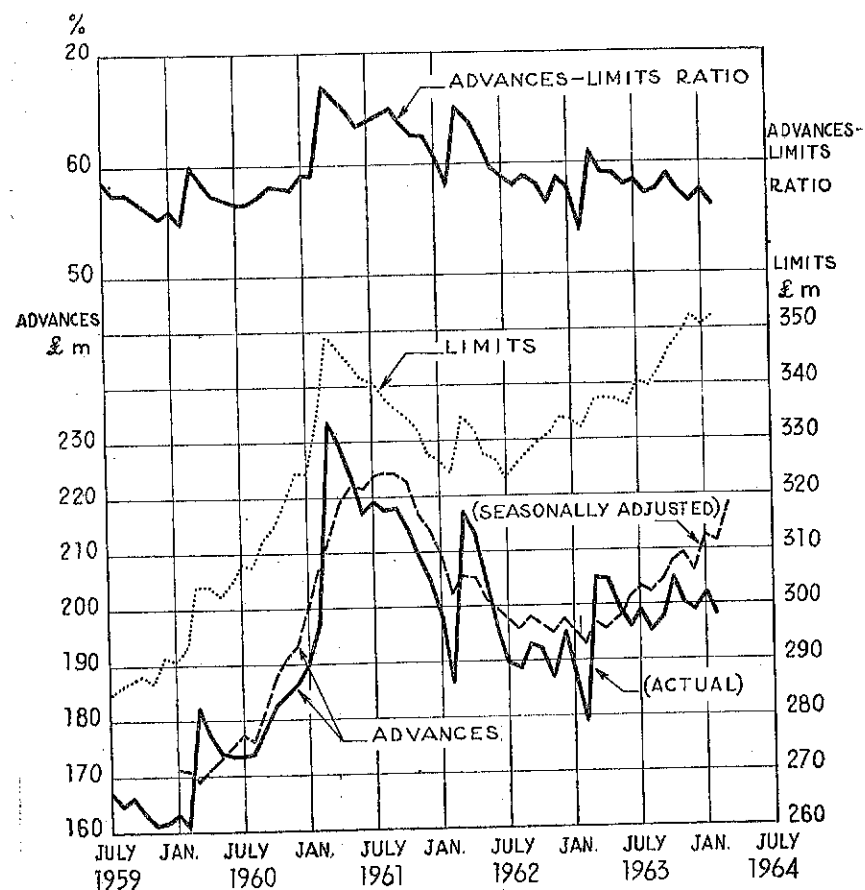
TABLE II (Cont'd.)

| Last balance day in | Limits | Advances | | Ratio of Advances to Limits |
|---------------------|------------|------------|---------------------|-----------------------------|
| | | Actual | Seasonally Adjusted | |
| | (1) £m. | (2) £m. | (3) £m. | (2) (1) % |
| 1962 Jan. | 326.7 | 197.9 | 209.4 | 60.5 |
| Feb. | 323.8 | 187.2 | 202.1 | 58.0 |
| Mar. | 334.4 | 217.2 | 205.3 | 65.0 |
| Apr. | 332.2 | 213.7 | 205.2 | 64.0 |
| May | 327.7 | 203.5 | 201.3 | 62.0 |
| June | 326.6 | 195.1 | 199.7 | 59.7 |
| July | 323.6 | 189.9 | 198.0 | 58.8 |
| Aug. | 325.8 | 189.6 | 196.1 | 58.1 |
| Sept. | 328.0 | 192.7 | 198.0 | 58.9 |
| Oct. | 329.6 | 192.0 | 196.8 | 58.2 |
| Nov. | 331.1 | 186.9 | 195.0 | 56.4 |
| Dec. | 333.9 | 195.1 | 197.5 | 58.6 |
| 1963 Jan. | 333.7 | 187.0 | 195.2 | 57.9 |
| Feb. | 331.9 | 179.4 | 193.0 | 54.0 |
| Mar. | 337.1 | 205.2 | 196.4 | 61.0 |
| Apr. | 337.5 | 204.3 | 196.0 | 58.9 |
| May | 337.2 | 199.2 | 197.6 | 59.0 |
| June | 337.0 | 196.2 | 200.7 | 58.1 |
| July | 340.2 | 199.2 | 202.9 | 58.5 |
| Aug. | 339.9 | 195.2 | 202.0 | 57.2 |
| Sept. | 342.3 | 197.4 | 204.2 | 57.5 |
| Oct. | (346.7) | 205.0 | 207.9 | (59.0) |
| Nov. | (348.6) | 199.6 | 209.4 | (57.2) |
| Dec. | (352.3) | 199.2 | 206.2 | (56.5) |
| 1964 Jan. | (350.8) | 202.0 | 212.3 | (57.5) |
| Feb. | (352.1) | 197.7 | 211.5 | (56.0) |
| Mar. | (362.0) | | 218.1 | |

