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**FINANCIAL
ANALYSIS**

**Towards a free financial system—
a response to the Green Paper on
monetary control**

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The present issue of *Financial Analysis* is devoted entirely to a discussion of two documents – the government's Green Paper on *Monetary Control* and the Bank of England's discussion paper on *The Measurement of Liquidity*. Our argument is that the opportunity exists for a move towards a much freer financial system. We are therefore critical of the extension of the "cash requirement" to all banks proposed in the Green Paper and of the liquidity norms proposed in the liquidity paper.

A summary of the argument is given on p. 3.

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Whilst every effort is made to ensure accuracy, we do not guarantee the information contained herein.

TOWARDS A FREE FINANCIAL SYSTEM

Ever since the nationalisation of the Bank of England in 1946 Britain's banking system has been subject to a sequence of controls on both the growth and composition of balance sheets. In principle, the Competition and Credit Control reforms of 1971 were to inaugurate a new era of freedom, as the authorities repudiated the quantitative lending restrictions which had been the most common interference in the 1960s. However, the Bank of England has been unable to match the hopes raised by CCC. It has introduced the supplementary special deposits scheme, in some respects as burdensome to the banks as lending restrictions, on three occasions since 1973. An encouraging feature of the March 1980 Green Paper on *Monetary Control* is that the Bank has reiterated its commitment to a liberal financial system. In particular, it has stated that the SSD scheme (or "corset") will not have "a permanent place in the techniques for controlling the money supply".

Indeed, perhaps the most important theme running through the Green Paper is that any officially imposed regulation in conflict with banks' genuine business needs is liable to distort competition between banks and to hamper banks in their rivalry with other financial institutions. Such regulation runs the danger of diverting financial intermediation from banks to non-banks and thereby complicating the operation of monetary control. The Green Paper observes that, although "there are no techniques of monetary control which involve no risk at all of disintermediation, . . . the authorities consider that any new technique must avoid providing a significant incentive to disintermediation". (1) But, unfortunately, in the companion document on *The Measurement of Liquidity* this stricture seems to have been forgotten. The liquidity paper proposes an elaborate set of liquidity norms many of which, if enforced, would be sharply at variance with existing bank practice and might well provoke an exodus of banks to offshore centres. Whereas the Green Paper rejects certain forms of monetary control on the grounds that they might cause disintermediation, the liquidity paper suggests arrangements for prudential control which would be very likely to cause disintermediation. This inconsistency is the principal defect of the government's proposals.

In this paper, we argue for a radical change in the financial system – the complete abolition of balance sheet ratio requirements, whether for monetary or prudential purposes, on the banks and, indeed, all financial institutions. The effective mechanism of monetary control, in which such ratios actually play a limited role, would remain intact. The proposal may seem extreme and even revolutionary to a generation of central bankers for whom reserve or cash ratios have become an assumption of thought. Ironically, however, it is backward-looking in that it would restore the position before the Bank of England's nationalisation in 1946.

The two documents

The *Monetary Control* Green paper – its rationale and motive

The current debate on monetary policy was largely provoked by commentators advocating "monetary base control", an arrangement in which the Bank of England would regulate the quantity of cash (i.e., notes and coin, and bankers' balances at the Bank of England) in the belief that it bears a stable multiplier relationship to bank deposits. (2) In one form of MBC, that with a mandatory cash ratio, the stability of the relationship is theoretically guaranteed by banks being required to keep base assets above a certain proportion of liabilities. The objection to a mandatory cash ratio is that it may oblige banks to hold an asset of a kind and in an amount which they would not otherwise want. More specifically, no interest is paid on cash and, if banks must keep more than they need, they are losing profits. To avoid this they will try to develop credit business outside the banking system, while non-banks which do not suffer the same profit disadvantage will capture more business at their expense. In other words, a mandatory cash ratio may lead to a classic disintermediation process.

TOWARDS A FREE FINANCIAL SYSTEM – A SUMMARY OF THE ARGUMENT

The *Monetary Control Green Paper* and the Bank of England's discussion paper on *The Measurement of Liquidity* would lead to major changes in the financial system. Although published together on the same day, they are inconsistent.

1. The Green Paper rejects certain forms of balance sheet ratio control, notably the mandatory cash ratio which has been proposed by some monetary base control advocates, because it would cause disintermediation. (Disintermediation is the transfer of credit business outside the banking system.)

2. The liquidity paper proposes a new set of controls over bank balance sheets, termed "liquidity coefficients", which are sharply at variance with existing practice and would cause massive disintermediation.

The Green Paper emphasises that interest rates, made effective by operations in the discount market, are the principal instrument for achieving control over sterling M3. The liquidity coefficients would have no importance in monetary control, but would be intended entirely for prudential purposes.

In this paper we argue that

1. The Green Paper is right to give interest rates the leading role in monetary control. Its proposal that the cash requirement (i.e., $1\frac{1}{2}\%$ of eligible liabilities deposited as balances at the Bank of England) be extended from the clearers to the non-clearers is therefore unnecessary.

2. Apart from the blemish about the cash requirement, the Green Paper is right to reject other mandatory balance sheet ratio regulation for monetary objectives. Indeed, even the cash requirement on the clearers could be abandoned, with the Bank of England relying instead on conjecture about the difference between desired and actual bankers' balances to make MLR effective.

3. The liquidity coefficients, and some of the accompanying proposals in the liquidity paper, would reduce the efficiency of the financial system and provoke a large shift of credit business to non-banks or offshore. The liquidity coefficient machinery should therefore be abandoned by the Bank. No balance sheet ratio controls are needed for prudential purposes.

4. A free financial system, with no balance sheet controls for either monetary or prudential reasons, is the ideal. This may sound utopian, but it existed for almost sixty years before the Bank of England's nationalisation in 1946 without any serious crises of confidence or (apart from in wartime) excessive monetary expansion.

The banks, if involved in retail deposit-taking, should publish regular and thorough information about their balance sheets. The clearing banks have, after all, been doing so since 1891. But they need make no other response in reciprocation for the more liberal financial environment recommended in this paper.

The Green Paper is eloquent on the dangers. After noting that banks could hold a variable excess of cash above the mandatory minimum, which would subvert the precision of the system, it says that "more damaging" would be a tendency for banks "to ensure that business over and above the level for which they had previously acquired base assets was done through channels which did not require base assets (such as the euro-markets and through the bill leak)". (3) The Green Paper is equally trenchant in its rebuttal of fancy MBC systems, in which the base consists not of cash, but "negotiable entitlements". (Such entitlements would be created solely by the Bank of England, solely for the purpose of being base assets.) (4) The difficulty is that not all financial institutions would have to keep NEs. In consequence, if credit demands were vigorous, a tight monetary policy restricting the supply of NEs "would effectively . . . tax the banks covered by the scheme, obliging them to raise the margin between their lending and deposit rates and/or to pass the business on elsewhere, and so provide an incentive to disintermediation". (5) It could be argued that the Bank of England can counter such slippage by extending to more institutions the mandatory cash ratio, the NE requirement or whatever. The problem is that credit pressures, when contained in one part of the system, have a habit of escaping somewhere else. As soon as one group of fringe institutions have been captured by the control system, another group develops outside. The distinction between banks and non-banks is a matter of convention. Any artificial restraint on banks gives more scope to non-banks and makes them more closely resemble banks in their functions. (6)

The disintermediation risks of a mandatory cash ratio are a major element in the Bank of England's case against MBC. Its objection to an MBC system without a mandatory cash ratio is that the banks have flexibility in the amount of cash needed for business purposes. As a result, "there is no presumption" that the link between the base and the money supply would be "sufficiently close . . . to produce a steadier path than now for the growth of sterling M3". (7) The Green Paper also points out the operational inconvenience of MBC, which might be accompanied by volatile short-term interest rates and uncertainty about the Bank of England's lender-of-last-resort role. All these considerations are presented forcefully and persuasively. Since they have not been answered by MBC advocates, the rest of this paper will deal only tangentially with the merits and demerits of MBC as such. (8)

Given the coherence of the official argument against a mandatory cash ratio as part of an MBC system, it is surprising that the Green Paper should recommend that a "cash requirement" apply to all banks. This would differ from a cash ratio in that the sole constituent would be balances at the Bank of England (i.e., excluding vault cash) and from the existing arrangement whereby only the clearing banks need to hold such balances, at an amount equivalent to $1\frac{1}{2}\%$ of eligible liabilities. But it would be a nuisance to many banks. The point here is that the balances are used to settle inter-bank debts after a day's cheque-clearing and are of functional value to banks involved in such clearing. Almost by definition, the non-clearing banks are not involved. Since bankers' balances pay no interest, extending the cash requirement to the non-clearers is an arbitrary tax on their profits and exactly that sort of interference which would provoke disintermediation. (9)

The conflict of interests between the clearers and non-clearers raises some delicate issues. Indeed, the dichotomy between the two types of bank, such a fundamental characteristic of the British financial system, has an important bearing on monetary control. It is therefore disquieting that the Green Paper does not mention the dichotomy once. As we shall see later, this is of some significance in analysing the contents of the liquidity paper.

But the recommendation on the cash requirement is a relatively minor blemish. On the whole, the Green Paper is an impressive document showing understanding of the financial system's capacity to disintermediate and thereby evade controls it does not like.

The discussion paper on *The Measurement of Liquidity* – its rationale and motive

Unfortunately, all the good resolutions on the need not to impose artificial balance sheet restrictions are ignored in the second effort, the Bank of England's paper on *The Measurement of Liquidity*. It is hard to find any banker who is enthusiastic about this production, while many are known to be downright hostile. That may not matter in itself; after all, every industry objects to official regulation. But it does matter if it means that banks would do whatever possible to avoid the impact of the proposals once they had been implemented.

