

Cheap Money: The English Experiment of 1945-47

by

DAVID ROWAN

Introduction.

The purpose of this paper is to describe and evaluate the post war attempt of the Chancellor of the Exchequer (Rt. Hon. Hugh Dalton, M. P.) to produce cheaper money — that is to lower the rate of interest (1). From July 1945 until August 1947 it was the principal preoccupation of the monetary authority to force the rate structure downwards until it became possible for the Government to borrow at $2\frac{1}{2}\%$ per annum on long term securities. Our task is to describe the campaign by which this objective was temporarily achieved; to record the failure to consolidate the new rate; and, finally, to attempt an assessment of the desirability or otherwise of the policy followed. The paper then falls naturally into three main sections devoted to description, explanation, and evaluation. Before, however, we embark upon the first part of our task it is necessary to say something about the economic background against which the Chancellor operated. We must therefore discuss, though only very briefly, the main changes produced by the war.

War Finance.

During the war the power to borrow from the market was rigorously controlled by the Capital Issues Committee. Only those organisations whose applications were approved by the Committee were permitted to make issues. Approval by the Committee meant, of course, approval by the Government. The main function of the market became the finance of the war

effort. Some measure of this change can be shown by comparing the total change in the deposits of the clearing banks from 1938 with the total change in their indirect and direct lending to the Government.

Change in Deposits, from £ m.
1938 to 1945 + 2415

Change in lending to the Government

(i) Increase in Money at Call + 55 (lent via the Discount Market)
(ii) Increase in T.D.R.s . . + 1811 (lent directly)
(iii) Increase in Investments + 519 (lent directly)
Total . . . + 2385

The close correspondence of the two figures tells its own story. During the same period Advances declined by £ 206 millions. The experience of the banks was broadly that of the other main financial institutions. All were engaged in the business of financing the Government and financial institutions in general absorbed a large proportion of the increase in the national debt (2).

The increase in bank deposits from 1938 to 1945 was over 100%. Since this increase would have been far smaller had the public's desire to hold money been less, the magnitude of the increase gives a rough measure of the public's desire for liquidity. Since the public, at the prevailing rates of interest, preferred bank deposits to securities the banks absorbed the securities and the public held the corresponding deposits. The liquidity (3) of the

(1) There is, of course, no single rate of interest. Dr. Dalton's objective was the long rate which may be defined as that on Government securities having a life of 20 years and more. The rate is measured, in this paper, by the return on Consols, which are, in fact, irredeemable.

(2) It has been estimated that the national debt formed some 40-45% of the value of private property in the country.

(3) We define the « liquidity » of the system as
$$\frac{\text{Clearing Bank Deposits} + \text{Currency with the Public}}{\text{National Income}} \times \frac{100}{1}$$

system as a whole increased from 1936 to 1944 — as a glance at the Table III reveals. During the same period the rate of return on Consols, and the rate on three months bank bills, were steady. These facts taken together seem to indicate a trend towards an increased general desire for liquidity (4).

In its capacity as dominant borrower, the Government attempted to provide securities to suit every taste. Nevertheless, as can be seen from the Tables I and IA and indeed can be inferred from the growth of Treasury Deposit Receipts, the greatest growth was in the very short and medium securities (5).

TABLE I

COMPOSITION OF NATIONAL DEBT AT THE END OF THE FINANCIAL YEARS 1938/9 AND 1943/4 (6)

Latest Date of Repayment	1938-9		1943-4	
	Value £ mill.	% of total	Value £ mill.	% of total
Under 1 year . . .	1305.3	18.1	7753.6	42.4
1-5 years . . .	452.8	6.2	1283.2	7.0
5-10 years . . .	306.7	4.2	2093.5	11.4
Over 10 years . . .	5182.1	71.5	7053.5	38.5

TABLE IA

ANNUAL AVERAGES

	Total Internal National Debt £m.	Total Treasury Bills & Treasury Deposit Receipts £m.	Proportion 2/1 as a %
	1	2	3
1944	18,562.2	4,538.7	24.4
1945	21,365.9	5,539.7	25.9
1946	23,636.5	6,082.4	25.7
1947	25,630.7	6,341.2	25.7

Source: Annual Abstract of Statistics.

There were two principal results from this expansion. In the first place it strained the

(4) By liquidity in general we mean a preference for holding money (i.e. tokens of indebtedness by bankers) as against any form of Government or private token of indebtedness.

(5) Cf. Prof. E. V. MORGAN, *The Future of Interest Rate*, in «The Economic Journal», December, 1944. This growth was plainly due to the need to provide securities suitable to institutional lenders.

(6) Source: Prof. E. V. MORGAN, *loc. cit.*

jobbing facilities in the bond market. This was partly offset by the expansion of the resources of the discount houses who provided a valuable stabilising influence in the case of bonds with relatively short periods of life (7). Secondly, the growth in the total volume of debt, and particularly in that held by banks and financial institutions meant that relatively stable bond prices had become a fundamental requirement for the liquidity of these institutions (8). The nature of the expansion shows the demand for relatively shorter dated issues. The Government's success in providing what was wanted rather than attempting to force the absorption of long term securities was probably an important factor in keeping interest rates low and thus providing cheap war finance.