Source: Reserve Bank of New Zealand, *Bulletin*; seasonally adjusted advances: *ibid.*, April 1964, p. 44.

An amount of £19.2 million, added to the published figures for limits from October 1963 in order to bring the figures for one bank into conformity with the standard definition, has here been deducted to retain comparability within the series.

GRAPH II - LIMITS AND ADVANCES, NEW ZEALAND



The corresponding data for New Zealand where monetary conditions have not been so abnormal yield rather more evidence about the relations between limits and advances (Graph II). There is a clear tendency for advances to lag behind limits. A deseasonalised series for limits would probably show a lag of about 3 months at the mid-1961 peak, but rather longer lags of 6-9 months in the two troughs of 1959-60 and 1962-63. This may well be a normal feature, reflecting the greater ability of banks to restrict than to expand advances. In New Zealand, as in Australia though to a much less degree, the advances/limits ratio has declined in the last three years, possibly here also reflecting a tendency to secure limits against a rainy day while credit conditions were relatively easy.

As the Reserve Bank of Australia points out in its *Statistical Bulletin*, it is possible, by deducting the monthly net increase in limits from the monthly rate of approvals, to calculate approximately the reductions (or cancellations) of limits during the month (34). By making the further, obviously somewhat heroic, assumption that reductions of limits occur in the main *pari passu* with repayments of advances, we can calculate also apparent drawings (Table III). Graph III shows approvals (monthly rate) together with apparent reductions and apparent drawings as thus calculated.

The first surprising fact brought out by Table III is the high mortality of overdraft limits. For every £10 million of new approvals per month, about £7.5 million are offset by reductions or cancellations of old limits, yielding a net increase in limits of only £2.5 million. One commentator, writing early in 1962, found this high rate of reductions so surprising that he took it to be an abnormal feature of that year (35). In fact, as the graph shows, the monthly rate of reductions has continued to rise since 1962, following the rise in limits (36).

Hardly less intriguing is the relation between approvals and drawings revealed by Graph III. Two points deserve attention. In the first place, it will have been noticed in comparing Graphs I and II that limits in New Zealand show a pronounced seasonal pattern (with the same March peak as advances), while at first sight limits in Australia show no such pattern (except for a sharp dip each January) (37). Graph III suggests faintly that in Australia, too, approvals (and therefore limits) (38) vary seasonally broadly in step with advances. This is interesting because it implies that

(34) Financial Supplement, September 1963, p. 14. For this calculation, it is necessary to multiply the published weekly rate of approvals by 4 or 5 depending on the number of weeks between the second Wednesdays of the preceding and the current month.

(35) Financial Editor, *Sydney Morning Herald*, 15 March 1962, 11 January 1963.

(36) The monthly average of apparent reductions was £30.6 million in 1961-62 (October-June), £35.0 million in 1962-63, and £37.7 million in 1963-64 (July-March).

(37) In the case of New Zealand, the March peak reflects payments of provisional and company tax in the last month of the financial year; a substantial part of these consist of drawings in excess of or without formal limit. The January dip in Australia appears to reflect the fall in approvals that occurs with the holiday shutdown of industry in that month and the practice of some banks in including in their returns to the central bank each January and July all reductions in overdrafts subject to monthly reduction of limits. (Cf. *Australian Financial Review*, 31 July 1964, p. 4.)

(38) The seasonal movement in limits is most clearly seen in the month-to-month changes in column 2 of Table III.