It should be said straight away that the liquidity paper is a subtle and sophisticated piece of work. Its intention is to define criteria for assessing banks' financial soundness following the radical change in the character of banking in the last twenty years. The essence of this change is that old-fashioned "retail banking", in which a bank takes deposits almost exclusively from the public and lends them out on overdraft, has given way to "wholesale banking". Wholesale banking relies on attracting deposits from the inter-bank market and on the issue of paper (principally certificates of deposit) in the parallel money markets. When retail banking was dominant the crucial requirement was that banks maintain a proportion of their assets in liquid form so that they could always repay deposits if the public demanded. This was embodied in a 1:3 ratio between "quick assets" and deposits, a relationship which came to be regarded as standard and found official recognition in the 30% (28% from 1963) liquidity ratio of the 1950s and 1960s. The rules for safe conduct with wholesale banking, however, are quite different. Risk arises not only because an insufficient quantity of liquid assets may be held, but also because of a possible mismatch between the maturity of assets and liabilities. For example, a bank could in theory lend for five years against one-month borrowings from the inter-bank market. In the liquidity paper's words, banks monitor this risk not by checking that they have enough liquid assets, but by making sure they can meet commitments by "examining the known flow of funds both on a particular day and in the future". (10) In the old-fashioned retail banking approach liquidity was a static concept; with wholesale banking it has become dynamic.

The aim of the liquidity paper is to construct an "integrated measure" of balance sheet strength which captures both the static and dynamic aspects of liquidity. To derive this measure the Bank has distinguished between maturity-certain and maturity-uncertain assets and liabilities, and suggested a set of required coefficients between total liquidity and various liability categories. The familiar liabilities of retail banking, current accounts and seven-day deposits, are maturity-uncertain. The Bank of England deems that the point of indifference between them and maturity-certain liabilities is three to six months. In consequence, the liquidity requirements on maturity-certain liabilities with less than a three-month term are higher than those on maturity-uncertain liabilities and those with more than a six-month term are lower. According to the paper, its starting point in fixing the liquidity coefficients was the historical 1:3 quick assets ratio. In fact, only 25% liquidity cover (not 33%) is proposed against maturity-uncertain liabilities.

All this sounds very clever. The Bank of England emphasises that the coefficients are to be norms rather than rigid ratios and that they are for prudential rather than monetary purposes. Unlike the 30% liquidity ratio and the 12½% reserve asset ratio, which, in combination with the special deposits mechanism, were at one time supposed to provide a lever over interest rates, the norms are not to play any deliberate role in monetary policy. In this way, the separation between the liquidity paper and the Green Paper is made to seem complete. They are presented as if they deal with different problems and, indeed, almost as if they were about different subjects.

The incompatibility between the Green Paper and the liquidity paper

The incentive to disintermediate

But the liquidity paper and the Green Paper must not be taken in isolation from each other. However novel and ingenious the Bank's liquidity norms are, they are much higher than banks themselves have thought necessary in recent years. If the norms were applied, banks would have to hold more low-earning liquid assets than at present and either suffer a profit loss or charge wider margins on their loans. Because the norms are more stringent than the banks themselves think appropriate, they give every incentive to disintermediation. The norms would initiate precisely that disintermediation process about which the Green Paper delivers so clear and effective a warning. In this sense, the liquidity paper and the Green Paper are totally inconsistent.

One aspect of this inconsistency is particularly worrying. The liquidity paper, prepared specifically to deal with the new problems of wholesale banking, should not have contained ideas which discriminate against institutions concentrating on this kind of business. But it does. The liquidity norms would be far more onerous for the non-clearing banks, which rely heavily on the inter-bank market for deposit resources, than the clearing banks. Indeed, some American

Table 1 The growth of the sterling inter-bank market

	London and Scottish clearers		Wholesale banks		
	(1)	(2)	(3)	(4)	(5)
	Gross sterling deposits	Sterling deposits from banking sector as a %age of gross sterling deposits	Gross sterling deposits	Sterling deposits from banking sector as a %age of gross sterling deposits	Ratio of sterling deposits with wholesale banks to sterling deposits with clearers
	£m.		£m.		
1979	41,389	11%	35,526	50%	0.86
1977	30,062	9%	26,498	46%	0.88
1975	24,875	5%	19,066	44%	0.77
1973	21,451	14%	19,674	46%	0.92
1971	12,840	4%	9,207	36%	0.72
1969	10,600	N.A.	5,300	34%	0.50
1967	10,200	N.A.	3,700	21%	0.36
1965	9,300	N.A.	2,900	13%	0.31
1963	8,400	N.A.	2,200	11%	0.26

Sources: *Financial Statistics*, various issues;
Bank of England Statistical Abstract No. 1, 1970

bankers have expressed astonishment at the severity of the Bank's scheme. By contrast, the clearing banks come off fairly lightly. We have already noticed that only 25% liquidity cover is to be held against maturity-uncertain liabilities, whereas tradition would have suggested up to 33%. As it is the clearing banks which continue to take predominantly maturity-uncertain liabilities, they would lose little from this proposal. It has been suggested, probably without foundation, that the Bank had more extensive consultations with the clearers than the non-clearers before the publication of the liquidity paper. This might be justified by the close and long-standing relationship between the clearers and the Bank, but it raises the possibility of inequitable treatment of different banking organisations. It is exactly the kind of imputation a central bank should avoid.

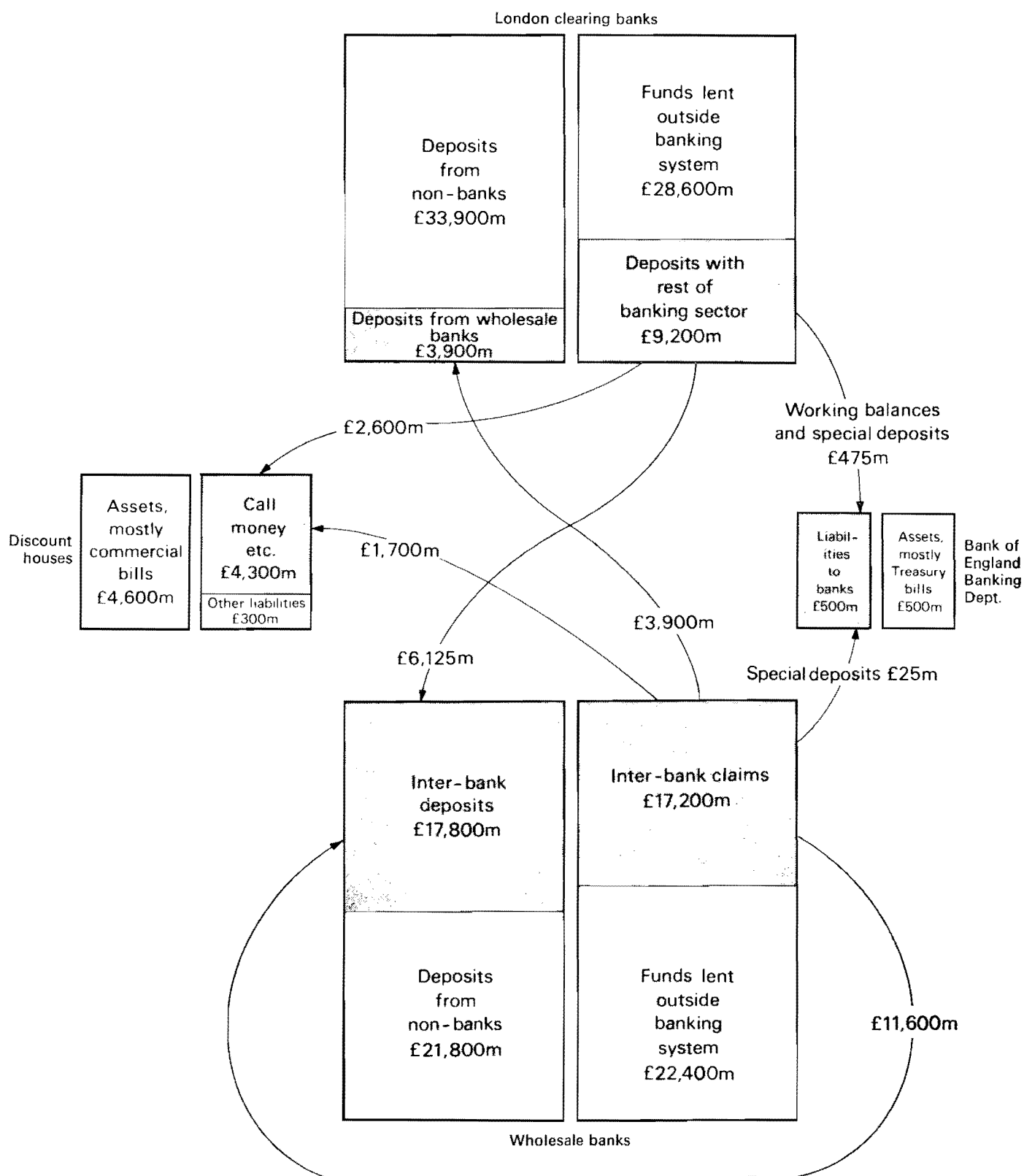
The biggest and most glaring offence to the non-clearers is the suggestion that banks maintain 100% liquid asset cover against gross market deposits from banks with up to a one-month term. In normal circumstances the instruments which the Bank categorises as "liquid assets" show a return not much higher than the rate of one-month inter-bank money. Indeed, cash and bankers' balances yield nothing at all, while Treasury bills usually have the lowest interest rate of any money market instrument. Since banks could not lend out any one-month inter-bank deposits to industrial and commercial customers, but would instead have to keep it all in liquid assets, they would lose money on such borrowings. As a result, this segment of the inter-bank market would have to be drastically curtailed. By cramping the inter-bank market, the 100% liquidity cover provision would reduce the efficiency of financial intermediation. It would impair the non-clearers' competitive muscle and establish a bias against the sort of banking business in which they specialise. In fact, the Bank of England seems to have already admitted that this particular idea was a mistake and should not be part of the prudential arrangements in their final form.