Outside the money market the principal result was the increased liquidity of industry. This was due to three causes. The first was the war time postponement of investment; the second the degree to which industry, in the main working on war contracts, was financed by the Government; the third was the piling up of credits via excess profits taxes. We shall come to the importance of these conditions later.

So much for the general background against which the post-war drive for cheaper money must be seen. We come now to the drive itself.

The Drive to Cheapen Money.

Any attempt to cheapen money rests fundamentally upon two weapons. The first of these is control over the volume of credit. The second is the ability to influence the market's outlook. There are two aspects of the latter problem. In the short run, when the problem is that of getting the rate structure down the authorities can, if they succeed in persuading the market that rates in the future will be lower than those obtaining today, enlist the support of speculators in their service. In the longer

(7) Cf. W. T. C. KING, *The Changing Discount Market*, in «The Banker», March, 1947.

(8) This is certainly the view of bankers, but it is probably not correct. A rise in interest rates involves the banks in large paper losses since they value securities at cost or market price whichever is the lower. These losses, however, only become real if the securities are realised and in practice banks tend to hold their securities until maturity.

run, the problem is one of persuading the market that the new rate, once attained, is likely to be a «safe» or «normal» rate. Failure in the latter task will involve constant creation of credit since the absence of any fundamental confidence in the new and lower rate will mean that any change in the internal or external political and economic outlook will stimulate a general demand for liquidity. If this occurs the authorities must either provide the extra cash or acquiesce in a general rise in rates — i.e. an upward shift in the rate structure.

This is a general statement of the problem. The particular problem facing Dr. Dalton was complicated by the fact that he was attempting to force rates down at a time when most people expected that they would have to rise. This was so because it was widely visualised that in the immediate post war period most firms would be anxious to undertake investment. As a result the demand for funds would be great and the price correspondingly high if the rate of interest was to be allowed to perform its traditional function of determining the volume and composition of investment.

There was, however, no intention of allowing the rate of interest to decide either the quantity or quality of investment. Both functions were to be performed by the authorities. This much is clear from the statement of the war time coalition Government made in a White Paper on «Employment Policy» published in 1944 (9):

“the use of capital will have to be controlled to the extent necessary to regulate the flow and direction of investment. Heavy arrears of capital expenditure on buildings, plant and equipment have to be overtaken, and construction on new development must begin. Without control therefore there would be a scramble to borrow, leading to a steep rise in rates of interest. The Government are determined to avoid dear money for those urgent reconstruction needs. In this period, therefore, access to the capital market will have to be controlled in order to ensure the proper priorities”.

This was the agreed policy of all three major political parties.

For the control of investment Dr. Dalton relied upon powers originally granted under

the Defence Regulations and subsequently extended under the Supplies and Services (Transitional Powers) Act of 1945 which gave the authorities power to allocate the existing real resources by means of licences and permits. These powers were buttressed by the extension of the Capital Issues Committee into the transition period (achieved by the Investment [Control and Guarantees] Act of 1946), the nationalisation of the Bank of England, and the Acts continuing the existing provisions for exchange control.

Thus, in attempting to force rates still lower when, in the absence of control, they might reasonably be expected to rise, Dr. Dalton was able to deploy a considerable number of weapons. He was assured (at least theoretically) of controls over investment. He was able, through the Capital Issues Committee, to restrict access to the capital market for the purpose of making new issues. He had, of course, complete control of the creation of credit in the system. He was able to vary the supply of securities through the «tap» whenever to do so seemed tactically advisable. Finally, he could count as an ally the existing tax structure which, while possessing no tax on capital gains, taxed additional income at rates which rose as high as 19/6d. in the £ (10). This last point was of considerable importance since it raised the relative attractiveness of capital gains. Indeed for those in the highest tax bracket, a capital gain of sixpence was the equivalent of an additional £ of income. If speculators could be brought to believe in his ability to lower rates (11), the Chancellor might, in view of this condition, be assured of considerable support — at least in the short run.

In addition to this favourable technical and institutional apparatus, Dr. Dalton was possessed of considerable personal skill in the art of persuasion and was by no means lacking in determination. He did not shrink from the creation of credit on large scale in order to obtain his objective. Accordingly in early 1947 he was able, after a campaign of some fifteen months, to issue 2½% Treasury Bonds 1975 at par. He succeeded in getting the long rate

(10) Cf. Prof. F. W. PAISH, *Cheap Money Policy*, in «Economica», August, 1947.

(11) In the short run.

(9) Cmd. 6527 of 1944.

down. As we shall see, he failed to keep it there.

There is not space available to deal in any detail with the actual technique by which Dr. Dalton accomplished his purpose (12). We shall deal only with one operation. It may, however, without any grave risk of error, be taken as typical.

The Technique of Cheaper Money.

