

A Second-Year Review of Mr. Butler's Monetary Policy

by

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I.

The changes in British monetary policy beginning in November 1951 and associated with the name of Mr. Butler have sometimes been represented, even in authoritative quarters (1), as a « return to monetary orthodoxy ». I am not at all sure that I know precisely what, in a British context, « monetary orthodoxy » means; but if it refers, as I suppose it must, to someone of the many different systems we have had in the past, I can find no justification for its use in describing what has happened in the last two years. The Butler policy has, indeed, affinities as close to what had gone immediately before it as to any earlier episode, and a review of it must begin with a brief mention of those earlier post-war years.

The post-war period began with a decision on the part of the authorities that the rate of interest would not be a useful weapon with which to regulate immediate conditions in the capital market, and that on a long view a very low rate of interest would be both desirable and feasible. They therefore established a system of direct administrative control of borrowing, including a loose control of bank lending, and at the same time went to quite unusual lengths in an effort to establish an extraordinarily low structure of interest rates. Largely because the policy failed to carry conviction in a market acutely aware of the underlying scarcity of capital, the authorities quickly failed to establish their most extreme objective; but much of it remained and to this day apparently inspires the present govern-

ment. Though the end of the Dalton episode meant the end of the attempt to hold long-term interest rates below 3 per cent, the peg in the short-term market remained, at the point at which Mr. Dalton had inserted it ($\frac{1}{2}$ per cent for 3-months Treasury Bills) and the structure of control of borrowing, far from being dismantled, was actually tightened from time to time — though at no pre-Butler date did it assume the fierceness of 1951-52. What distinguished the years 1947-51 from the Dalton period was the fact that the authorities now left the longer-term rates of interest broadly free to move, and these rates moved decidedly upwards. The yield on Consols, from 3 per cent in 1947, moved up to $3\frac{1}{2}$ in 1949 and nearly to 4 per cent in the summer of 1951. In describing these longer-term rates of interest as « free to move », it is necessary to remember that the 3-months rate remained absolutely fixed at $\frac{1}{2}$ per cent. To the extent that the various rates are bound up with each other, the authorities were still, by their readiness to create money indefinitely to keep the 3-months rate down at $\frac{1}{2}$ per cent, exerting a continuing downward pull on all rates of interest. Throughout this period, 1947-1951, the commercial banks retained much of the abnormal liquidity that had been induced by the exigencies of war finance. This high degree of bank liquidity was not permitted to exert quite its full force in expanding bank advances, because the loose borrowing control was maintained and indeed tightened. The liquidity of the banks was of course a supporting element in the long-term securities market, but certain inhibitions and fears in the banks prevented any substantial exertion of this support.

(1) See e.g., I. G. PATEL: *Monetary Policy in Post-War Years*, in « I.M.F. - Staff Papers », Vol. III, no. 1.

Into this scene Mr. Butler injected in November 1951 a group of spectacular changes, and he followed these up with an apparent intensification in March 1952. His measures included the raising of the official Bank Rate, first from 2 to 2½ and then to 4 per cent, the withdrawal of the peg which had held the Treasury Bill rate down at ½ per cent, a mild but induced «funding» operation which appeared to remove the abnormal liquidity from the commercial banks, a considerable narrowing of the private borrowing permitted by the Control, and a general warning to prospective borrowers that they had better not take for granted either the availability or the cheapness of funds.

At first sight the so-called funding operation seemed to be a very important part of the plan. A large block of Treasury Bills was replaced by one, two and three-year stocks, the banks being told to convert about £ 500 millions of their Treasury Bills into these new stocks. These new stocks were classed as «Investments» in the banks' balance sheets, whereas the displaced Treasury Bills had counted as liquid assets. The operation therefore removed at one stroke the main element in the abnormal liquidity of the commercial banks. The «liquid assets ratio» fell to 32 per cent, uncomfortably close to the 30 per cent which with some justice is often alleged to be the minimum at which a commercial bank feels comfortable. Without subscribing to any mechanical view of the operation of this liquid assets ratio, it was possible to suppose that this change would have two important consequences: it would remove the urge the bankers had felt, for many years, to expand Advances, and it would force the banks to become sellers rather than buyers of gilt-edged securities if the demand for Advances should continue to expand. Thus the banks were now for the first time given a strong incentive to check the growth of Advances: their interest was now on the side of implementing unreservedly the Chancellor's directives about the discouragement of borrowing. Teeth at last had been put into the control of bank borrowing.

The rise in interest rates, on the other hand, was a mild measure and appeared to

have been adopted mainly as a demonstration for the benefit of foreign opinion, though also as a warning to home trade that the post-war days of very cheap money were over. While Bank Rate was raised by 2 per cent, the Treasury Bill rate was raised by a trifle less, and the banks' overdraft rates were raised by only ½ or 1 per cent. The government was thus hurt much more than the private trader; but the maximum rise was in the official rate that receives most publicity abroad. The bill market rates had to be raised substantially for two reasons: to make London a more expensive centre in which to finance foreign trade, and to prevent competition from the discount market from undermining the higher overdraft rates thought proper in the commercial banks. The general tendency of the new measures was to narrow the range over which overdraft rates were spread.