The confusion between prudential and monetary control

Why, it may be asked, did the Bank of England favour 100% liquidity cover against one-month inter-bank deposits? The explanation, in paragraph 16 of the liquidity paper, is that one-month inter-bank loans are regarded as liquid assets in the hands of the counter-party bank and so "a coefficient of less than 100% would enable banks to create illusory liquidity through interbank transactions". This observation may be related to the worry, expressed in paragraph 2, that the Bank's control arrangements "need to ensure that adequate liquidity is held by the UK banking system as a whole". If a situation emerged in which several banks' liquidity was sufficient only because they had a high proportion of their assets lent at short term to other banks, the Bank would have grounds for concern. From the viewpoint of the system as a whole inter-bank liquidity is not as genuine as liquidity which represents claims on outside bodies, such as the central government or large companies. If one or two banks found themselves in difficulties the inter-bank market might disintegrate and reliance on inter-bank liquidity could prove risky. (11)

A high ratio of inter-bank (or inside) liquidity to true outside liquidity *for the system as a whole* does need to be monitored by the Bank of England. (12) But, at the level of the system as a whole, there is no difficulty in overcoming it. All that is needed is for the Bank to inject outside liquidity by conventional central banking operations – buying long-dated gilts from the banks and selling them Treasury bills; going easy on gilt-edged sales to non-banks in order that the banks' Treasury bill holdings rise; extending eligibility to more bank bills; and so on. The objection to these operations might be that they would increase banks' total liquidity and therefore their scope for lending. But the banking system's lending potential is a monetary, not a prudential, consideration. The Green Paper makes clear at several stages that interest rates, not the regulation of balance sheet ratios, are the principal weapon for controlling the growth of bank lending and deposits. It specifically rejects, in paragraph 3.6, the notion that the reserve asset ratio – to which the liquidity norms are in effect the successor – was ever "designed to serve as an officially-controlled monetary base through which the pyramid of credit created by the banks might be directly limited". In view of this, to worry about the monetary repercussions of a liquidity injection under the new system, intended to be purely prudential in character, would be rather odd.

The workings of the sterling inter-bank market



Source: March banking statistics, published by the Bank of England.

Notes: 1. The discount houses had small claims (certificates of deposit £79m., funds lent to UK banking sector £13m.) on the banks, which are not separately identified in the diagram.

2. The figures are rounded to the nearest £100m., and not too much reliance should be placed on their accuracy because, for example, lending between the wholesale banks and discount houses cannot be exactly quantified from the official figures. The broad orders of magnitude are nevertheless correct.

Table 2 The sterling inter-bank market: 19th March 1980

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Sterling deposits received from non-banks	Sterling deposits received from banking sector	Total sterling deposits col (1) + col (2)	Sterling deposits from banks as a %age of total deposits col (1) ÷ col (3)	Sterling funds placed with banking sector	% of total sterling deposits received and subsequently placed with banking sector col (5) ÷ col (3)	Sterling inter-bank claims minus liabilities col (5) — col (2)
	£m.	£m.	£m.		£m.		£m.
1. London clearing banks	33,900	3,900	37,800	10%	9,200	24%	+5,300
2. Scottish clearers and N. Ireland banks	4,500	900	5,400	17%	1,000	19%	+100
3. Accepting houses	2,400	1,400	3,800	37%	1,700	45%	+300
4. British banks: other	8,100	7,000	15,100	46%	8,100	54%	+1,100
5. Overseas & consortium banks	6,800	8,500	15,300	56%	6,400	42%	—2,100
6. Sub-total	55,700	21,700	77,400	28%	26,400	34%	+4,700
Bank of England	—	500	500	100%	0	0%	—500
Discount Houses	300	4,300	4,600	93%	100	2%	—4,200
Total: UK banking sector	56,000	26,500	82,500	32%	26,500	32%	0

Source: *Financial Statistics*, April 1980, Tables 6.3 to 6.15.

Notes 1. The banking sector comprises 'UK banks' (lines 1 to 5) plus the Bank of England Banking Dept. and the Discount Houses.

2. Total sterling deposits represent sterling sight and time deposits and sterling CD's. In *Financial Statistics*, sterling CD's are not categorized by ownership for individual groups of banks. However, for the banking sector as a whole, sterling CD's outstanding at March 1980 were £3,817m., of which non-banking sector holdings amounted to £800m. or 21%. It has been assumed in the table above that for each category of bank, 21% of its sterling CD's are held by non-banks.

Moreover, as long as the ratio of inside to outside liquidity for the system gives no reason for alarm it is unnecessary for the Bank to concern itself about the ratio of inside to outside liquidity *for any individual bank*. If the ratio for the system is satisfactory there should be no question of a banking crisis through multiple failures. A bank which prefers to hold inter-bank claims, rather than Treasury bills or one-year gilts, as its liquidity cushion should not be reprimanded by the Bank or expected to alter the composition of its assets. In short, the Bank's anxiety about adequacy of the system's liquidity is bogus since, as a central bank, it can add liquidity by very simple, well-known operations; and, because the system's liquidity can be strengthened without difficulty, it is unnecessary to correct a high ratio of allegedly "illusory" inter-bank liquidity in a single bank's balance sheet. The drawback to liquidity-restoring open market operations is that they have monetary effects. But to recognise this is to concede that monetary and prudential control are not distinct. It follows that the liquidity paper and the Green Paper cannot and must not be analysed separately.

The confusion about the interaction of monetary and prudential control surfaces in another way in chapter 3 of the Green Paper. It is proposed that the authorities retain the option to call for special deposits, while abandoning the reserve asset ratio. The theory behind the reserve asset ratio, when it was introduced in 1971, was that it gave the Bank another tool for regulating interest rates. The banks' first response to a special deposits call would be to sell liquid assets, such as those contained in the reserve asset definition; they might then have a lower reserve asset ratio than the mandatory $12\frac{1}{2}\%$; so they would have to bid in the inter-bank market to obtain the funds for the purchase of more reserve assets, forcing up inter-bank rates and in due course interest rates generally. As it turned out, the special deposits mechanism was rather clumsy and inefficient as an interest rate manipulator, for technical reasons explained in Annex A of the Green Paper. But why, then, do the authorities want to keep special deposits as a monetary policy instrument? The answer, according to paragraph 3.9 of the Green Paper, is "to guard against possible adverse effects of excess liquidity in the banking system as a whole". But what are such "adverse effects"? They cannot be the risks of a multiple expansion of bank deposits because the Bank does not believe in the multiplier approach to the determination of banks' balance sheets. They can only be that excess liquidity would undermine official control over interest rates. But how would a call for special deposits bolster official control except in conjunction with the liquidity norms? The liquidity norms would become a tool of monetary policy; they would not be solely prudential in effect.

The diversion of credit offshore and the regulation of foreign currency business

The Green Paper does not devote much space to the form that disintermediation might take. It refers to "the bill leak" as a particular by-product of the supplementary special deposits scheme. But one obtrusive development in world banking over the last twenty years must have been uppermost in its authors' minds – the growth of the Eurocurrency markets. Before the abolition of exchange controls the prohibition on sterling bank borrowing overseas by UK entities placed a constraint on the Eurosterling market. That obstacle has now been removed. If the domestic banking system becomes riddled with controls, the transfer of sterling financial intermediation to offshore territories could take place on a massive scale, as has already happened with dollar business. The problems which the Federal Reserve, aided and abetted by the US Congress, has created for itself by injudicious regulation, should be an instructive lesson to the Bank of England. In the Green Paper the Bank seems to have learnt it as paragraph 1.17 notes, "The distortion of monetary indicators by a quantitative control is less misleading if it can be measured . . . [I]t has at least been possible to monitor the main form of disintermediation hitherto: the bill leak. However, other forms are less easily measurable especially now that United Kingdom residents are free to transact business abroad in sterling or in foreign currency".

But the liquidity paper is much less cautious and self-effacing. On the subject of overseas branches of UK banks it says that the Bank "wishes to extend its surveillance as rapidly as possible to cover UK banks' branch activities worldwide". In the process of establishing reporting requirements, the Bank "would wish to discuss bilaterally with banks special liquidity rules imposed by overseas authorities on particular foreign operations". Although no more details are spelt out in the paper, it ends with the rather intimidatory words that this "is a subject to which the Bank will wish to return".

It would be hard to imagine a sharper contrast in tone between the two documents. The liquidity paper's thinly veiled ambition to regulate offshore business is surprising not only in relation to the Green Paper's doubts on whether disintermediation can or should be curbed, but also in relation to the Bank of England's known attitudes towards Eurocurrency supervision. Unlike the Federal Reserve and the Bundesbank, both of which would like a regulatory framework for Eurocurrency markets, the Bank of England has consistently argued that to institute controls in certain centres would only push banking business to other centres. Financial institutions will keep migrating to territories where they are not subject to unwanted interference. There is at least an element of self-interest in the Bank's case, as the world's largest Eurocurrency market is in London. The Bank appreciates that, if it accepted the Federal Reserve's view and brought in controls, the City's status as a financial centre would be damaged. This makes it all the more disturbing that the Bank should be contemplating rules on the offshore sterling operations of British banks. The conflict between the liquidity paper's approach to offshore sterling business and the line the Bank takes with the Federal Reserve on offshore dollar business is patent.