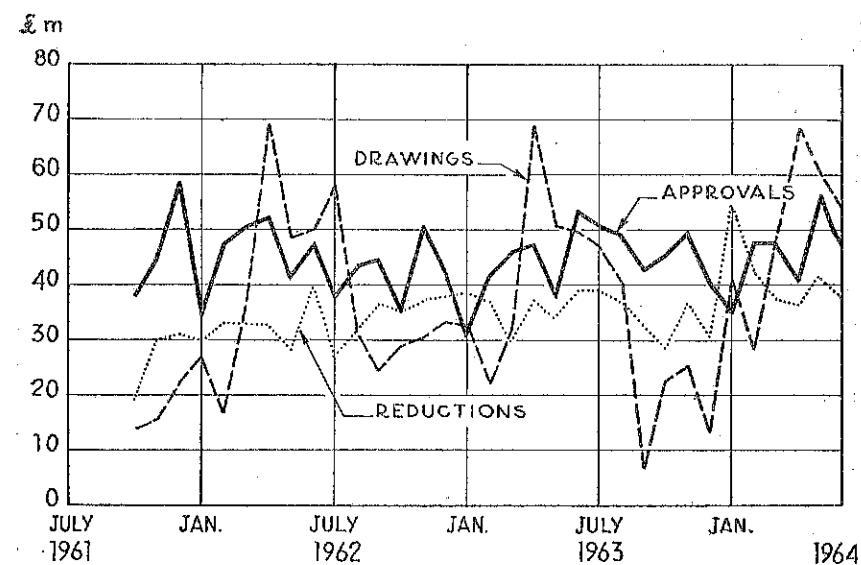
APPROVALS, REDUCTIONS AND DRAWINGS, AUSTRALIA
(£ million)

| | Approvals (monthly rate) (1) | Limits (net monthly change) (2) | Apparent Reductions (3) (1-2) | Advances (a) (net monthly change) (4) | Apparent Drawings (5) (3+4) |
|-----------|---------------------------------------|--|--|--|--------------------------------------|
| 1961 Oct. | 37.6 | 18.8 | 18.8 | - 5.3 | 13.5 |
| Nov. | 44.4 | 14.5 | 29.9 | - 14.7 | 15.2 |
| Dec. | 57.5 | 26.8 | 30.7 | - 8.9 | 21.8 |
| 1962 Jan. | 34.4 | 4.4 | 30.0 | - 3.4 | 26.6 |
| Feb. | 47.0 | 13.8 | 33.2 | - 14.8 | 16.4 |
| Mar. | 50.0 | 17.3 | 32.7 | 3.6 | 36.3 |
| Apr. | 51.6 | 18.6 | 33.0 | 35.7 | 68.7 |
| May | 40.8 | 12.6 | 28.2 | 20.1 | 48.3 |
| June | 47.5 | 8.2 | 39.3 | 10.7 | 50.0 |
| July | 37.6 | 10.9 | 26.7 | 31.3 | 58.0 |
| Aug. | 43.2 | 11.5 | 31.7 | - 0.5 | 31.2 |
| Sept. | 44.5 | 7.8 | 36.7 | - 12.6 | 24.1 |
| Oct. | 35.6 | 0.8 | 34.8 | - 5.6 | 29.2 |
| Nov. | 50.5 | 13.6 | 36.9 | - 6.5 | 30.4 |
| Dec. | 42.4 | 4.4 | 38.0 | - 4.6 | 33.4 |
| 1963 Jan. | 30.8 | - 8.2 | 38.2 | - 6.0 | 32.2 |
| Feb. | 41.5 | 4.6 | 36.9 | - 15.2 | 21.7 |
| Mar. | 45.6 | 15.9 | 29.7 | 1.1 | 30.8 |
| Apr. | 47.6 | 10.4 | 37.2 | 31.4 | 68.6 |
| May | 38.4 | 4.4 | 34.0 | 16.4 | 50.4 |
| June | 53.0 | 14.2 | 38.8 | 10.7 | 49.5 |
| July | 50.4 | 11.6 | 38.8 | 8.4 | 47.2 |
| Aug. | 49.0 | 12.3 | 36.7 | 3.6 | 40.3 |
| Sept. | 42.4 | 10.1 | 32.3 | - 26.2 | 6.1 |
| Oct. | 45.2 | 15.9 | 29.3 | - 6.7 | 22.6 |
| Nov. | 49.5 | 12.3 | 37.2 | - 11.7 | 25.5 |
| Dec. | 40.4 | 9.3 | 31.1 | - 17.8 | 13.3 |
| 1964 Jan. | 35.2 | - 19.1 | 54.3 | - 13.1 | 41.2 |
| Feb. | 47.5 | 4.9 | 42.6 | - 14.5 | 28.1 |
| Mar. | 47.6 | 9.8 | 37.8 | 10.9 | 48.7 |
| Apr. | 40.8 | 4.0 | 36.8 | 40.9 | 77.7 |
| May | 56.0 | 14.4 | 41.6 | 24.3 | 65.9 |
| June | 46.8 | 10.7 | 36.1 | 14.3 | 50.4 |