The intention of the Labour Party to promote cheaper money was, of course, well known. To some extent it had been an issue in the 1945 election. Labour took office at the end of July, and Dr. Dalton may be said to have opened his campaign when, on the eve of the « Thanksgiving Week » savings campaign, he announced that « It was his intention to examine ways and means of lowering interest rates ». The yields on representative Government securities reacted as follows:

Period	« LONGS »	« MEDIUMS »	« SHORTS »
	2½% Consols	3% Savings Bonds 1960/70	2¼% War Bonds 1952/4
1945 - August . .	2.89	2.95	2.39
September . . .	2.82	2.97	2.43
October	2.80	2.98	2.47

There was clearly some switching from both « shorts » and « mediums » (13) to the longer securities. The fact that the gap between « shorts » and Consols narrowed is hardly surprising but the rise in the yield on « shorts » is, and probably indicates the inability of the jobbers to absorb the sales of speculators who were either switching to Consols, or absorbing the existing « tap » issue of 3% Savings Bonds.

In October the Chancellor moved against the ultra-short rates. He reduced the return on Treasury Deposit Receipts from 1% to 5/8%. The rate on Treasury Bills declined to ½% and the banks reduced their deposit rate accordingly. On November 28th the Chan-

(12) Nor do we discuss the associated controversies regarding the nature and degree of official intervention; whether or not certain extra budgetary funds were used and so on.

(13) « Short » is defined as having 5 years or less to run before maturity; « medium » from 5 to 20 years.

cellor announced that the issue of securities through the tap would cease on December 15th. Next came the first conversion offer. 2½% Conversion Stock 1944-49 and 2½% National War Bonds 1945-47 were called for redemption in April and July 1946. The conversion stock offered was 1¾% Exchequer Bonds 1950.

In the event, of £ 650 millions of these two issues outstanding, the option to convert was exercised with respect to £ 458 millions. £ 192 millions had therefore to be found for repayment.

This brief description illustrates the way in which the Chancellor employed his weapons to achieve his first conversion.

1. Initially he operated on the markets expectations.
2. Next he moved against the ultra-short rates, by far the most easily controlled by the authorities since the elasticity of supply of funds in the short market is low for institutional reasons (14).
3. Then he stopped the supply of the existing 3% « tap » issue.
4. Finally came the first conversion which took the form of replacing one « short » by another stock of similar life but lower yield. The repayment of £ 192 millions was, of course, effected by borrowing on floating debt.

Clearly if the pattern continued there must be, as a first result, an increase in the floating debt relative to the funded debt. Table II shows the relative changes in these two components over the period, together with a summary of the movements in bank deposits, bond prices, and industrial share prices.

It will be noticed that there was little, if any, tendency for the short and long rates to come closer together. There was, however, a considerable spill over of newly created credit from the bond to the share market, a process which is clearly revealed by the movement of the index of industrial share prices.

(14) The authorities dominated both sides of the short market. They are the principal borrowers and, through the Bank of England, their control over the clearing banks and the discount houses is strong. A fall in short rates thus does not cause an embarrassing volume of switching by banks or discount houses. Moreover, the special buyer stands ready to relieve any temporary strain on the market and make the authorities wishes effective. In fact, within the limits of reasonable differentials, the rate on Treasury and other bills was almost completely insulated from the rates on long term securities.

As can be seen, the peak of the cheaper money drive was reached in January 1947 with the issue of 2½% Treasury Bonds (1975). In February of that year came the fuel crisis. Gilt-edged and industrials recorded losses, but both markets recovered by May.

In August 1947 came the failure of convertibility. Once again both markets reacted sharply. By the 13th of August 2½% Consols were yielding £ 3. 0. 3. per cent as against £ 3 per cent in July 1945. The index of industrial share prices reached 159 by October while Consols showed a slight recovery to yield 2.90%. Thus, inside the first twenty seven months of the Labour Government's administration the interest wheel had turned its full circle. The situation was practically that

which existed before Dr. Dalton's drive as can be seen from the comparison below:

	Bank Bills Rate	Yield on Consols	Index of Industrials
July 1945	1.03	3.00	158
Jan. 1947	0.53	2.54	191
Oct. 1947	0.53	2.90	159

Since December 1947 the yield on 2½% Consols has not fallen below £3 per cent. It can thus be seen that Dr. Dalton's success was purely temporary. He succeeded in driving down rates to the required level. But he was unable to convince the market of the survival value of 2½% at long term once it had been reached. Consolidation proved to be beyond

(Monthly averages of weekly Amounts)