But the liquidity paper is not content to weaken the Bank of England's argument against Eurocurrency regulation and indirectly, therefore, the City's attractiveness as a home for foreign banks. It also proposes to restrict UK banks' capacity to compete with foreign banks in London. It suggests that the same liquidity norms should be applied to UK banks' foreign currency business as to their sterling business because the Bank "has not been able to identify, in a prudential sense, any fundamental difference" between the two activities. But the treatment of the foreign currency business of foreign banks' London branches is "more difficult", since this business is "integrated into the parent's operations" and is monitored by another central bank. (13) In effect, UK banks will face the handicap of the liquidity coefficients on their foreign currency side whereas foreign banks will not. This is discriminatory and would do serious harm to UK banks' competitive position. It is a regrettable instance of the Bank of England not protecting the City's interests and accommodating existing arrangements, but instead foisting on banks controls which they have not sought and would thoroughly dislike.

Uncertainties and the scope for administrative discretion

Aside from the identifiable disturbance of established balance sheet patterns, the liquidity paper would increase banks' management costs. The day-to-day calculation of the liquidity norms – and, in particular, of the rather complicated "integrated measure" – would be more messy than that of the present reserve asset ratio. The Bank of England may contend that this would not be a nuisance because its new requirements are only norms, not precisely defined limits which must always be satisfied. But this raises the question of when and how a bank would have transgressed and what sanction would be applied to it for misbehaviour. By not stating in exact quantitative terms what would constitute an unacceptable deviation from the norms, an area of uncertainty has been opened up. (14) It would be particularly awkward if a liquidity shortage arose from broad monetary events, such as a persistent excess of government debt sales over the budget deficit, from which the banks could legitimately expect relief through open market operations. A bank could be anxious about being disciplined by prudential supervisors from one section in the Bank of England, while awaiting help from the money market managers in another.

Artificial manoeuvres to evade the norms would also take up management time and effort. For example, because 100% cover is needed against inter-bank borrowing under one month, but 90% for non-bank deposits under 8 days and 75% between 8 days and one month, a two-tier market would develop with commercial deposits being worth more than inter-bank. As Mr. Peter Wood of Barclays Merchant Bank has remarked, this "would play havoc with the vast majority of medium-term pricing agreements which refer to the London inter-bank offered rate as the reference rate of interest, because this Libor would be lower than the rate payable on commercial deposits". (15) Moreover, there would be a temptation to jerrymander positions. For example, call and notice monies, being "maturity-uncertain", have less onerous reserve requirements than deposits of a defined period. It would be logical to change a three-month deposit into 90 days fixed plus one day's notice, which brings it into the notice category and reduces its average liquidity requirement by about two-thirds.

Deposit structures – the growth of foreign currency business between 1971 and 1979

	1971		Total deposits £m.	1979		Total deposits £m.
	Sterling	Foreign currency		Sterling	Foreign currency	
London clearing banks	96%	4%	12,194	82%	18%	45,789
Scottish clearers	98%	2%	1,126	78%	22%	5,048
N. Ireland banks	99%	1%	331	99%	1%	1,266
Accepting houses	46%	54%	3,382	42%	58%	9,116
Other banks in the UK	25%	75%	29,823	16%	84%	185,180
All banks in the UK	47%	53%	46,856	31%	69%	246,399

Source: Table 3.

Table 3 Foreign currency business of the British banking system – its growth in the 1970s.

	(1)	(2)	(3)	(4)	(5)	(6)
	Sterling Deposits £m.	% of all sterling deposits %	Foreign Currency Deposits £m.	% of all foreign currency deposits %	Total deposits £m.	% of all deposits %
The position end-1971						
London clearing banks	11,735	53	460	2	12,194	26
Scottish clearers	1,105	5	21	—	1,126	2
N. Ireland banks	328	1	3	—	331	1
Accepting houses	1,556	7	1,825	7	3,382	7
Other banks in UK	7,323	33	22,500	91	29,823	64
All banks in UK	22,047	100	24,809	100	46,856	100
The position end-1979	£m.	£m.	%	%	£m.	%
British banks:						
London clearing banks	37,443	49	8,346	5	45,789	19
Scottish clearers	3,946	5	1,102	1	5,048	2
N. Ireland banks	1,249	2	17	0	1,266	1
Accepting houses	3,858	5	5,258	3	9,116	4
Other	15,417	20	19,649	12	35,066	14
Overseas banks:						
American	7,438	10	51,309	30	58,747	24
Japanese	560	1	28,452	17	29,012	12
Other	6,193	8	46,292	27	52,485	21
Consortium banks	810	1	9,060	5	9,870	4
All banks in UK	76,914	100	169,485	100	246,399	100

Sources: *Bank of England Statistical Abstract* Number 2, 1975, Tables 8.1 to 8.11
Financial Statistics, March 1980, Tables 6.5 to 6.14

Bank of England checks on banks' balance sheets would necessitate a large bureaucracy. The scope for administrative discretion which is envisaged at several points in the liquidity paper would be greater than exists at present, while the ambit of the Bank's supervision would be wider. After losing staff through the abolition of exchange controls, the Bank would soon rebuild its numbers in the enforcement of a new set of controls.

Conclusion on the liquidity paper

This thinking behind the liquidity paper is basically wrong-headed. A diverse financial system contains many different types of banking institution, each operating in accordance with its own management rules. It is a basic principle of financial intermediation that large institutions need a lower proportion of safe, low-yielding assets in their balance sheets than small institutions. The small institutions compensate for the cost of their low-yielding reserves by specialising in particularly profitable forms of lending. (This is part of the explanation of how merchant and consortium banks, which in recent years have had higher reserve asset ratios than the clearers or the American banks, are still able to compete.) To introduce an identical set of liquidity norms for all banks may seem fair, but because they have their own individual needs it is not. The Bank of England's actual proposals are particularly objectionable in that they would penalise wholesale banking, a development of the last twenty years which has stiffened competition in lending and improved the efficiency of the financial system. As the proposals would provoke substantial disintermediation, it is surprising that the Bank of England and the Treasury published – at the same time as the liquidity paper – a Green Paper which advanced an effective, well-argued case against certain types of monetary control mainly on the grounds that they would cause disintermediation.

The protests against the liquidity paper have been so loud and vigorous that it seems unlikely to be embodied, except in a much diluted version, in a regulatory framework. But this raises the question of what controls, if any, should be instituted. We may now set out the argument that no balance sheet ratio requirements of any kind are needed.

A system of monetary control

The basic framework

The greater part of sterling M3, to which the Bank of England pays obeisance in the Green Paper as the monetary target aggregate which “best suits the present circumstances of the United Kingdom”, consists of bank deposits. Since its other constituent, notes and coin in circulation with the public, responds passively to transaction requirements, monetary control is tantamount to control over the banking system. At first sight it is to banks' advantage to expand their balance sheets as rapidly as possible, since they can always make a profit by charging a higher rate of interest on their loans than they are paying on their deposits. How can the banks be prevented from growing without limit?

One part of the answer is that, for prudential reasons, banks need to maintain a proportion of liquid assets in their balance sheets and these yield less than advances to the private sector. If the supply of liquid assets is restricted, so too should be the size of bank liabilities. The difficulty with this approach is that, if the Bank of England checks the supply of liquid assets to the banks, the banks can make good this shortage by obtaining them from other financial institutions and the public. The liquidity ratio of the 1960s and the reserve asset ratio since 1971 both became of little help to monetary control for this reason. (16)

But there is another indispensable ingredient of bank balance sheets – cash. It is from this very sound premise that the monetary base enthusiasts start out. Cash has two elements, notes and coin and bankers' balances at the Bank of England. Because their customers are continually withdrawing (and replacing) deposits, banks must keep some notes and coin in their tills. This is, indeed, the most commonplace banking function. Also basic to banking routine is clearing – the settlement of debts left over after totalling debits and credits arising from cheques drawn against particular banks. A London clearing house has been in existence since the late eighteenth century when settlement was completed by gold coin or, more normally, Bank of England notes.

In 1854 settlement in notes and coin was replaced by settlement in Bank of England balances; and in 1864 the Bank of England joined the clearing house for payments due to itself. (17) Ever since bankers' balances have been to the banks what notes and coin are to the general public, the ultimate paying instrument for finalizing small residual debts between themselves.

But, however minor and trivial its role may appear, banks must have cash. If a bank could not repay its depositors or failed to cover an imbalance against it at the daily clearing, it would not have honoured its commitments. All cash (with the exception of coin, a liability of the Royal Mint) is a liability of the Bank of England. This is the vital point. According to the monetary base advocates, not only is cash essential to the banks, but also the relationship between their holdings and their deposit liabilities is stable. If the Bank of England controls its own liabilities, it is also controlling total bank deposits. But, as we saw earlier, the Bank does not consider the relationship to have the stability required for monetary control purposes. It is also sceptical about a system focusing on the quantity of monetary base assets because that would conflict with its traditional lender-of-last-resort function.

The Bank's approach is quite different. It supplies cash to the system (or "mops it up") every day through discount market operations so that the banks always have just about the amount they want. But it provides the system with cash at a price – Minimum Lending Rate. (18) MLR is the central element in the interest rate structure. Because the banks need cash and the Bank of England determines the price at which cash is made available, the authorities are able to regulate interest rates. In the words of the Green Paper, the banks' cash requirement is "effectively the fulcrum on which the Bank of England works when it seeks to affect short-term interest rates through its money market operations".

It is through interest rates that the Bank is able to control the money supply. There are two main mechanisms the authorities have in mind. First, bank lending to the private sector should respond to the level of interest rates. Advances are banks' principal asset and changes in assets are accompanied by roughly equivalent changes in deposit liabilities. Secondly, the attractiveness of gilt-edged securities depends on whether interest rates are expected to rise or fall. Other things being equal, the higher are interest rates, the more likely are they to decline and thus generate capital gains on gilts. An increase in MLR therefore induces gilt purchases. Whenever a non-bank agent buys gilts from the Bank of England, a bank deposit is liquidated and the money supply falls. It follows that there is a simple rule for money supply regulation. If the money supply is growing faster than target, interest rates are increased; if more slowly, they are reduced.

