



Ce: J. Whittingdale ✓

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

6 October 1989

P R C Gray Esq
Private Secretary to
Prime Minister
10 Downing Street
LONDON
SW1

1. DM - to see
2. CA pc.

Dear Paul

CREDIT CONTROLS IN UK AND OTHER COUNTRIES

You asked for a note on the use of credit and monetary controls in other countries following Mr Kinnock's and Mr Smith's comments that most other countries controlled lending in this way as an alternative to using interest rates.

... The attached article from the Economic Progress Report for April this year sets out what happens in various other countries in some detail. You will see that it concludes that 'most major industrial countries now rely on interest rates as the main instrument of monetary policy. Some which previously relied on direct credit controls have either dismantled them altogether or no longer make use of them.' In particular, it states that the Federal Republic of Germany has never used controls on bank lending as an instrument of monetary policy.

In discussing this subject, it is important to distinguish four different things:

- (i) direct controls on borrowing/lending either like hire purchase controls or schemes which penalise excess bank lending, for example the corset in the UK in the 1970s;
- (ii) prudential requirements which exist in all countries for example on capital adequacy; and
- (iii) the means by which different national authorities keep control over short term interest rates; in some countries



like the UK this is done by the sale and purchase of bills, in others like Germany it is done through reserve asset requirements.

One development since the article was written has been in Holland. The Dutch have recently introduced a form of credit control not dissimilar to the "corset" used in the UK until 1980. The Dutch guilder market and Dutch financial institutions are generally less well developed than in the UK and it may be that substantial leakages will take a little longer to appear than they would in the UK. But it would be surprising if they did not start to appear fairly quickly, for example in extra business channelled through London and extra domestic commercial paper issues.

... I also attach our standard briefing line. I hope this is helpful.

V.

JG.

JOHN GIEVE
Principal Private Secretary

LINE TO TAKE - CREDIT CONTROLS

Credit controls simply would not work. Government inherited a variety of controls eg corset, HP controls which were abolished as they became increasingly ineffective.

With the abolition of exchange controls (which has been wholly beneficial) it would be even easier to circumvent UK credit controls; private sector can borrow or deposit money through offshore banks and UK banks can place business through offshore subsidiaries. Also with new financial instruments such as sterling commercial paper, there are even more ways open today to avoid controls.

Credit controls not only ineffective, but they also create distortions and inefficiencies in the market which act to the disadvantage of borrowers and savers alike, and they are unfair. They give unregulated and often less reputable lenders a competitive advantage. And they mean that less well paced borrowers have to pay more and are driven to loan sharks, while respectable lenders direct cheaper credit to the safest borrowers.

Even to the extent that any scheme could be made effective, would work simply by raising the cost of credit. This can be achieved more simply and effectively by increasing interest rates.

Other major countries like the USA, Japan, Germany and France, have also abandoned any controls they had on the amount of consumer lending, recognising them to be ineffective, unfair and damaging. Like the UK, they rely on interest rates.

USEFUL QUOTE

"..Of total household debt, some 85 per cent is on mortgages. The total of credit card and hire purchase lending - the two together- amounts to only a little over 5 per cent of household debt, so it is nonsense to imply that introducing controls on hire purchase or credit cards would do any significant to reduce the growth of consumer credit, or to allow interest rates to be one whit lower. In any event any such controls would be simplicity itself to get round.

(Chancellor of the Exchequer in House of Commons debate on economy 7 June 1989 c262)

Monetary control in other countries

Most major industrial countries now rely on interest rates as the main instrument of monetary policy. Some which previously relied on direct credit controls have either dismantled them altogether or no longer make use of them. This article explains why the change of emphasis has occurred and examines some of the techniques used by central banks to influence market interest rates.

Interest rates as the instrument of monetary policy

Changes in interest rates affect spending in a number of ways. Increases raise the price of borrowing and the return on savings and so encourage people to postpone spending and save instead. In addition, higher interest rates tend to reduce the value of financial and other assets, and consequently to reduce their holder's expenditure. Higher interest rates redistribute current income from borrowers to savers. When savers have a lower propensity to spend than borrowers, this too leads to a fall in aggregate expenditure. All of these effects of increased interest rates serve to restrain expenditure. A fall in interest rates works in the opposite direction.

Problems of using direct controls

Major countries that previously relied on quantitative controls on bank and other credit have found them to have serious costs and drawbacks.