Finally a new «directive» was issued to the Capital Issues Committee and to the banks, appreciably narrowing the range of uses for which the raising of capital would be permitted. On this occasion the directive included quite sharp negative clauses and special steps were taken to impress these not only upon the head offices of the banks but also upon the rank and file of branch bank managers.

II.

Looking back from the summer of 1953, the distribution of emphasis appears to have become rather different. The steps taken to remove abnormal liquidity from the commercial banks appear to have been half-hearted and, as things have turned out, more or less ineffective. The rise in interest rates has been trivial, and the tendency has been if anything to let them go down again. On the other hand, the qualitative control of bank lending has been very sharp and, though there may have been some relaxation during 1953, this remains the most effective aspect of the Butler measures. There has scarcely been time to test the reality of the alleged restoration of «flexibility», to which much weight was attached in some of the early pronouncements; but it is already clear that this flexibility must

be something quite different from anything previously known in the British monetary system.

The «funding» operation of November 1951 reduced the liquidity ratios (Cash, call money and bills as a proportion of total deposits) of the commercial banks from 39.2 per cent to 32.2 per cent. The latter figure was generally believed to be uncomfortably close to the (somewhat elastic) minimum which the banks would nowadays desire; and this belief was reinforced when the news spread that some banks, including one of the «Big Five», were selling appreciable amounts of their Investments during the next two months, presumably in order to strengthen their liquidity. During the early months of 1952 the liquidity ratios continued around 32-33 per cent. But during the second and third quarters of 1952 the expected government financial requirements were met to an unexpectedly large extent by increased issues of Treasury Bills, this increase in government short-term borrowing more than offsetting the decline in «private» borrowing from the banks. The authorities, despite the stress that had been laid upon the closing of the ever-open door through which new cash had been supplied at a fixed rate of interest, allowed the banking system to obtain, without any hardening of interest rates, the additional cash necessary to enable the banking system to provide the funds required by the government. Consequently, while Advances by the banks to the private sector were going down, the increase in government borrowing from the banking system pulled the liquidity ratio up from 32 per cent in March to 38 per cent in October 1952.

At this stage, when the first batch of the Serial Funding Stock issued in November 1951 was about to mature, the authorities launched a new funding operation. This included provision for a block of £ 522 millions of National War Bonds. The new stocks issued were again quite short-term — the longest having a three-years' life. Also once again the commercial banks received a «hint from headquarters», the effect of which was that they took up sufficient of the new stocks to bring down their their liquidity ratios to about 34

per cent. This has proved sufficiently high to leave the banks just not under pressure to unload other assets during the seasonal tightness in the first quarter of 1953: the liquidity ratios have been a little higher than in the corresponding months of 1952.

In spite of the absence of actual pressure in this direction, it is of course true that the liquidity ratios are now so near to «normal» figures that comparatively slight action by the authorities would now create such pressure, if the occasion for applying it arose. To this extent the situation does differ from that of the first six post-war years, when a massive operation would have been necessary to bring the «70/30 scissors» into operation. On the other hand, the Treasury has not yet ventured to substitute on a substantial scale medium and long-term bonds for the short paper that is a very large part of the banks' investment portfolios. The bonds issued in the «funding» operation of October 1952 have a maximum life of three years, and other rather short-term paper is abundant, so that the banks have no difficulty in arranging that among their «Investments» as much as one-third or even one-half is maturing at intervals over the next five years. This is in striking contrast to the pre-1914 position, when government paper with a definite maturity within five years was extremely scarce, and the «investments» of the banks were therefore subject to much more serious fluctuation in value. In short, the banks' Investments are nowadays in large part scarcely less liquid than bills. It follows that, even if the authorities keep the banks' liquidity ratios close to a conventional minimum, the demand for Advances would have to rise very rapidly before the prospect of losses in the realisation of immature Investments would check the willingness of the banks to meet their customers' demands.

It must also be remembered that, even to the small degree to which it has occurred, the reduction in the liquidity of the banks has been brought about not by reliance on the market attraction of higher rates on long-term paper but by persuasive hints from headquarters. Mr. Butler has in this as in some other respects relied upon exhortation rather than the natural functioning of the market.

III.

As regards interest rates, it is notable that the biggest change has been in the official Bank Rate, which receives most publicity but is not an operative rate for anyone. For the discount market the effect of this Bank Rate was in any case modified by the introduction of a new Advances Rate, $\frac{1}{2}$ per cent below, instead of the traditional $\frac{1}{2}$ per cent above, the formal Bank Rate. Under current circumstances, however, with the continual large turnover of funds between government and private accounts, the authorities have been in constant direct contact with the market and have been able to hold market rates of discount at levels of their own choice. For commercial borrowers these are now about $1\frac{1}{2}$ per cent above the « pre-Butler » level.