The Green Paper is the first official document to give its blessing to this system, although its workings have become familiar to financial markets over the last three or four years. Money supply targets were introduced in July 1976 and so it would be wrong to date the system's inception from the Competition and Credit Control reforms of 1971. CCC was nevertheless important in that it envisaged control over credit through interest rates and thereby began the process by which the focus of interest rate moves shifted from the exchange rate to a domestic indicator. Unfortunately, owing to a certain amount of squabbling among economists and politicians, it took some time before it was accepted that the money supply was the appropriate domestic indicator. The result of this interregnum was the financial turmoil of the 1971 to 1976 period.

Some doubts used to be expressed about the feasibility of adjusting interest rates and fiscal policy to reach a given money supply target. But the recent track-record shows that these are not justified. In the twelve months to mid-April 1979 sterling M3 rose by 10½%, compared to a 7 to 11% target; and in the ten months to mid-April 1980 it rose by 10% at an annual rate, compared to another 7 to 11% target. As the Green Paper says, "Using the basic weapons of fiscal policy, gilt-edged funding and short-term interest rates, the monetary authorities can achieve the first requisite of control of the money supply – control, say, over a year or more." (19)

The irrelevance of balance sheet ratios

In a system where interest rates alone provide the operational cutting-edge of policy, it is unnecessary for the Bank of England to force banks to maintain a particular ratio of liquid assets to deposits. Interest rates are used to influence the size of the *total* balance sheet and so the level of *total* bank deposits. The *composition* of balance sheets is irrelevant.

This is a great merit. Assuming no tinkering with interest rates by the government, the same interest rate configuration faces all banks and all financial institutions. They can respond on equal terms to the same price signals in a competitive environment. Since their balance sheet structures are determined by their own free choice, they cannot complain about official distortions due to unwanted controls and they have no incentive to disintermediate. (20)

Moreover, from the central bank's standpoint, the information it is receiving about monetary trends should be unambiguous and trustworthy. As there are no mandatory balance sheet ratios, banks are not handicapped in their rivalry with other financial intermediaries. The growth of other intermediaries' liabilities, which may be a major component of the economy's liquidity, should not be significantly different from the banks'. In consequence, money supply numbers are a meaningful guide to economic agents' likely behaviour. Because an interest rate-governed system minimises disintermediation risks, it promotes the effectiveness of both financial competition and monetary control.

Bank of England control over interest rates

However, a question-mark remains. Can the Bank of England be confident about its ability to determine interest rates? The answer requires a little more explanation of how the system works.

As we have seen, banks need cash. But the biggest constituent of "cash" – the issue of notes and coin – is adjusted automatically to the transaction needs of the general public. If the public wants more, it converts bank deposits into notes and coin; the banks then have less in their tills than they would like and convert some of their balances at the Bank of England into notes to replenish their stock; and there is no doubt that the Bank will make the notes readily available. In consequence, it is the second constituent of cash – bankers' balances – which is critical. Its pivotal character is formalised in the current arrangement that the clearing banks must maintain balances at the Bank of England above $1\frac{1}{2}\%$ of eligible liabilities.

The level of bankers' balances is determined by several factors. The public's demand for notes and coin is obviously one. More important in terms of size are flows into and out of the Exchequer. As the Bank of England is the government's banker, Exchequer disbursements are paid for by cheques drawn against the Bank which add to bankers' balances, while tax payments are drawn against commercial banks and therefore reduce them. Equally, if the government sells debt not to the Bank of England, but to any other economic agent, non-bank *or bank*, it must be covered by a cheque in favour of the Bank and bankers' balances fall. This is the crux of the system. By transactions in debt between it and the banks, the Bank is able to alter the level of bankers' balances. The most common and important such transactions are daily sales and purchases of Treasury bills in the discount market. As the discount market is just a staging post between the Bank and the banks, no harm is done by regarding Treasury bill transactions as directly affecting bankers' balances. If the balances are significantly above $1\frac{1}{2}\%$ of eligible liabilities, and other influences on discount market money flows are neutral, the banks do not have to borrow from the Bank. They have enough cash for their needs and the Bank cannot enforce MLR. It therefore sells Treasury bills to "mop up" the surplus. Once this has been done, should the money flows subsequently go against the market and balances threaten to drop much beneath $1\frac{1}{2}\%$ of eligible liabilities, the banks must either sell Treasury bills to the Bank or borrow cash. The cash loan (i.e., the cheque which the Bank makes over to the banks and is credited to their balances) is at MLR. By Treasury bill operations the Bank strives to keep the banks not far from their $1\frac{1}{2}\%$ target. As a result, they are continuously on the brink of having to rely on official assistance and MLR can become effective. (21)

It is clear from this account that interest rate control takes advantage of an official balance sheet requirement, the $1\frac{1}{2}\%$ ratio. We earlier claimed that no mandatory balance sheet ratios need to be imposed by the Bank for monetary control reasons. As they have several drawbacks, it would be desirable if they could be avoided. In fact, the clearing banks, the only institutions to whom the ratio applies, do complain. They would prefer a much lower ratio, perhaps about $\frac{3}{4}\%$, which they say would be quite enough for the safe completion of their cheque clearing business.

Evidently, the high level of the ratio is an irritant to the clearers and must cause some profits loss due to the absence of interest payments on the balances. The Bank of England justifies the arrangement by their convenience to its own money market managers. Because its officials can quantify exactly the clearers' target balances they know with some precision how tight or easy the discount market is and they can gauge what intervention is needed to accomplish their interest rate objectives. But is it indispensable for the bankers' balance ratio to be obligatory? Is a voluntary arrangement feasible?

The determinants of the banks' desired level of Bank of England balances must be well-known to the money market managers from many years' experience. At one stage the Green Paper notes that, "if the mandatory requirement applying to the London Clearing Banks were removed and not replaced by a more general one, a bank's requirement for cash balances would depend far more on the total level of transactions and type of business than on the size of its balance sheet". (22) Fair enough, but the Bank is fully informed about "the total level of transactions", as statistics on the value of cheque clearing have been compiled for many decades. In any case, the money market managers should be able to judge from inspection of call money rates when banks' desired balances diverge from actual. The Bank of England could still make MLR effective if there were no mandatory bankers' balance requirements at all, but instead it used notional estimates of the balances banks would like to maintain.

This may sound like a flight of fancy, an ideal libertarian suggestion which practical men need not take seriously. But, before the Bank's nationalisation, this was exactly how interest rate objectives were attained. In the late nineteenth century and the early twentieth century, no cash ratio was in existence, but Bank Rate was respected and influential in the City and, indeed, in every major financial centre. The operational procedure of the "Greene-Gibbs policy", as it has been termed, dated back to two particularly able Governors of the Bank of England in the 1870s. In the view of Henry Gibbs, Governor from 1875 to 1877, bankers' balances were "the most certain and the most intelligible of the Bank's accounts"; the Bank was able to judge approximately the minimum balances that bankers needed; only the margin above that could be considered excess reserves. When balances were low, bankers could not withdraw cash unless the Bank first lent the money; when there were spare balances, the Bank could still remain "the real arbiter" by market sales of securities. Broadly speaking, the character of open market operations and interest rate tactics has not altered from Gibbs' design; it is substantially the same today as it was in the late 1870s. Bank Rate was the most powerful interest rate in the world over most of this hundred year period *without the banks having to meet any mandatory cash requirements whatever*. (23)

The recommendation being made here is, therefore, hardly original. A system without a mandatory cash requirement was consistent for many years with full Bank of England control over interest rates. In the USA the abolition of all reserve requirements was proposed by Dean Carson in 1964 on the now persuasive grounds that they were inequitable between banks and would spur disintermediation. He argued, in very much the same spirit as Henry Gibbs had in the late 1870s, that:

Cash reserves can be controlled by open market operations, and the tone of the market observed by the simple device of central bank hypothesis of the market's desired level of cash reserves. Given continuance of reporting requirements, the device of "shadow reserve requirements" suggested here would enable the central bank to observe "excess reserves", "free reserves" and "net borrowed reserves" as indicators of money market conditions without the necessity of formal requirements. (24)

Perhaps if the Federal Reserve had paid more attention to this viewpoint the rapid expansion of the Eurodollar market and the proliferation of non-bank credit channels, which have been the bugbear of American monetary policy in the mid-1970s, would never have happened.

An explicit cash requirement is not vital for controlling interest rates. The Bank of England can exert sufficient influence by estimating a shadow cash requirement and adjusting discount market operations accordingly. As the authors of the Green Paper explain in some thoroughness why the reserve asset ratio cannot be used as an instrument for varying interest rates we do not need to outline the arguments against using a broader liquidity ratio. No mandatory balance sheet ratios of any kind are needed for monetary control purposes. (25)

The setting of interest rates

One issue in monetary control remains to be discussed, the authorities' scope for manipulating interest rates. At present they have discretion about the level of MLR. In principle, they react to deviations of money supply from target to ensure that the target can be attained. As the Green Paper admits with refreshing honesty, this may result in "a bias towards delay". The reason is that "there may be a built-in tendency to avoid increases in interest rates that could prove in the event to have been unnecessary, by delaying the decision until the new trend is clearly established". (26)

To avoid the problem of undue tardiness in interest rate moves, the Green Paper proposes in chapter 5 two "indicator systems". The two indicators are the monetary base and sterling M3. If deviations of either of these from target occur, interest rate changes are made automatically by the Bank of England. There would be a pre-set graduated scale of MLR adjustments depending on the size of the deviations, but the Green Paper comments that the scale "would inevitably be somewhat arbitrary". An indicator system would have the virtue of taking interest rate decisions out of the political arena or, at any rate, of providing politicians with the excuse of "technical factors" for unpopular interest rate changes.