First, they are inefficient. When credit is rationed there is no mechanism to ensure that it is allocated to those who can make most use of it. Some potential borrowers who could put the funds to good and productive use will be thwarted by the controls. Others will find themselves able to borrow but then use the money to less purpose. This source of inefficiency will be reinforced by the disincentive which direct controls offer to competition within the financial institutions. If their overall level of business is restricted, financial companies have little reason to compete vigorously with each other.

At the same time, direct controls are unfair. Some people will be lucky enough to be able to borrow as much as they want. Others with an equal or better claim will find themselves excluded just because the regulations do not allow enough lending in total to meet the amounts everyone wants to borrow. This has often led to government attempts to direct credit in one direction rather than another, replacing market forces with bureaucratic decisions.

Apart from being inefficient and inequitable, direct controls were also increasingly seen to be ineffective. They can only work if they prevent willing lenders giving credit to willing borrowers – otherwise they would in any case be redundant. But in these circumstances both parties have a strong incentive to find ways to evade the control. Moreover, direct controls are likely to be costly. Administrative costs alone are appreciable and must increase if the authorities attempt to counter rising circumvention. But perhaps more important is the deadweight cost imposed by the circumvention process itself. Energies expended in that direction could certainly

be used more productively and with benefit to all concerned. Deregulation and increasing sophistication of financial markets in all major countries means evasion is much easier than it was even a few years ago.

A particularly important factor has been the increased international mobility of capital and the dismantling of exchange controls. National monetary authorities can no longer hope to isolate their financial markets from international influences. So domestic direct controls are inherently likely to fail.

Not surprisingly, in the light of all these drawbacks, direct controls have become increasingly unpopular. The next section looks at the position in major countries other than the UK. Most monetary authorities which used to rely on them have either ended them or are in the process of doing so.

Abolition of quantitative controls

Most countries in the OECD have used controls on bank lending as an instrument of monetary policy at one time or other. The main exceptions are Canada and the Federal Republic of Germany, which have never used them, and the United States, which applied them only briefly in 1980 in an effort to curb the expansion of consumer credit. Amongst the major industrial countries, Japan, France, the UK and Italy, who have all made extensive use of controls on bank lending at various times, now use interest rates as the main instrument of monetary policy.

Japan

In Japan, controls on lending by financial institutions used to be one of the most important instruments of monetary control. Under the system of 'window guidance', financial institutions eligible to borrow directly from the Bank of Japan were given guidance as to their appropriate growth of lending. The system was one of 'moral suasion'. There were no explicit penalties for institutions exceeding their guidelines, but they knew that to do so persistently could damage their relationship with the central bank.

Window guidance has not been used systematically to restrain lending since 1982. It was increasingly realised that it was only appropriate in a heavily controlled financial system, such as existed in Japan until the mid-1970s. The process of financial deregulation and innovation has had two effects. It has weakened the effectiveness of window guidance, because a major part of lending is now done outside the banking system. At the same time, it has made interest rates more effective, as much more credit is extended at market rates and less of it is rationed.

France

In France, quantitative controls on bank lending were enforced systematically from 1972 to 1984 as part of a set of more general restrictions in the banking system. The controls took the form of monthly norms for the growth of bank lending which, if exceeded, required the banks to make supplementary deposits at the Bank of France on a steeply rising scale. The system was modified over the period in which it was in force to alleviate the worst distortions arising from it. Different norms were set for different types of credit and banks were allowed to carry forward or sell to other banks unused rights to make loans.

But the system became increasingly complex to administer and also caused serious concern about adverse effects on allocation of resources. This, together with fears that Paris could be left behind as a major financial sector, led to the reform of the system in 1985 and the complete abandonment of quantitative controls from 1 January 1987.

Italy

In Italy, ceilings on bank loans remained in force, almost without interruption, from 1973 until June 1983. Initially controls were selective. They did not affect the most important projects, or foreign currency loans or loans of less than a certain amount. While there was some attempt to extend the coverage of the controls, they were never made comprehensive, so circumvention was relatively easy. The controls have been re-introduced on two separate occasions – early in 1986 and from September 1987 to March 1988 – to counter downward pressure on the lira. Used in conjunction with exchange controls, some of which remain in force in Italy, the authorities thought that direct controls had some effect.