(a) Actual, excluding term loans, etc.

Source: Reserve Bank of Australia, *Statistical Bulletin*.

GRAPH III - APPROVALS, REDUCTIONS AND DRAWINGS, AUSTRALIA



not all seasonal bank credit is of type I, i.e. seasonal drawings against a permanent limit. Some considerable part appears to be of type III, a limit being established (or increased) for a few months and reduced with repayment of the seasonal advance.

Secondly, Graph III tells us something about the relation between month-to-month changes in approvals and drawings. In about half the months during the three-year period covered by the graph, drawings appear to have followed approvals with a lag of one month; in the other half (most of which consists of the period May-December 1963) approvals and drawings seem to have moved together. With monthly data, one cannot infer more from this than that there appears to be a lag of some weeks. But the evidence confirms the impression that, of those overdrafts which account for month-to-month changes in advances, a considerable portion consists of type III, approval being sought not long before the actual drawing.

One disadvantage of all these statistics is that they are too highly aggregated. It seems likely that a good deal more light could be thrown on the behaviour of overdrafts if separate data

on approvals and limits of various categories of borrowers were available. No such data are published for Australia (although the Reserve Bank obtains a classification of limits for its own use). For New Zealand, a classification of limits, corresponding to that for advances, has been published at six-monthly intervals for the last three years (Table IV). Graph IV shows movements in the advances/limits ratio for some of the main classes of borrowers. The information is in many ways surprising.

Contrary to what one might expect, farmers made very intensive use of their limits, their advances/limits ratio being exceeded only by that for personal loans. (The fact that the ratio was somewhat lower for sheep farmers suggests that the average ratio for primary producers may be a little lower in Australia.) It is urban business, manufacturing and commerce (especially finance) that has the low ratios, or in other words, holds the bulk of the unused overdrafts. (New Zealand importers, however, still subject to fairly tight selective control of advances, have a higher ratio in New Zealand than the rest of commerce.)