It is very difficult to choose between the existing discretionary system and an indicator system. The main argument in favour of discretion is that the authorities possess information about likely future monetary developments, relating to the government's financial position and private sector loan demand, which should enable them to make more suitable judgements about required interest rates than any pre-determined adjustment formula. There are at least two occasions in the last two years when they have been correct to override the signals given by sterling M3. The first was on 9th November 1978. MLR was raised from 10% to 12½% even though sterling M3 in the previous six months had been growing at an annual rate towards the lower end of the 8 to 12% target. As monetary growth in subsequent months was ahead of target, the move was absolutely right. The second was earlier this year when sterling M3 growth was still above target. Despite pressure on short-term rates from money market conditions, the authorities held MLR at 17% and again they were justified by events as sterling M3 has now fallen back to the lower end of the 7 to 11% target.

It seems likely that the present system of interest rate determination – focused on the money supply, to the exclusion of the exchange rate – dates only from the middle of 1978. Before that the confusion between external and domestic signals for interest rate adjustment was responsible for the unfortunate plunge in MLR to 5% in late 1977 and the later excessive monetary expansion. Since the middle of 1978 the authorities have, in fact, been rather successful in meeting their targets. In view of this, the authorities can be safely left to manage interest rates. The case for automatic interest rate changes has not been established. This leaves open the much bigger question of whether the Bank of England should be granted a greater degree of autonomy from Whitehall, perhaps by a constitutional provision or even denationalisation.

Prudential Ratios

Consumer protection

If no mandatory balance sheet ratios are required for monetary control purposes, are they necessary for prudential reasons instead? Both the Green Paper and the liquidity paper agree that they are and, on this point at least, seem to be in harmony. But at no stage does either document provide a fully-articulated theoretical case for prudential supervision and control. It is simply taken for granted that such supervision and control is desirable. (27)

In criticising this attitude, certain possible reasons for prudential regulation have to be advanced, even though they may not correspond to official thinking. The first question which has to be asked is why banking differs from other industries. Despite the fashion for industrial interventionism in recent years, no one has yet suggested that prudential controls are needed over the balance sheets of, for example, engineering companies, breweries or house-builders. Why is banking different?

Perhaps the most obvious point is that the greater part of a bank's liabilities are to depositors rather than shareholders. As members of the general public depositors should be guarded against commercial risks which are regarded as acceptable to shareholders. This is a characteristic consumer protection argument; it accords well with what might be termed "the spirit of the times" and would probably be enough to convince a majority of legislators. However, on its own merits it is not persuasive. Most industrial companies' liabilities to their trade creditors exceed by a wide margin their liabilities to shareholders. In this respect, the difference between them and banks is a matter of degree, not of kind. More fundamentally, it is bogus to distinguish between depositors, represented as innocent and vulnerable "members of the public", and shareholders. Although they may be disguised through intermediaries such as insurance companies and pension funds, shareholders are also members of the public. A sharp distinction between depositors and shareholders is false.

It could be claimed that depositors are generally badly-informed and that they have little time to assess risks of low-quality financial institutions. The simple reply is that it is their duty to obtain the information and devote the time necessary to protect themselves against placing deposits with unsound banks. However, this is not a complete answer. It fails to mention the ways by which the banking system already reduces both information costs and deposit risks. There are two principles here – the larger a bank's balance sheet and the more diversified its assets, the smaller its risk; and the more banks any individual leaves deposits with, the smaller his risk. Both principles have been exploited in the structure of the present system. It is the big clearing banks, about whose trustworthiness there is no question, which take the bulk of deposits from the general public and are active in "retail business". Companies, which have greater ability to assess banks' status, leave deposits with less well-known names, including accepting houses and American banks. The clearing banks channel part of their deposits into the inter-bank market where they lend to many banks (reducing their risks) and to small, specialised institutions such as consortium banks (enabling the public to avoid the cost of appraising their credit-worthiness). In other words, the present division of functions between retail and wholesale banks itself has the effect of reducing risks to the ultimate depositor. The free operation of market forces has already created a system which protects the "consumer" (in this context, typically equated with the "man in the street") from bad banking. The obstacles the liquidity paper would place on the inter-bank market's smooth functioning might therefore *increase* the public's exposure to banking risk, rather than reduce it. (28)

The inter-bank market is particularly efficient in another respect – its ability to identify when a bank's balance sheet is deteriorating. Inevitably, when several banks are participating in syndicated loans, competing between themselves for the same corporate lending business and exchanging deposits to overcome timing differences in lending opportunities, they learn a great deal about the quality of each other's loan portfolio. The market can soon impose its own corrective to unsound practices; the margin a particular bank is charged over inter-bank rate is adjusted upwards if its assets are known to be unsatisfactory; it must then charge more to companies borrowing from it and becomes uncompetitive compared to banks with a stronger asset position. In short, the inter-bank market is a mutual information club which penalizes poor banking quickly and without any need for the Bank of England to intervene. This aspect may explain why banks which have been inactive for a time simultaneously borrow and lend in the inter-bank market to keep their "name" familiar. (29)

The danger of multiple banking failures

If the consumer protection argument does not stand up, there is another apparently more satisfactory case for prudential regulation. It rests on the distinction between social and private costs. Broadly speaking, economists are against government intervention because in most markets the actual prices of factors of production – or private costs – indicate their scarcity to society and therefore perform appropriate allocative functions. But occasionally social and private costs differ, establishing a ‘prima facie’ argument for interference.

Dr. Goodhart has suggested in his book, *Money, Information and Uncertainty*, that a bank closure entails a wealth loss to depositors because they are forced to sell assets at low prices in order to rebuild their cash. This capital loss on assets other than bank deposits is over and above the loss due to a bank’s inability to repay its liabilities in full. Indeed, banking failures might initiate a cumulative process of asset realisation, associated with an increased preference for liquidity and eventually causing severe deflation. By contrast non-bank financial institutions do not have such short-term deposit liabilities. Their closure would not result in the same scramble for cash or have major macro-economic repercussions. “For this reason the authorities are likely to impose more stringent prudential requirements on the composition of bank-asset portfolios than on other intermediaries, since with banks the social, external costs of failure may well be much greater than the private costs of failure, whereas the gap between the social and private costs of failure is less marked for OFIs.” (30)

There are two difficulties with this approach. First, it is improbable that the closure of any one bank could have a sufficiently profound effect on asset values to lead to a cumulative collapse threatening the entire system. Of course, much would depend on the size of the bank in question and its relationships to other banks. In Britain the clearing banks dominate retail deposit-taking. It is reasonable to claim that no crisis of confidence could arise unless a clearer was involved. No non-clearer has deposit liabilities to the general public large enough to precipitate a rush into cash if it closed its doors. But the likelihood of any of the clearers going into liquidation is negligible, unless there were a drastic change in management practices. In other words, given the British banking system as it is at present constituted, no institution liable to cause multiple bank failures can be identified.

Secondly, the problem raised by Goodhart only arises if a bank has deposit liabilities to the general public. But the wholesale banks have only a small proportion of deposits from that source. His argument for prudential regulation scarcely applies to them. But it is with the prudential regulation of wholesale banking that the liquidity paper deals. It might be pointed out that retail banks could withdraw deposits from high-risk wholesale banks, which would undermine the system in the same way as a large-scale attempt to convert deposits into cash by the public. However, the Bank of England can exert moral suasion over retail banks to ensure that they behave more responsibly. Indeed, it did so very effectively in the “lifeboat operation” of 1974. It seems that Goodhart’s rationale for prudential regulation is not relevant for wholesale banking.

The alleged difference between the private and social costs of a banking failure does not, therefore, substantiate the broad philosophy or the specific proposals in *The Measurement of Liquidity* paper. In fact, there is something anomalous about imposing liquidity requirements on a wholesale bank. By definition, it has only a small proportion of maturity-uncertain liabilities in its balance sheet. The maturity date of most of its liabilities is known and fixed. The need to maintain a liquidity cushion arises, in the case of a retail bank, because depositors’ views about the safety of their money may change radically and prompt rapid, unpredictable withdrawals. But withdrawals from a wholesale bank *cannot* be rapid and unpredictable. It is very questionable whether any system of liquidity norms is appropriate for wholesale banks. At present there is a division of labour in the banking system between the retail banks, which have a comparative advantage in deposit-taking, and the wholesale banks, which have a comparative advantage in lending, particularly lending to the corporate sector. The liquidity paper would hamper this division of labour and perhaps increase the dangers of aggressive, risky deposit-taking practices. (31)

Prudential regulation in the past

It is difficult, therefore, to assemble a viable argument in support of mandatory balance sheet ratios for prudential purposes. Although the liquidity paper is a clever document and the first significant attempt by any central bank to propose a regulatory framework for wholesale banking, it would do great damage to the efficiency of the British financial system. The irony is that wholesale banking has developed more extensively in this country than elsewhere because banks face fewer restrictions and enjoy a freer competitive environment. To hinder the specialisation of deposit-taking and lending functions between different institutions would be a retrograde step, quite contrary to the spirit of both CCC and all recent policy statements on the desired structure of the financial system.