TABLE II

Month	Treasury Bills Outstanding (£ millions)	T. D. R. s. Outstanding (£ millions)	Bank Deposits London Clearing Banks (£ millions)	3 months Bill Rate %	Rate on Consols %	Industrial Index (1938=100)
1945						
July	3,980.3	2,135.0	4,818.5	1.03	3.00	158
August	3,984.7	2,148.0	4,874.6	1.03	2.89	152
September	4,021.3	2,174.4	4,897.9	1.03	2.82	154
October	4,020.7	2,111.3	4,859.0	1.03	2.80	156
November	4,036.5	1,904.6	4,788.8	0.53	2.75	161
December	4,171.5	1,712.3	4,849.8	0.53	2.75	155
1946						
January	4,211.5	1,631.0	4,729.3	0.53	2.71	158
February	4,238.3	1,553.5	4,684.3	0.53	2.70	159.5
March	4,297.5	1,565.8	4,749.0	0.53	2.67	160
April	4,526.5	1,575.9	4,864.9	0.53	2.60	165
May	4,411.1	1,520.9	4,894.2	0.53	2.58	173
June	4,466.4	1,394.4	5,045.2	0.53	2.57	179
July	4,430.5	1,450.1	5,112.6	0.53	2.58	179
August	4,413.6	1,559.9	5,197.5	0.53	2.59	176
September	4,487.4	1,751.0	5,302.3	0.53	2.56	171
October	4,530.1	1,764.0	5,396.9	0.53	2.54	164
November	4,528.2	1,742.8	5,502.5	0.53	2.53	176
December	4,586.7	1,709.1	5,685.4	0.53	2.54	184
1947						
January	4,601.5	1,667.7	5,629.1	0.53	2.54	191
February	4,642.9	1,530.4	5,518.8	0.53	2.58	179
March	4,839.9	1,442.3	5,556.0	0.53	2.64	181
April	4,894.7	1,453.5	5,583.4	0.53	2.63	181
May	4,816.3	1,450.6	5,571.0	0.53	2.62	193
June	4,762.2	1,398.9	5,658.3	0.53	2.68	191
July	4,698.6	1,363.6	5,643.8	0.53	2.78	188
August	4,619.6	1,298.0	5,628.1	0.53	2.99	166
September	4,704.1	1,255.7	5,615.1	0.53	2.99	160
October	4,781.2	1,300.0	5,689.8	0.53	2.90	159

Source: Cols. 1 and 2 Annual Abstract of Statistics, Table 2 47; 3 Monthly Digest of Statistics; 4 and 6 L.C.E.S. Bulletins; 5 Monthly Digest of Statistics.

his scope. The active drive for cheaper money collapsed with convertibility. Cheap money, however, remained (15).

The Reasons for Failure.

In order to see the reasons for Dr. Dalton's failure, it is useful to discuss briefly the course of an earlier cheaper money drive: that which initiated the policy in 1932.

During the whole period, with the exception of 1932 itself, the capital market was in general free from control. Control was imposed for a short time in 1932 in order to effect the conversion of £ 2,000 millions of 5% War Loan which were put on a 3½% basis.

From February 1932 to November 1934 the deposits of the clearing banks increased by £ 142 millions. Of this increase £ 162 millions took place by the end of 1932. Once

TABLE III

Year	National Income: £ Mill.	Clg. Bank Deposits £ Mill.	Notes in circulation £ Mill.	Total 2 + 3 £ Mill.	Liquidity $\frac{2+3}{1}$ as a %	Rates and prices.			
						Consols.	3 months Bank Bills % per annum	Index of Industrials	Wholesale Price Index
	1	2	3	4	5	6	7	8	9
1929	3,925	1,762	361	2,123	54.1	4.60	5.30	113	112.6
1930	3,800	1,763	358	2,121	55.8	4.48	2.62	91	98.6
1931	3,450	1,723	354	2,077	60.2	4.39	3.53	71	86.2
1932	3,325	1,752	360	2,112	63.5	3.74	1.94	68	84.4
1933	3,550	1,914	371	2,285	64.4	3.38	0.71	84	84.5
1934	3,700	1,842	378	2,220	60.0	3.10	0.81	102	86.9
1935	3,925	1,961	394	2,355	60.0	2.89	0.57	113	87.7
1936	4,150	2,104	432	2,536	61.1	2.94	0.61	131	93.0
1944	8,310	4,153	1,135	5,288	63.6	3.14	1.03	120	163.7
1945	8,355	4,692	1,284	5,976	71.0	2.92	0.93	127	166.7
1946	8,100	5,097	1,358	6,455	79.7	2.60	0.53	138	172.7
1947	8,770	5,650	1,385	7,035	80.2	2.76	0.53	145	189.1

Sources: Col. 1. 1929-36 - Bowley; 2. 1944-47 - Cmd. 7371; 2. Monthly Digest of Statistics; 3. Monthly Digest of Statistics; 6. Annual Abstract of Statistics; 7. Annual Abstract of Statistics; 8. London & Cambridge Economic Service, Index 1924:100; 9. Annual Abstract of Statistics.

The Chancellor of that time (16) began his operations after a period of financial crisis, capital flights, and exchange deterioration. The structure of the main rates moved as follows:

	Bank Rate	Bank Bill Rate	Price of Consols	Industrial Index
Febr. 1932.	5 %	4.68 %	55	80.5
In November 1936 rates were	2 %	.57 %	85	169.0
By November 1934 they were	2 %	.46 %	88	132

(15) Between 1948 and the time of writing (November, 1950) there has been a considerable volume of advice urging the use of monetary policy to promote disinflation, e.g. «The Economist», «The Banker», and the Chairmen of some leading banks, notably LORD BALFOUR (Lloyds). But compare LORD LINLITHGOW (Midland) who expressed a different view.

(16) The Rt. Hon. Neville Chamberlain, M.P.

again we can see from the Table III how readily the short rate responded. The long rate, however, responded poorly. In marked contrast to the period from 1849 to 1931 when the rate of discount on bank bills and the long term rate were approximately equal, a gap of from 2-2¼ per cent persisted. The growth of this risk differential can be considered as due to a general increase in uncertainty over the period and the increased preference of investors for capital certainty (17). In view of the political and economic history of the period from 1931 onwards to World War II this view does not seem implausible. If it is correct it explains Mr. Chamberlain's inability to force the rate on Consols much below 3-3¼%.