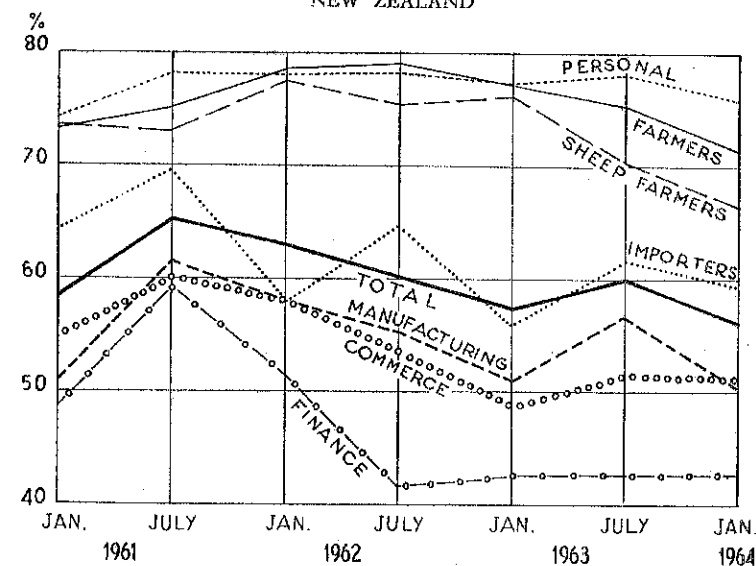
TABLE IV
ADVANCES/LIMITS RATIOS BY CLASSES OF BORROWERS,
NEW ZEALAND

| Classes | 1961 | | 1962 | | 1963 | | 1964 (a) |
|-------------------------------|--------|--------|--------|--------|--------|--------|----------|
| | Jan. % | July % | Jan. % | July % | Jan. % | July % | Jan. % |
| 1. Farming etc. . . | 73.3 | 75.1 | 78.6 | 79.0 | 77.1 | 75.3 | (71.5) |
| 1 (b) mainly sheep . . . | 73.6 | 73.1 | 77.6 | 75.4 | 76.1 | 70.3 | (66.5) |
| 3. Manufacturing . . | 51.0 | 61.4 | 57.8 | 55.2 | 51.0 | 56.6 | (50.3) |
| 7. Commerce | 55.0 | 60.0 | 58.0 | 53.5 | 48.5 | 51.5 | (51.0) |
| 7 (a) mainly importers | 64.6 | 69.6 | 58.0 | 64.8 | 56.0 | 61.7 | (59.5) |
| 7 (f, g) finance | 48.7 | 59.1 | 51.5 | 41.4 | 42.3 | 42.4 | (42.6) |
| 10. Personal | 74.2 | 78.1 | 78.1 | 78.3 | 77.2 | 78.1 | (76.0) |
| TOTAL | 58.4 | 65.2 | 62.9 | 60.1 | 57.2 | 59.9 | (56.0) |

(a) Not strictly comparable since limits include £19.2 million on new definition of overdrafts.

Source: Reserve Bank of New Zealand, *Bulletin*.

GRAPH IV - ADVANCES/LIMITS RATIOS BY CLASSES OF BORROWERS,
NEW ZEALAND



The graph brings out a number of interesting points. The movement in the overall ratio (rising to a peak with advances in July 1961, falling until January 1963, followed by a smaller rise to July 1963) reflects the movement of the ratios for manufacturing and commerce. The ratio for farmers continued to rise for another year after the 1961 credit squeeze. The finance group appears to have felt the squeeze in 1961 but has since then been able to hold on to a large volume of unused limits. The oddest feature of the graph is an apparent seasonal movement — high in July and low in January — which is most marked for importers but also shows itself in the personal and manufacturing categories. It is clearly unrelated to the seasonal pattern of all advances which is dominated by the March peak for tax payments (39).

One important aspect on which none of the available statistics throws any light is the extent to which changes in limits, advances and the advances/limits ratio are influenced by firms of different

(39) The explanation in the case of advances to importers appears to be that in June, the last month of the import-licensing year, importers tend to hold large stocks of imported goods and therefore use their limits more fully than in January after the Christmas spending period. In the case of manufacturing and personal advances the apparent seasonal pattern is probably spurious.

size. Some banks in Australia have found that the relation between advances and limits is much more stable if the large accounts are eliminated from the statistics. Similarly, in England quite large slices of total bank advances are thought to be due to a few giant firms who use overdrafts as stop-gaps in their capital development programmes. A size analysis of the statistics of limits and advances would be useful to test this point.

The Problem of Unused Limits

At various points in the preceding discussion reference has been made to the problem which unused limits present to the central bank in its efforts to maintain the economy in internal balance. We must now look at this aspect more closely. What precisely are the disadvantages for monetary policy of the overdraft, as compared with the fixed-loan, method of bank lending?

It is worth emphasising that some of the main obstacles to the effective use of monetary and banking policy for economic stabilisation have nothing to do with the difference between the two methods. The difficulties that central banks sometimes have in controlling the lending policies of commercial banks — in the sense of the rate at which banks are prepared to grant loan approvals — are clearly independent of the method of lending. Nor are the difficulties in controlling the current level of spending through expansion and contraction (or restraint upon expansion) of bank credit necessarily any different under the two methods.