Indeed, the liquidity paper's dirigiste tone is a departure from the Bank of England's long tradition of leaving the City to develop without meddlesome bureaucratic intervention. Such controls as have been introduced since nationalisation have preponderantly been for macro-economic or monetary objectives. Apart from the secondary banking crisis in 1974, arguably the result as much of bad central banking and the false macro-economic signals given by the government as of irresponsible private banking, there has been little doubt about banks' soundness and integrity. It is definite, moreover, that the secondary banks' problems in 1974 stemmed from the low quality of their loan portfolios, not from inadequate holdings of liquid assets. Throughout the Barber boom, all banks scrupulously observed the reserve asset ratios prescribed in CCC. The explanation for the failure of a number of institutions was that they had lent against property just before property values were about to collapse. The liquidity paper would not prevent similar blunders, or their reverberations throughout the financial system, as it gives no guidance at all on the industry or sector composition of banks' lending. Of course, controls on the composition of loan portfolios – which do exist in other countries – are an overt infringement of banking freedom.

In the nineteenth century, when no prudential or other controls were in force, there were financial crises. They seemed to come at eleven or twelve year intervals and were associated with profound macro-economic upheaval. But the financial system was continuously evolving and progressing, while banks learned from experience. Between the Barings crisis of 1890, in which no depositor lost money, and 1946 there was uninterrupted and well-justified confidence in bank deposits. Over this almost sixty year period, the Bank of England did not enforce any balance sheet ratios for the sake of prudential regulation.

The Bank of England has a magnificent record behind it. Because it has tried to be the servant rather than the master of the financial system, banks have been attracted to London and the City has retained its pre-eminent position as an international financial centre. Although the thirty-four years since nationalisation have been less satisfactory than the earlier period, the climate of official regulation has in general been more friendly than elsewhere. It is regrettable that the Bank in its *Measurement of Liquidity* paper has started to lapse into the bad habits of other central banks. No prudential controls are required. In their defence against the Bank's initiative, it would be best if the banks resisted root-and-branch the notion of mandatory balance sheet requirements rather than accept the idea and try to modify the "liquidity norms" (or their successor) into acceptable conformity with their current business arrangements. Through improved financial technology, those arrangements may change and ratios which at present seem harmless may later become a serious nuisance.

It may be asked whether the banks need to do something to reciprocate the absence of balance sheet controls advocated here. The prime need is the ready availability of information about their balance sheets. The clearing banks have in fact been publishing their balance sheets since 1891, following a suggestion by Goschen, the Chancellor of the Exchequer, after the Barings crisis. In the next twenty years it became an important barometer of banks' position that they maintain stable reserve ratios. Although this was accomplished partly by "window-dressing" (the banks had different make-up days and shuffled reserve assets between themselves to maximise holdings on their own particular days), the practice resulted in the public being continuously well-informed about the security of their deposits. (32) The monthly clearing bank statement is, of course, still quite an important event today, but more for financial analysts than for members of the general public. If more banks move into retail deposit-taking, they should be obliged to publish a monthly balance sheet statement in the same way as the clearing banks. A problem does arise here because the most likely entrants into retail business are the American banks. The greater part of their business is in dollars, not sterling. The dollar activities are

obviously relevant for their balance sheet strength, but there is something anomalous about the Bank of England requiring disclosure about them when it is only the sterling deposits which are legitimately a British concern. This issue of overlapping central bank jurisdictions is likely to become of increasing importance in the next few years. (33)

Towards a free financial system

The ideal of a free financial system has not been particularly popular with legislators, journalists or economists. Because there has in the past been a tendency to regulate banking more closely than other industries, it has come to be assumed that regulation is inevitable and central banks have been the obvious candidates to enforce it. But the explosive growth of offshore banking in recent years, and the insidious trend for non-controlled financial intermediaries to capture market share from controlled, has given a warning that market forces always find ways of breaking out. The best system would be one in which banks are subject to no mandatory balance sheet requirements of any kind. They should be free to choose the structure and composition of both their assets and liabilities.

The question then arises of how banks' balance sheet growth is to be contained. The first approach is to posit a stable relationship between "cash" or high-powered money (i.e., central bank liabilities) and commercial bank liabilities, and then to control the quantity of cash, allowing interest rates to be set (somehow) in the money markets. (34) Despite their protestations of continued open-mindedness, the authorities have more or less rejected this monetary base system in the Green Paper. The second approach is for the central bank to set interest rates in order to influence the determinants of banks' balance sheet expansion, while readily supplying the banks with as much cash as they want. Our argument has been that the Bank of England can control the money supply in this way. Moreover, it does not need a mandatory cash requirement for the effective conduct of the money markets, as the *Monetary Control* Green Paper implies. It could exert sufficient sway over interest rates by hypothesising desired bankers' balances and carrying out operations to remove any divergence between actual and desired balances, as it used to do before 1946.

The safety of bank deposits is, in principle, a separate issue from their rate of growth, although, as we have seen, prudential and monetary control considerations often coincide. The Bank of England has not put up a theoretically coherent argument for prudential regulation of balance sheets in the liquidity paper. We have been unable to find one either. Goodhart's argument on the difference between the private and social costs of banking failures does not seem altogether relevant for wholesale banks. Our conclusion is that the "liquidity norms" favoured by the Bank of England are not required and, because of their harmful side-effects in other directions, should be abandoned. No other formal prudential controls should be introduced in their place.

Much of the impetus for the present spate of supervisory proposals stems from Britain's membership of the EEC and its harmonisation objectives. The recent Banking Act was largely motivated by the December 1977 EEC Banking Directive "on the co-ordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions". The Directive required central banks to formulate precise arrangements for licensing deposit-taking institutions. It may be asked how the Bank of England can comply with the Directive unless it introduces proposals of the sort contained in the liquidity paper. The answer is that it can specify balance sheet ratio requirements which are so generous in relation to existing business practice that they would serve only a symbolic function. This is more or less the situation with building societies at present. The Department of Trade mandates that they have liquidity ratios of $7\frac{1}{2}\%$, but in practice most societies have ratios above 15%.

The big problems of monetary control in Britain relate not to the absence of a monetary base mechanism or to inadequate prudential supervision, but to the interest-insensitivity of domestic credit. In consequence, money supply control in the last four years has been accompanied by large interest rate swings. Although volatility in the price of money may be an unavoidable corollary of emphasis on its quantity, these swings have contributed to an uncertain macro-economic environment and in themselves are highly undesirable. Most discussion of the interest rate volatility problem has focused on the gilt-edged market, with its rather predictable "Duke of York" melodramatics. The difficulties in forecasting the level of official gilt sales have led to the recommendation of regular auctions of government stock, rather than sale by the

“tap” method. However, the gilt-edged market has in fact been a useful escape-valve for the Bank of England in recent years. It has often been possible to neutralise the unwanted monetary effects of excessive bank lending by aggressive gilt-selling campaigns. (35)

Another equilibrating mechanism, which has become powerful in recent years is that foreign demand for UK government and bank debt seems to be highly responsive to interest rate changes. The role of overseas purchases (or sales) of gilts in monetary control is obvious. But the changes in overseas sterling deposits, which have soared by about £4b. in the last eighteen months, are even more important. Assuming that banks’ total balance sheet size and their net foreign currency position are unchanged, every increase (decrease) in overseas sterling deposits is matched by an equivalent decrease (increase) in UK resident sterling deposits and so in the money supply. It follows that the interest-elasticity of foreigners’ sterling holdings facilitates monetary control. The benign effect of these short-term international capital flows was probably increased by the abolition of exchange controls in October last year.

A free banking system of the kind proposed here would, like a free international payments regime, promote the responsiveness of the money supply to interest rate variations. At present banks have to hold the same proportion of reserve asset to eighteen month deposits as for current accounts. (36) In consequence, there is a penalty in incurring medium-term liabilities and banks do not actively try to attract such deposits from the public. But medium-term deposits are less liquid than current accounts or the conventional seven-day clearing bank deposits. If the public can be induced to transfer from these traditional short-term deposits into medium-term deposits by interest rate changes the economy’s liquidity would be reduced by an interest rate increase. (If bank deposits of more than a certain maturity were excluded from the money supply definition, the money supply would also be reduced.) In West Germany, where a high proportion of bank liabilities are not short-term deposits but take the form of savings deposits and bearer bonds (“monetary capital formation”, for short), the interest-responsiveness of the money supply has been greatly strengthened by this means. By abolishing the reserve asset ratio, which discriminates against medium-term deposit-taking, the authorities’ proposals in the *Monetary Control* Green Paper open up the possibility of similar developments in Britain. (37) A banking structure uninhibited by official balance sheet ratio restrictions would therefore allow more flexible shifts between short-term and medium-term deposits. The reaction of the money supply to interest rate changes would be quicker and more worthwhile.

It is not to be expected that the government or the Bank of England will accept the proposal advocated in this paper. Having devoted so much time to preparing a liquidity norm scheme and so much effort to negotiations with bankers over how it should work, officials are unlikely to enthuse when someone suggests that the whole enterprise is mistaken. Even economists who normally favour a non-interventionist approach to policy may regard the recommendation of no official balance sheet ratio requirements whatever as too daring. (38) But there is nothing inherently unworkable in our proposal. On the contrary, it would respect existing institutions and practices. It would also re-instate the liberal financial climate which existed before the nationalisation of the Bank of England in 1946. In the nineteenth century and the first half of the twentieth century admiration for the Bank’s efficiency and integrity was universal; it was a model for central banks in other countries. The proposal made here recalls the Bank’s best traditions, whereas those in the liquidity paper are a regrettable lapse into artificial regulatory devices and unnecessary intervention.