Mr. Chamberlain's successes were, however,

(17) Cf. also note (16) above.

more easily obtained in terms of credit creation. A reduction of the Bank Rate and a 3.3% increase in the liquidity ratio produced a satisfactory decline in the short rate and a decline, though a less satisfactory one, in the long rate. In 1933 the liquidity ratio was virtually static while from 1933 to 1934 the liquidity ratio declined by 4.4%. Nevertheless, in both years rates declined while from 1934 to 1935 the average rate on Consols fell to below 3% and that on bills to 0.57% while the liquidity ratio remained constant. The inference is obvious. While the risk premium demanded in respect of the additional uncertainty of longs remained constant, or roughly so, the progress of recovery from the bottom of the depression greatly reduced the general preference for money rather than near moneys. From this shift in the liquidity preference schedule as a whole, all rates benefited.

The continued fall in the rate structure unsupported by any increase in the liquidity of the economy and unaccompanied by any marked change in the relative rate structure can easily be explained if it is recollected that the unusually high rates obtaining in early 1932 reflected official policy designed to check capital outflows. They were therefore above the market's idea of the «normal» level of the rate structure as a whole. Consequently, once the temporary uncertainty associated with the crisis disappeared, speculative stocks regained some of their customary elasticity and the influence of long run conceptions of the «normal» rate reasserted itself (18).

Once we look at the matter in this light, Dr. Dalton's experience becomes immediately explicable. There is little reason to suppose that general political and economic uncertainty in the post-war period is less than it was in the thirties. It is therefore improbable that the gap between the short and long rates will be any less. On the contrary, in view of the high degree of uncertainty prevailing in the present decade there seems every reason to suppose that the risk element will have increased and where the differential between the two rates was

(18) In contrast to the Daltonian period there was considerable support in the City for the Chamberlain policy and its continuation. It was, after all, an orthodox reflationary proceeding.

formerly from 2-2½% it will probably in the future, unless political conditions improve greatly, be nearer 3% (19).

Thus, given the Chancellor's ability to manipulate the short rate, the market, on our assumptions, would expect the long rate to settle at about 3.5% — the «normal» or «safe» rate reflecting the expected short rate plus risk premium (20).

But the influence of these long run expectations was probably masked, during the earlier part of the campaign, by the existence of short run expectations regarding the long rate based upon the market's estimate of the Chancellor's ability to reach 2½% — even temporarily. The Chancellor's ability to take advantage of these short expectations ensured his reaching 2½%. Conversely, his inability to alter fundamental ideas with regard to the «normal» long term rate ensured his final failure. With his virtual retreat from the market after the convertibility crisis, long run expectations reasserted themselves and the rate on Consols, with minor fluctuations, climbed steadily towards 3½%.

The Case of the Crisis.

One of the more surprising features of the drive for cheaper money carried out by Dr. Dalton was the volume of criticism it provoked from journalists, financial writers and economists (21). Before we proceed further with the case for the prosecution we must make it quite clear that there is a distinction between cheap money in general and the cheaper money campaign. Criticism of cheap money in general would imply unwillingness to accept the principles laid down in the White Paper on «Employment Policy». In other words it implies that post-war inflation must be fought by the use of monetary policy. This argument, in

(19) The fact that the bill rate is largely insulated from the remaining rates does not mean that it may not influence expectations regarding the latter.

(20) In present circumstances, this should perhaps be modified to read «expected short rate plus a conventional differential».

(21) Cf. Professor LIONEL ROBBINS, in «Lloyds Bank Review», October 1949 and the annual statement of the Chairmen of Lloyds, Barclays, National Provincial and District Banks for the end of 1948.

fact, is for a return to allowing the rate of interest to determine the demand for investment. In other words, given full employment during the transitional period, and given the fact that investment demand would tend to exceed the available savings of the community, higher interest rates should have been used as a means of checking the former and stimulating the latter (22). In some forms this argument rests upon the a priori proposition that the authorities with their controls would tend to misallocate resources between conflicting uses, whereas, conversely, if the allocation was decided by the rate of interest it would be better (in some sense).

If we consider the functions of the rate of interest in a full employment economy we shall see that it has two. By deciding the volume of investment it reflects the community's preference for present as opposed to future consumption. Secondly it allocates resources between the various investment projects. That is it supplies both a qualitative and quantitative control over investment. The case of the authorities as revealed in the White Paper and as expressed in the House of Commons was that it should do neither. Once this case is conceded, the dear money argument which implies complete reliance on the interest weapon is waived. In practice most of the critics appear to have accepted the official argument that investment, both as regards total volume and type, must be decided by administrative controls.