The difficulties in using banking policy to stimulate spending in a recession are no worse under the overdraft than under the fixed-loan system. In so far as a rise in the level of (bank-financed) spending depends on a rise in the level of "actual borrowing" from banks, the real trouble is the sluggishness of response of *advances* to an easier lending policy by the banks, and there is no reason to suppose that this is any greater under the overdraft system. In so far as spending decisions are stimulated by the "assurance of financial accommodation" (40) provided by an easier lending policy, the effect is probably much the same whether customers, under the overdraft system, are induced actually to apply

(40) See p. 245 above.

for new or increased limits, or whether, under the fixed-loan system, they are merely made more confident that they will be able to secure bank accommodation when the need arises.

The difficulties banks experience in a boom in resisting pressures of demand for credit are also unlikely to be affected by the method of lending. Neither refusal of additional accommodation nor recall of outstanding advances is any easier under the fixed-loan system.

In fact, the special problems of the overdraft method arise entirely from the existence of unused limits. Unused limits constitute a reservoir of liquidity, additional to deposits, which does not exist where all bank credit takes the form of fixed loans. An increase in unused limits presents a problem for monetary policy because it constitutes an increase in the liquidity of the private sector. In turn, "the importance of the growth of liquidity in the private sector lies in the scope it gives to the community to change its behaviour quickly should its attitudes and expectations change — to spend more freely and to move into less liquid assets, increasing the capacity of others to spend more freely" (41).

Even in its effects on the liquidity of the public, the overdraft system makes less difference than might appear at first sight. In the interval between the approval of a bank loan and its use for cheque payments, the borrower's liquidity is increased to exactly the same extent whether the increase takes the form of a larger credit balance on current account or an equivalent unused limit (42). The special features of the overdraft system, in fact, reduce to two points, both of which we have noted before.

First, the liquidity of the public is liable to be under-estimated if unused overdraft limits are ignored, and it is in any case difficult to assess so long as the only available statistics relate to deposits and advances. Once statistics of limits are collected and published, this point loses most of its significance. Both Australia and New Zealand have now gone a long way in this direction, though the Australian Reserve Bank might follow the New Zealand example by publishing a classification of limits, and the New

(41) Reserve Bank of Australia, *Annual Report 1963*, p. 16.

(42) In the case of the fixed-loan system the increase (in terms of the Fisher equation) raises M , in the case of the overdraft system it raises V in the first round; there is of course no difference in subsequent rounds.

Zealand Reserve Bank the Australian example by publishing statistics of approvals.

Secondly, unused limits under the overdraft system cost nothing (43), while on their equivalent under the fixed-loan system — the unused part of a bank loan — the customer has to pay the same rate of interest as on the used part (44). Under the fixed-loan system customers have a strong incentive to economise in the holding of borrowed deposits. So long as an unused limit is virtually a free good, the total volume of unused limits held on average by the public will be larger, and unpredictable substantial increases in advances more likely, than would be the case for their equivalents under the fixed-loan system.

To distinguish this defect of the overdraft system from other problems of monetary control common to all forms of bank lending is not to play down its importance. It is a serious defect which, as we have seen, has on two earlier occasions aggravated the difficulties of monetary policy in Australia and may yet prove even more troublesome. What can and should be done to remedy it?

The Case for a Commitment Fee

Nothing as drastic as sudden complete abolition of the overdraft system and its replacement by the American-type fixed-loan method is likely to commend itself in countries in which the overdraft has been part of their way of life. The overdraft has advantages to the customer which will not be lightly given up.

An approach towards more gradual diminution of the role of the overdraft and its disadvantages may emerge in Australia from the recent introduction of the term loan. As term loans increasingly replace traditional overdrafts for longer-term requirements, especially for the acquisition of fixed assets, overdrafts will represent a declining part of bank credit.

For the rest, the main practical question is whether something should be done to discourage the retention of unused limits by a commitment charge. When I proposed this in 1957 (45), the suggestion met with two main objections in trading bank quarters.

(43) Subject to the qualifications noted on p. 235 above.

(44) Subject to the qualification noted in footnote 7 above.

(45) *The Australian Trading Banks*, 1st edition, Cheshire, 1957, p. 194.