Notes

- (1) Cmnd. 7858 *Monetary Control* HMSO: London 1980, p.4.
- (2) Chapter 4 of Cmnd. 7858 shows that the concept of "monetary base control" encompasses a variety of arrangements.
- (3) Cmnd. 7858, pp. 23-4. The remark is made in an analysis of the "lead accounting" form of the mandatory cash requirement. But it is relevant also for the "lagged" and "current accounting" forms.
- (4) N. W. Duck and D. K. Sheppard "A proposal for the control of the UK money supply" *Economic Journal* March 1978, pp. 1-17.
- (5) Cmnd. 7858, p. 29. The argument is very similar to that in an article "Should Britain's banking system be controlled through a 'cash ratio'?" in *Messel's Weekly Gilt Monitor*, 4th May 1979.
- (6) The distinction between banks and non-banks is a complicated subject on which there is a large and fascinating academic literature. See chapter 7 "Banks and other financial intermediaries: differences and similarities" in C. Goodhart *Money, Information and Uncertainty* Macmillan: London 1975 for an introduction.
- (7) Cmnd. 7858, p. 22.
- (8) As it happens, the Green Paper is silent on two drawbacks of MBC emphasized in the L. Messel & Co.'s January 1980 *Financial Analysis* on MBC – the low ratio of the banks' to the public's cash and the possible resulting instability of the banks' cash base; and the different impact of the proposal on clearing and non-clearing banks. The omission of the clearing vs. non-clearing bank issue is perhaps understandable because of the special interests involved, but the split between the public's and the bank's cash does not seem to have been thought worthy of mention. This is surprising given how crucial it was in the major financial crises of the nineteenth century and the 1930s.
- (9) The clearing banks complain that they suffer unfairly from the $1\frac{1}{2}\%$ requirement, as it is more than they need and does not apply to non-clearers. In fact, their cheque-clearing activity is vital to their dominance of retail banking and so to their access to interest-free current accounts. The resulting "endowment profits" compensate for the profit loss due to the $1\frac{1}{2}\%$ requirement. There would be no offsetting compensation for the non-clearers, unless they moved into retail banking and cheque-clearing.
- (10) Bank of England consultative paper, *The Measurement of Liquidity* March 1980, p. 5.
- (11) A situation resembling this developed for a few days in 1974 when, following problems at the Scottish Wholesale Co-operative Society, it was difficult to deal in certificates of deposit issued by some banks.
- (12) The distinction between inside and outside liquidity made here self-consciously echoes that between inside and outside money in economic theory. The inside money-outside money distinction originated in J. Gurley and E. Shaw *Money in a Theory of Finance* The Brookings Institution: Washington 1960.
- (13) Bank of England consultative paper, *ibid*, p. 13.
- (14) A talk by Mr. Peter Wood, Treasurer of Barclays Merchant Bank on 24th April 1980, welcomed the flexibility of the arrangements, with the separate negotiations with each institution on its required secondary liquidity being described as "a sensible approach". Although it is true that the relationship between the Bank and the banks is of a commercial, rather than purely legal, character and some scope for discretion may therefore be admissible, it is difficult to feel so sanguine about this aspect of the proposals.
- (15) Mr. Peter Wood's talk on 24th April 1980, p. 5.
- (16) This deficiency of the liquidity ratio and special deposits mechanism was explained in W. E. Norton "Debt management and monetary policy in the UK" *Economic Journal* 1969, pp. 475-94.
- (17) L. S. Pressnell "Gold reserves, banking reserves and the Baring crisis of 1890", p. 179, in C. R. Whittlesey and J. S. G. Wilson (eds.) *Essays in Money and Banking in Honour of R. S. Sayers* Oxford University Press 1968.

(18) This is not quite right, since much assistance is at less than MLR. But the Bank can choose to charge MLR whenever it wishes.

(19) Cmnd. 7858, p. 2.

(20) The remark on p. 4 of Cmnd. 7858 that "there are no techniques of monetary control which involve no risk at all of disintermediation" therefore seems too pessimistic. An argument could be presented that interest rate volatility, a side-effect of monetary targets, discourages financial intermediation, causing the banking system to be smaller than it would otherwise be. But the same costs of interest rate changes apply to all institutions and so the relative sizes of banks and non-banks should be unaffected.

(21) Given the importance of discount market operations and the $1\frac{1}{2}\%$ of eligible liabilities requirement to monetary policy, it is surprising how little attention is paid to them in the textbooks. Thus, A. Crockett *Money: Theory, Policy and Institutions*, Nelson: London 1973 refers to the arrangements, but establishes no connection with interest rate policy. A good account of open market operations in J. Revell *The British Financial System* Macmillan: London 1973, pp. 227-37, does not bring out the discount market's strategic position in monetary policy.

(22) Cmnd. 7858, p. 9.

(23) L. S. Pressnell, *ibid*, p. 187. For a discussion of the behaviour of bankers' balances during the late nineteenth century trade cycles, see chapter 15 of C. A. E. Goodhart *The Business of Banking 1891-1914* Weidenfeld and Nicholson: London 1972.

(24) D. Carson "Is the Federal Reserve really necessary?" *Journal of Finance* 1964, reprinted on pp. 238-45 of L. S. Ritter *Money and Economic Activity* Houghton Mifflin: New York 1967. The quotation is from p. 243.

(25) There is a further question, not analysed in the text, about whether the expansion of the parallel money markets has not undermined the effectiveness of discount market operations. It was – at least in part – this fear which resulted in the inclusion of call money in the reserve asset ratio and the extension of the ratio to all banks in 1971. (The 28% liquidity ratio applied to the clearers, who made little use of the parallel money markets.) See J. Revell, *ibid*, p. 288, where it is stated that the 1971 arrangements "have had the effect of integrating the discount market and the parallel money markets just as they have integrated the wholesale business of deposit and secondary banks". In view of the Bank's present scepticism about the reserve asset ratio, it seems doubtful that the encouragement given to the non-clearers to place money with the discount houses was necessary to ensure official control over short-term interest rates.

(26) Cmnd. 7858, p. 13.

(27) The closest that the Bank has come to presenting an argument for more prudential supervision was in two articles in its *Quarterly Bulletin*. ("The secondary banking crisis and the Bank of England's support operations" *Bank of England Quarterly Bulletin* September 1978, pp. 383-85.) They are nevertheless disappointingly thin in formal, reasoned justification for prudential regulation. Instead they concentrate on giving a narrative account of how the Bank's supervisory procedures expanded in 1974 as a reflex response to the secondary banking crisis.

(28) To elaborate, small and untried banks involved in profitable, but marginal and perhaps dangerous, lending would seek funds from the general public rather than from bigger banks. The big banks could absorb the losses if their lending went sour and no depositor need lose. But depositors would lose if they had money with a fringe institution which went bankrupt.

(29) This practice is most common in the Eurocurrency markets. It is described on p. 226 of G. Dufey and I. H. Giddy *The International Money Market* Prentice Hall: Englewood Cliffs 1978. Dufey and Giddy remark that there may seem to be "unnecessary recycling or churning of inter-bank deposits with cosmetic rather than economic value", but continue "trading deposits may be an efficient way of trading information" and "this form of information transfer occurs at little cost to the public".

(30) C. Goodhart *Money, Information and Uncertainty* Macmillan: London 1975, p. 140.

(31) It is interesting that, since the publication of *The Measurement of Liquidity* paper, American banks have been considering a move into retail banking. Citibank is about to offer a cheque account paying interest of 13.2% on credit balances, much more than the clearers. According to *The Sunday Times*, the aim is "to siphon off a substantial amount of the clearing banks' bread and butter business". (Joe Irving "Yanks join the battle for your bank account" *The Sunday*

Times, 25th May, 1980.) Of course, to mention this development is not to suggest that it is in any way risky or unduly aggressive.

(32) J. M. Keynes *A Treatise on Money* vol. 2, pp. 48-54, in vol. 6 of D. E. Moggridge and Mrs. E. Johnson *The Collected Writings of John Maynard Keynes* Macmillan: London 1971. Publication in 1891 was initially by thirteen banks whose combined deposits were about 30% of total deposits in the country. It should be noted that, following the "lifeboat" episode, 160 or so institutions have been making quarterly balance sheet returns to the Bank of England. See "Supervision of banks and other deposit-taking institutions" *Bank of England Quarterly Bulletin* September 1978, p. 384.

(33) Some fascinating questions are raised. Banks, left to themselves, would choose to come under the umbrella of the most relaxed and least interventionist central bank. They would also prefer to conduct financial intermediation in the currency it superintends. But could a central bank provide lender-of-last-resort facilities in more than one currency in order to capture more "client" banks?

(34) The "somehow" in brackets is deliberate. Even the most fervent monetary base control advocates must accept that on occasions cash loans will be made from the central bank to the banks. The central bank *must* set interest rates, in the not so trivial sense that it must charge the same price for assistance to all institutions. If the quantity and price are fixed, the central bank must discriminate between institutions to ration out the assistance available. Aversion to such discrimination is perhaps the most fundamental reason why central bankers object to monetary base control. Under MBC, they would lack a criterion for deciding on the allocation of loans to different banks. This sort of problem may also explain the Bank of England's obvious preference for confining lender-of-last-resort help to a set of institutions, the discount houses, it knows well, rather than several hundred banks.

(35) Dr. Goodhart has shown, in a paper to the Money Study Group, that in recent years the authorities have successfully neutralised the instability of the PSBR and bank lending by varying the level of official gilt sales.

(36) Deposits over two years are, however, not categorised as eligible liabilities and therefore have no associated reserve asset costs.

(37) *The Financial Times* (9th June, 1980) carried a story that the banks were considering offering long-term savings account facilities, similar to the building societies', when the "corset" is removed. The prospective abolition of the reserve asset ratio may also have been a consideration in bank managements' minds.

(38) It is intriguing that monetarists of Chicago School lineage are generally eager to control the banking system. It is the one industry which they seem to consider inappropriate for free market treatment. This line of thought can be traced back to the 100% reserve proposal of Irving Fisher, which was supported by Friedman in his early academic career. (See M. Friedman "A monetary and fiscal framework for economic stability" *American Economic Review* 1948, pp. 245-64.)