Building Society Survey 1979

Monetary control

TIM CONGDON, the economist at L Messel & Co, Stockbrokers and author of Monetarism: an essay in definition

Building society deposits doubled in the four years to the end of 1978, while bank deposits grew by less than half. It is arguable that, in many respects, the two kinds of deposits are similar. Both have to be repaid at short notice and many depositors regard their building society and bank accounts as of identical liquidity. But only bank deposits are included in sterling M3 – the money supply measure in which the current government target is specified. Not surprisingly, this situation has been criticised as anomalous. The most rapidly expanding form of private sector liquidity is not under official supervision or control.

There have been suggestions – notably from the London clearing banks in their evidence to the Wilson Committee – for the formal and explicit incorporation of building societies into the monetary control system. A wider monetary aggregate, dubbed 'M5' and including building society deposits, has been recommended as more suitable as a target-variable than sterling M3; and proposals have been advanced to subject the societies to disciplines such as the 12½ per cent reserve asset ratio and the 'corset'. But so far nothing has been done.

No need for reform?

Part of the explanation may be that the direction and force of monetary policy in Britain is conveyed primarily by interest rates, either by announced changes in minimum lending rate or by official operations in the short-term money markets to make that rate effective. Like the banks, building societies are very susceptible to interest rate variations. Because of political obstacles to frequent mortgage rate adjustments, a sharp increase in the general level of interest rates soon leaves the building societies uncompetitive and their deposit inflows weaken. It could reasonably be claimed that this brings the building societies within the framework of monetary control already. There is no need for reforming the system.

However, demands for the application of the reserve asset ratio and 'corset' to the building societies are misplaced for other reasons. They overlook that the building societies are mutual, non-profit making associations. In consequence, certain traditional instruments for slowing down the growth of bank deposits, some of which rely on the impact of profitability, would be blunted if used against the societies. Other control mechanisms are simply inappropriate. For example, the 'corset' is stated in terms of interest-bearing eligible liabilities but nearly all building society liabilities pay interest and the notion of 'eligibility', which was developed specifically in relation to the reserve asset ratio in the banking system, cannot be naturally extended to the societies.

More fundamentally, it should be emphasised that the building societies do not lend to companies and individuals in the economy for almost any purpose, but operate instead in the pampered, and very distorted, environment of the housing market. This is crucial because it takes away any meaningful market-imposed constraint on the growth of building society assets. Tax relief is available on mortgage interest payments. These have risen substantially in recent years with higher inflation and nominal interest rates, but are now regarded by home-owners as early capital repayments. As such, they receive an implicit subsidy of 30 per cent or more, depending on the marginal tax rate of the individual concerned. The result is that having a mortgage is a simple, but highly profitable, business arrangement, available to anyone who has the initiative to choose a property, see his local building society manager and incur the irritating transactions costs involved in house-purchase. For almost any conceivable interest rate, there is an insatiable demand for mortgage advances.

The banks have suffered

With no effective limit on the expansion of their assets, building societies are able to offer attractive interest rates on their deposits. Indeed, the Building Society Association can more or less decide whatever interest rate structure it likes without fearing competition from rival financial institutions. It follows that there is a real sense in which the banks have suffered from 'unfair competition' in recent years. In the early 1960s, the differential in favour of building society share rate (gross) compared with bank deposit rate was typically 1 per cent, but in the mid-1970s it has been over 3 per cent. It is this contrast which lies behind the more rapid growth of building societies recently and it is the tax advantage of home-ownership which explains the wider interest rate discrepancy.

This is not to say that the building societies have total licence about the interest rates they set. They must behave responsibly towards recent borrowers and are, therefore, reluctant to increase the mortgage rate too abruptly. That might cause serious difficulties to house-holders at just the stage when they are financially most vulnerable. As the impact of changes in the mortgage rate on the family budget is powerful, politicians consider it to be electorally sensitive. Government interference with building society interest rates, which was particularly marked in 1973 and 1974 at the end of the 'Barber boom', is an ever-present threat. But this inhibition is essentially political, not economic or market-based, in character.

Can the societies be regulated?

What is the solution? Can the building societies be regulated without altering their form and objectives? The analysis presented here suggests that the problem is rooted in the very structure of the property market, and social attitudes towards that market, in this country. Any recommendation for change is likely to be futile unless these wider issues are remembered.

In practice, the government has decided on a rather clumsy and unwieldy method of restraint, which has not, as yet, greatly disturbed the building societies. It has been to impose ceilings on the net new commitments the societies may make for house purchases when lending is considered excessive and liable to lead to an exaggerated rise in house prices. The ceiling figure is agreed by the Joint Advisory Committee on mortgage finance, a body set up jointly by the Building Society Association and the government in October, 1973. Possibly the only occasion on which a JAC restriction proved irksome was in March, 1978, when it specified that new commitments should be held down to an average of £610m per month compared with over £700m in the first quarter. But deposit inflows fell back shortly afterwards and the official constraint became irrelevant.

As a permanent control device, a JAC ceiling is unsuitable. Although it is laid down for the building society movement as a whole, separate quotas must be attributed to each society. But societies' initial liquidity positions and deposit inflows may differ markedly, with the result that quotas can discriminate against the fast-growing, efficient institutions. Effects such as these, which were drawbacks of similar quantitative lending restrictions on the banks in the 1960s, would become more serious and pronounced the longer the ceiling was in force.

A possible solution

An alternative, proposed by the author in a recent article in *The Building Societies Gazette*, is that the Bank of England has the power to specify a minimum liquidity ratio for all societies and to vary it from time to time according to monetary policy needs. (The liquidity ratio could be defined in exactly the same way as that currently followed by the societies, which includes gilt-edged securities, local authority debt and short-term assets). Thus, when deposits are rising too fast, the Bank would increase the minimum liquidity ratio. In normal circumstances, the return on liquid assets is lower than on mortgages, the societies' operating surplus would be cut and they would be obliged to discourage new deposit inflows by lowering their interest rates.

At present, such ideas are mainly of academic interest, although it should be noted that an arrangement similar to a variable minimum liquidity ratio operates on savings and loans associations in the United States. In Britain the true conflict is not between money supply restraint and building societies' autonomy from the authorities' control system, but between the need to curb the expansion of a broad measure of liquidity and the ideal of the widest possible home-ownership. While the owner-occupier remains the target of fiscal bribes and political blandishments, it would be naive to expect building society deposits and bank deposits to increase at similar rates over the long run. It is inevitable that financial institutions whose assets' growth is artificially promoted by the government will gain an increasing share of deposits business from their main competitors.