This brings us to the second argument. This proceeds as follows. Since the rate of interest, by assumption, is to be below the rate which would equilibrate savings and investment at full employment then the economy must be subject to inflationary pressure. This is plainly undesirable. Moreover the lower the rate the greater will be the volume of inflationary pressure. Hence a drive to push rates down could only intensify inflation, strain the control apparatus, promote the misallocation of resources, produce bottle-necks in production, and, finally, handicap the export drive. Hence Dr. Dalton's

(22) Cf. Lord Balfour's statement cited above and Professor JAMES MEADE, in « Planning and the Price Mechanism ».

policy was the equivalent of pouring petrol on an existing blaze.

This is a different argument from the first. It is quantitative and empirical rather than a priori. What is being asserted in fact comes to this; that both the consumption function and the investment function are significantly interest elastic. And that downward changes in the rate of interest, within the practicable range, would have unfortunate effects. This is, of course, an empirical proposition. There is a second proposition implied in the argument; namely, the alleged imperfection of controls. This second proposition is necessary because even if the first were true inflation would not follow if the control system were perfect. This latter proposition is, however, obviously true. The real bones of contention are the two propositions with regard to the consumption and investment functions. We shall examine each in turn beginning with investment.

Investment Demand.

The investment demand of the community may be conveniently subdivided into that originating from the private sector and that from the public sector. We shall discuss the private sector first.

There are, in general, three channels through which a fall in the rate of interest may affect a business man. In the first place it may produce more or less optimistic expectations with regard to future profit. In the second place it may lower his cost of borrowing. In the third place it may substantially increase his liquidity.

There seems no a priori reason to expect one psychological change rather than another. It is perfectly true that a sharp rise in Bank Rate plus a contraction of credit may dampen business enthusiasm. On the other hand it may, if it is seen as an orthodox and therefore « sound » way of dealing with the problem of inflation, even increase confidence (23). In the context of this paper what is being discussed is not a large rise or fall in the rate structure.

(23) The perversity of the business world in face of deficits designed to increase effective demand and thus stimulate output and raise employment is well known.

We are dealing with movements of the order of $\frac{1}{2}\%$. It therefore seems unlikely that business men's profit expectations were substantially improved by Dr. Dalton's operations. Indeed if business men pay much attention to the opinions of financial writers they can hardly have avoided deterioration. Cautious judgement would regard this factor as neutral.

The cost of borrowing to a business man takes one of three forms. It is either the cost of a new issue; the cost of an overdraft; or the opportunity cost of using his own funds for investment rather than purchasing securities. All three will tend to fall when the rate of return on relatively riskless assets falls. In general, due to income effects operating through the portfolios of such institutional lenders as insurance companies there is some presumption that risk bearing funds will fall further in price (24). In practice, during the Dalton period, all three costs fell. Overdrafts rates may have fallen rather more than the return on gilt-edged (25), and costs of new issues rather more yet.

The effect of this fall in the cost of borrowing on a businessman's desire to invest depends, *coeteris paribus*, on the length of the period which he expects to elapse before the investment pays for itself. It is thus difficult to believe that the fall of $\frac{1}{2}$ - $\frac{3}{4}\%$ actually recorded during the Dalton period increased investment to any great extent. We take this view for two reasons. In the first place the dominant idea in the minds of most businessmen in the post-war period must have been to replace and modernise their existing capital as soon as possible and thus ensure an early start in the race to the waiting sellers markets. Secondly, a change in the discount factor of the order under discussion is not likely to be important, even assuming constant prices, unless the planning period is very long. Moreover, prices were not constant. They were rising and were probably expected to continue rising which, again, was a strong incentive to undertake in-

(24) Cf. RICHARD A. MUSGRAVE, *Credit Controls and Public Debt*, in « Income, Employment and Public Policy », pp. 221-254, especially pp. 226-227.

(25) Bank finance is, however, less important to the business world than it used to be.

vestment immediately if possible and not to worry about any over nice balance of less or more. Finally, in those departments of investment activity in which the planning period is necessarily long, e.g. housing, the state was in either direct control or possessed of the dominating influence.

On balance there seems little to be said in favour of expecting a high interest elasticity of the investment demand schedule due to the cost effect.

When we turn to the liquidity effect, however, the picture is more promising. There is no doubt that business in general ended the war holding large quantities of Government securities. Even the small fall in rates which Dr. Dalton achieved must have substantially increased the liquidity of many firms. Indeed the capital gain on a long term security paying 3% purchased at £100 would be £20. Not a negligible change by any means. Again, if we refer back to the absorption of securities by the clearing banks during 1945, 1946 and, to a lesser extent, 1947 — we must infer that industry was happy to take its capital gains, or part of them, in cash. Thus some effect, in an inflationary sense, is probable; but to give it a quantitative estimate is impossible particularly since industry would have, almost certainly, sold large parcels of securities anyway whether rates had fallen or not.

In sum there seems little reason to suppose that the quantitative effect on private investment was large. Indeed, when we consider the available evidence provided by the researches of the econometricians (26) and the questionnaire surveys (27) of pre-war periods, we must

(26) For discussion of this evidence see Dr. L. KLEIN, *The Keynesian Revolution*.

(27) Professor JAMES MEADE and Mr. P. W. S. ANDREWS, commenting on the results of the well known Oxford Survey, write as follows (Oxford Economic Papers, No. 1 1938 and No. 2 1940).