The effect on rates in the long-term market has been very restrained. The yield on « irredeemable » Consols, for instance, rose from about 3.9 per cent pre-Butler to about $4\frac{1}{2}$ per cent in the second quarter of 1952, but has since been allowed to fall to only a shade over 4 per cent. It should be emphasised that these rates appear in a free market in which the central bank makes only limited interventions; it is fairer to say that the authorities have acquiesced in them rather than created them. Apart from the movement of Bank Rate, the effect of which on the market in long-term securities is naturally very limited, the authorities have studiously avoided anything that could be interpreted as a « lead » to the market in the direction of a general rise in long-term interest rates. It was not, for example, until several months after the main changes that the interest offered on new Defence Bonds was raised from 3 to $3\frac{1}{2}$ per cent; nothing has been altered for other small savings; and in other directions (e.g. the Agricultural Mortgage Corporation) the authorities have almost ostentatiously followed rather than led the market. It appears, in short, that the government has no policy for long-term interest rates. Certainly it exhibits no desire to use high rates as market rationers of the scarce capital. Nor has it sought to stimulate savings by offering appreciably higher rates of interest. On the contrary, a change in the taxation practice has

had the effect of *reducing* the net interest paid to certain small savers. There has been no rehabilitation of the interest rate as an important weapon in the struggle against inflation.

IV.

The really powerful part of the Butler policy has undoubtedly been in the qualitative restriction of bank advances. The great banks were evidently more impressed than previously by the Chancellor's « request », and the terms of this request were much sharper in that for the first time the banks were asked to discourage certain loans although the need for these might arise in the normal course of business. The banks took the unusual step of writing to « The Times » a letter which their branch managers could put before applicants for loans, and some of them appear to have given strict instructions about the reduction of certain classes of overdraft. Some spokesmen of the banks have attached importance to the raising of interest rates, in explaining the behaviour of Advances (2), but their emphasis has been rather upon the « psychological shock » of the raising of Bank Rate than upon the rise in the actual cost of borrowing at the banks (3). The general consensus of opinion, however, is probably best represented by following statement of the Chairman of the Midland Bank (4): « The decline in advances, after an upward trend which had continued right through the post-war years, is traceable partly to the fall in primary commodity prices and the slackening of trade in some branches. The rise in interest rates may have induced here and there a more economical resort to bank credit, but probably more important has been the effort of the banks, in accord with reiterated statements of Government policy, to limit their lendings by reference to sterner concepts of what are essential purposes... ».

This view certainly has been borne out by the banks' published figures — particularly the quarterly classification of Advances, which

(2) Most prominently, the Chairman of Barclays Bank in his annual Statement to Shareholders, 1953.

(3) See e.g. the Statement to Shareholders of the Chairman of Lloyds Bank, 1953.

(4) Annual Statement to Shareholders, 1953.

shows very large falls in Advances to retail trade and on « personal and professional » accounts. Further evidence of credit rationing has been seen in the advertisement columns of the newspapers, where intending borrowers squeezed out by the banks have shown that they are far from being priced out of the market (5).

V.

One important claim of the authorities is that « flexibility » has been restored to monetary policy. This claim is justified, if it means that the presumption of fixity of the Treasury Bill rate at $\frac{1}{2}$ per cent has been removed: but there has been no evidence of exposure of the short-term market to the tide of events. For over a year the authorities have held the three months' rate pegged at about 2.4 per cent. This can only mean that the authorities have wanted to keep it fixed; anyway, the flexibility has yet to appear.

The long-term market has been allowed to move; but this had been so ever since 1947. It has in fact shown a broad downward tendency in yields, based largely on growing expectations that Bank Rate would soon be reduced. The Bank of England has more or less stood aside while the yield on Consols has fallen from $4\frac{1}{2}$ per cent in mid-1952 almost to 4 per cent in mid-1953. If the authorities did not like this move, but did not want to stop it by direct intervention in the market, they could easily have stopped it by raising Bank Rate to 5 per cent. As they have taken no such step, it must be presumed

(5) On this evidence, see an important forthcoming article in « *Economica* », By Mr. J. S. G. Wilson.

that they are satisfied with the present levels of gilt-edged yields, though these are scarcely above those ruling before Mr. Butler came on the scene. When account is taken of the taxation system which cuts the extra yield to investors and the extra cost to borrowers, the difference made by Mr. Butler is quite negligible. Evidently, dearer borrowing for long-term investment is no part of the government's policy; nor has there appeared any wish to rely on the rate of interest as a sieve for projects of capital development, or as a stimulus to saving.

To summarise: Such changes as have been made in interest rates appear to have been dictated primarily by a recognition that in a world of exchange restrictions some capital movements still get through. The pound has needed protection in world markets, and rather dearer short-term money in London has helped. This is the only element in the Butler policy that can by any stretch of the imagination be called « a return to orthodoxy ». For the rest, the authorities have been anxious to demonstrate, by their raising of Bank Rate, by their attitude to the discount market, and by their so-called « funding operations », that they can turn on the deflationary screw, if subsequent developments should require it. They have even, in producing this demonstration, been willing to add some tens of millions of pounds to the cost of servicing the Floating Debt. In the event the main part of their policy — the qualitative control of the old « planning » kind — has combined with the deflationary tendencies of the outside world to put an end to the inflationary tightness in the British economy, and the authorities have accordingly abstained from any pressing home of the weapons with which they rather expensively armed themselves.