First, it was claimed that overdraft limits were in many cases so informal that no precise volume of limits could be determined. The successful collection of statistics of limits has disposed of this point. Secondly, it was argued that the trading banks could not impose a charge for granting a limit without abandoning the fundamental principle that the limit was revocable at any time at their discretion. Here again the proof of the pudding has been in the eating: the banks seem to have had no difficulty in reconciling their right to cancel limits at will — a somewhat tenuous right in practice — with the establishment fees and overdraft management fees which most of them have adopted in recent years.

There remain two more substantial difficulties. One is that a commitment fee would fall severely on primary producers and others who retain a limit from year to year for purely seasonal use during a few months of the year. Since fairly stable unused limits during the off-season months present no problem for monetary policy, there is a case for meeting this difficulty by the banks granting a partial or complete rebate of the fee for any part of his limit which the customer agrees in advance to use only during three or four specified months of the year.

The other difficulty arises from the fact mentioned before that a powerful and valuable customer does not need a formal limit since his bank can hardly refuse credit as and when he wants it. A commitment charge would simply lead all the larger and weightier customers to rely on this fact and do without a formal limit. This might be a real difficulty for an individual bank. But it is hard to believe that all trading banks acting together, as they tend to do in these matters, could not enforce the practice of insisting henceforth on a formal limit for all customers.

It has been reported that early in 1964 the Australian trading banks themselves submitted to the Reserve Bank proposals for a commitment fee (46). The immediate occasion was reported to be the development of inter-company lending on the security of unused bank overdrafts. A commitment fee of 1½ per cent would bridge the gap between the then minimum bank overdraft rate of 5½ per cent and the current market rate of short-term inter-company loans of about 4 per cent and could thus be expected to shepherd the borrowers back to the trading banks and the lenders to fixed

(46) *Australian Financial Review*, 17 January 1964; also 2 March 1964.

deposits or the official short-term money market (47). For companies that chose to continue to use an unused limit as security for inter-company borrowing, the fee would, in effect, serve as an acceptance commission.

The newspaper reporting the proposal was doubtful whether the Reserve Bank or the Federal Government would agree to "such a sweeping change as an across-the-board commitment fee — which could be of great significance to bank profits" (48). The additional revenue which such a fee would yield to the banks can easily be exaggerated. It is true that on the April 1964 level of overdraft limits of £1,880 million an across-the board fee of 1½ per cent would yield over £28 million a year. But if the fee is applied to unused limits only (by being absorbed in overdraft interest on debit balances), if it also replaces the present establishment and management fees, if it is wholly or partially rebated for limits confined to seasonal overdrafts, if it serves to stimulate further resort to term loans, and, above all, if it succeeds in its main object of encouraging customers to keep unused limits to a minimum, then the extra revenue from such a fee might turn out to be relatively small (49).

Perhaps Australia's experience in 1961-64 was altogether exceptional and the New Zealand Reserve Bank right when it said, as recently as 1963, that "allowing for very short-term deviations there is on the whole a fairly stable relationship between limits and actual advances" (50). But if, as I am inclined to think, this is too complacent a view, then a commitment fee circumscribed in the manner suggested is probably the best approach to the problem.

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(47) The case of inter-company lending suggests an alternative formulation of the problem of unused limits. Banks normally act to a considerable extent as lenders of last resort for trade credit. Hence the commonly observed phenomenon of rising advances in a liquidity crisis. The widespread resort to inter-company lending in Australia during the 1963-64 boom, apart from doing the banks out of business, involved the risk that a tightening of credit conditions would lead to wholesale substitution of bank credit for inter-company trade credit. But this is merely another way of describing the risk of wholesale use of the unused limits which served as security for inter-company lending.

(48) *Australian Financial Review*, 17 January 1964.

(49) One commentator (Financial Editor, *Sydney Morning Herald*, 12 November 1960) has adumbrated the idea of variable commitment fees as a technique of monetary control; it is hard to see that any useful purpose would be served by influencing unused limits through a varying commitment fee (rather than used limits through a varying advance rate).

(50) *Money and Banking in New Zealand*, Reserve Bank of New Zealand, Wellington, 1963, p. 6.