« 1. There is almost universal agreement that short term rates of interest do not affect investment either in stocks or fixed capital

2. The majority (of firms) denied that the long term rate of interest affects investment directly though some indicated that it is of importance to them ».

These remarks apply mainly to the cost effect. Of the liquidity effect the same two writes record:

« There is, however, some evidence that a fall in long term rates would have favourable indirect effect. VI. 3 (the design-

conclude that the investment demand schedule of the private sector was likely to have possessed a low, rather than a high interest elasticity in the Daltonian period.

Public Sector.

Evaluation of the public authority demand for investment is probably a task for the political theorist as much as the economist. It is difficult to believe that this component in investment demand shows, in any period, much response to changes in interest rates. Public investment is largely policy determined and such factors as political pressure, recent access to office by a Government, and the state of public opinion as revealed by the Press are likely to be far more important in determining the volume of investment demand. There is some hope that the investment decisions of local authorities might be influenced by the interest weapon in normal times but little reason to suppose that this condition existed in the immediate post-war period.

Since there is little empirical evidence available and since on a priori grounds we should expect little effect, the safest procedure seems to be to regard this item as interest inelastic.

Private and Public Consumption.

The savings of the private sector of the economy consists in three components: personal savings, depreciation allowances, and undistributed profits. The two variable components being the first and the last. Since the policy of industry with regard to dividend distribution was subject to a number of official hints and pressures, it seems that any large effect must be sought through the first component.

The first point which needs to be made here is that net personal savings are, in general, of diminishing importance in the finance of

ation of a particular firm) emphasises that this, by raising the price of gilt edged securities, increases the liquidity of the business and that this is very important in affecting the decision to go ahead ».

capital formation. The figures of Table IV are from Cmd. 7933.

PERSONAL SAVINGS

TABLE IV

	1938	1946	1947	1948
	£ m	£ m	£ m	£ m
Gross Personal Savings	217	802	440	409
Net Personal Savings	139	658	276	174
Gross Personal Savings as a % of disposable incomes	4.8	10.5	5.5	4.8
Net Personal Savings as a Proportion of Gross Investment financed at home	18%	50%	19.5%	8.0%

The high figures for 1946 are easily explicable in terms of the continuing non-availability of goods. They represent « enforced » savings as opposed to genuinely desired savings.

Given that the relative importance of personal savings is diminishing and that the levels achieved in 1946 and 1947 were primarily due to inability to find the goods on which to spend, it seems clear that small changes in interest rates were not likely to have a significant effect on the economy as a whole, even if they influenced personal savings.

Moreover, in the period under review much of the personal savings was a small savings. It seems intuitively unlikely that small savers are much influenced by minor fluctuations in the rewards obtainable on Government securities particularly since the Post Office Savings Bank rate remained unchanged at 2½% per annum.

This, however, is not to deny that the fall in rates may have encouraged consumption of resources by those who were either making actual or paper profits from speculation.

Against this we must set the influence of those whose demand for a given future income is completely inelastic. They would tend to increase their rate of saving.

The upshot of this discussion appears to incline towards the view that, though it seems intuitively possible that there was some increase in private consumption demand due to the fall in rates, it was in fact small. The evidence provided by the econometrists lends some ad-

ditional support to this view. Dr. Klein (28) for example, is emphatic and states

"no econometrist has ever found any significant correlation between consumption and interest rates when the correlation between consumption and income is taken into account".

He continues

"it must be concluded that the consumption function is interest inelastic; i. e. consumption is not sensitive to changes in the rate of interest".

Public Expenditure.

When we turn to the expenditure of the public authorities one effect of the fall in rates is clear. There is a reduction in the interest burden of the national debt. This comes about in two ways. The effect via the floating debt which makes itself apparent immediately, and the effect via the remaining debt which only comes later when conversion operations are carried out. These savings, however, can easily be exaggerated. In the first place the total debt figure is misleading since part of it is held by Government departments. Secondly the real saving to the authorities is less than the apparent saving by the amount of income tax foregone. Our estimates of the savings are as follows.

	1945	1946	1947
	£m	£m	£m
Gross Saving on Floating Debt	7	30	29
» » on other debt	—	6.5	7.2
Net Saving after adjustment for tax	3.7	20.2	19.9

Tax at 9/— in the £ is assumed. These estimates almost certainly overstate the savings effected.

We have already remarked that public expenditure is largely politically determined. Therefore we can provisionally assume the budget surplus or deficit to have been decided in these years quite independently of the level of interest rates. This being so the net infla-

(28) Dr. L. KLEIN, *op. cit.*

tionary effect of a fall in rates on the economy as a whole depends upon

- the magnitude of the increased private investment demand
- the magnitude of the increased private consumption demand

relative to the saving effected via the reduction in debt servicing costs (29). Any estimate of which way the net effect went in the Dalton period is guesswork. A reasonable guess is that (a) the net effect was inflationary (b) that it was quantitatively insignificant.

If this last view is accepted much of the case against the experiment collapses. One further accusation can be made and that is to the effect that, by increasing the liquidity of the system, the Chancellor was putting the public in a position to finance an inflationary spending spree if it so desired. This is true but the point which matters is the magnitude of the risk, about which dispute would be profitless.

Conclusions.

From the point of view of the authorities we may list a number of advantages to be obtained from cheaper money. They were:

- lower cost of National Debt service;
- reduced interest costs of the housing programme;
- reduced interest charge on nationalisation compensation issues;
- distributional effects.

The first of these we have already discussed. The estimates of net savings on this account do not appear to be large. But in this connection we must remember that the authorities must have thought that the savings, in the longer run, would be much greater since, if 2½% at long term had been capable of consolidation, conversion operations would gradually have spread the gain over the whole national debt.

There is no doubt of the importance which the Labour Government attached to the pro-

(29) This amount will not be the same as that given in the table above unless those who would have received greater incomes had interest rates been higher possessed a marginal propensity to consume of unity.

vision of cheap finance for the housing drive. The whole housing policy was directed to providing, through the agency of local authorities, houses to let at low rentals. These houses were then allocated not in accordance with ability to pay but in accordance with individual need. In this context «need» was usually defined in terms of criteria such as the number of children, years of war service, adequacy or inadequacy of existing accommodation, health of applicant and so on. There can be little doubt that even a saving of $\frac{1}{2}\%$ per annum on interest charges is significant in this context. At the time of writing the housing programme is, by Government action, still insulated from the rise in rates which has, in fact, taken place.

It can, of course, be seen that one preoccupation of the authorities was with distributional questions. One aim of the policy was to redistribute income away from the rentier class. That is to begin the «euthanasia of the rentier».

When we turn to the disadvantages two stand out. There is first the added inflationary pressure, with its concomitant misallocation of resources, bottlenecks and so on; second there is the fact that speculators must have made large capital gains. In some cases these may have become losses later, but not in all. We do not feel that the volume of additional inflationary pressure generated by cheaper money drive can have been very significant. Indeed it is a matter for surprise that critics have concentrated on this aspect of the Chancellor's policy when the annual budget deficits were (Source: Cmd. 7371, Table 15):

	1945	1946	1947
	£m	£m	£m
Deficit	2290	966	491

Dr. Dalton, however, cannot avoid the reproach that his policy generated speculative profits. Their magnitude, however, is a different question.

From the national point of view the balance of advantages and disadvantages is against the Chancellor. This is particularly so when the nature of Dr. Dalton's fundamental error is recalled. This was his failure to appreciate the probable nature of the long run expectations

of the market. In our view, these expectations were (and are) such as to require a differential between the short and long rates of the order of 3% . If this is correct then the policy was a grave mistake since it had to end in failure (30). Moreover it seems likely that Dr. Dalton overestimated the efficiency of the existing controls which, when the cessation of hostilities removed the patriotic sanction, were subjected to severe strains.

Nevertheless though the attempt to provide cheaper money was certainly a blunder the continuance of cheap money in a broad sense is probably sound. Monetary policy in the future must attempt to reconcile a number of conflicting claims. These are:

- (a) the claims of debt management and servicing;
- (b) the claims of income and price stabilisation;
- (c) the claims of particular financial institutions to stability in the value of their capital assets (31).

The first of these seems certain to put pressure on the authorities to maintain low rates. The last of these probably precludes all but small rate changes since large changes would involve banks, insurance companies and other financial institutions in enormous paper capital losses. On the other hand, the available empirical evidence seems to point to the conclusion that both consumption and investment expenditures are comparatively insensitive to small rate changes.

The authorities are thus faced with a dilemma. Small rate changes are feasible but ineffective. Large rate changes may be effective but involve severe risks (32).

In view of this, and the pressing claims of debt service and debt management, the wise course would appear to be to stabilise rates at around $\frac{1}{2}\%$ for short loans and $3\frac{1}{2}\%$ for long term loans. Moreover, in addition to this, the authorities would be well advised to borrow

(30) To use a military analogy, Dr. Dalton embarked upon a campaign in which victory was impossible in the prevailing circumstances.

(31) Cf. note (8).

(32) The practicable range is probably from $2\frac{1}{2}\%$ to say 5% or 6% . No doubt a rate of interest at long term of 10% would check investment and stimulate savings.

in the main by means of medium length bonds carrying definite redemption dates. Securities such as these are particularly well adapted to the needs of financial institutions.

If this policy is in fact followed, and the indications are that the authorities are moving in its direction, then the task of income and price stabilisation must fall upon fiscal planning (33). This is not the place to enter into a full discussion of the advantages and disadvantages of budgetary control. Nevertheless we must assert that, during the Chancellorship of

(33) There is, of course, considerable scope of qualitative credit controls. The Federal Reserve Board has already developed this technique considerably while maintaining cheap money and stable bond prices. Monetary policy thus need not and should not be entirely neglected.

Sir Stafford Cripps, fiscal disinflation was, broadly speaking, successful. The years from the end of 1947 to 1950 were, in general, years of considerable progress. During this period control of the economy by means of operating on the interest rate has been many times advocated but never attempted. In our view this reliance on fiscal planning should continue and much more thought should be given to the institutional and other problems which it raises. The use of the interest weapon should be avoided until much fuller empirical investigation has been undertaken to discover the precise way and the degree whereby changes in it over the practicable range influence people's decisions to consume, invest and save.