Other countries

Among most of the smaller European countries the same trend towards abolishing controls has emerged. In the Netherlands, an informal agreement between the central bank and the banks to limit net credit creation lapsed at the end of 1987. In Luxembourg, Belgium, the Republic of Ireland and Denmark there are currently no explicit controls on credit creation, though some controls on bank lending remain in Spain, Greece and Portugal. Further afield, Australia and New Zealand have abolished a wide range of financial controls recently.

Reserve requirements

Although direct controls on credit are now the exception rather than the rule, confusion is sometimes caused by the fact that many countries impose reserve asset ratios on their banks. These are quite separate from direct controls. As explained below, their purpose is to ensure that monetary authorities can maintain control over short-term interest rates – the essential instrument of monetary policy.

Flexible pay in the civil service

Unions representing over 300,000 executive, clerical and secretarial civil servants have recently agreed long-term flexible pay agreements with the Treasury. Members of the National Union of Civil and Public Servants (NUCPS) and the Civil and Public Services Association (CPSA) have voted in favour of the deals in a series of ballots.

In the year ahead, pay increases will vary but will be contained within an overall paybill cost of 7 per cent in 1989-90, with the biggest increases going to the most experienced clerical staff and those in London.

Like previous flexible pay agreements, those with the NUCPS and CPSA have three main characteristics:—

- *flexibility* to vary pay by location and skills to meet recruitment and retention needs;
- *performance* pay related to how well an individual does the job;
- *agreed, stable, long-term* pay determination arrangements.

Taken with earlier agreements, it means that nearly all the half a million non-industrial civil servants are covered by flexible pay agreements.

Normally central banks influence interest rates generally by changing the rate of interest at which they are prepared to supply funds to the banking system. If a central bank wants to influence market rates more widely, it needs to ensure that the financial system has to borrow from it so that its own lending rate is transmitted into market rates. Reserve asset requirements facilitate this because they ensure that the commercial banks have a continuing need for reserve assets which the central bank can then supply at a price of its own choosing. Reserve assets generally consist of cash and sometimes other short-term liabilities of the monetary authorities. The following two examples show how such systems work.

US

In the United States, the commercial banks are required to hold reserves of notes and coin and deposits at the central bank against their deposits. The central bank, the Federal Reserve, can change the total amount of these reserves by buying or selling government and federal agency securities or, more often, engaging in repurchase or matched sale agreements. For example, if it wanted to raise interest rates it might sell securities. As payments are made for these securities, so the reserves of the commercial banks will fall. In order to replenish their stocks the banks will attempt to buy reserves in the market for reserves assets – the 'Fed funds' market – and in the process the Fed funds rate is bid up. An alternative source of funds for the banks is to borrow from the Federal Reserve 'discount window'. But in that case the Federal Reserve itself sets the rate at which the banks obtain funds. Although this rate, the discount rate, is usually below market rates, the Federal Reserve makes it clear that banks should not make regular and heavy use of this facility. Either way, the Federal Reserve can ensure that the cost of borrowing to the banks is raised. To maintain profit margins, the banks then have to raise their own lending rates, reducing the demand for credit.

Federal Republic of Germany

In Germany, the situation is similar to that in the US, in that the commercial banks are required to hold reserve assets against their liabilities. But differences in the market structure mean that the details of operations are different.

Normally, the banking system is short of the deposits it needs to hold with the Bundesbank as reserve assets. So it has to borrow them from the Bundesbank itself. They are usually provided by repurchase agreements ('repros') against the banks' holdings of government debt. At regular intervals, the Bundesbank offers to purchase debt from the banks temporarily, usually at rates of its choosing and the banks can use the cash they receive to meet their reserve requirement.

However, there have been occasions when the banking system has not needed to borrow from the Bundesbank. For example, when the Bundesbank has been selling deutschemarks to prevent the exchange rate rising, the reserve assets – the deutschemarks – in the financial system increase. To counter this the Bundesbank has increased the reserve asset requirements of the banks in order to reinstate the shortage and regain control of interest rates.

Reserve requirements and the UK

The main difficulty with reserve asset requirements is that they impose costs on the banking system by forcing the banks to hold low yielding assets in excess of what they require for prudential reasons to meet unexpected deposit withdrawals. Required reserve holdings as a proportion of banks' assets or liabilities vary markedly between different countries. Minimising the distortions arising argues for as low a requirement as possible.

If a country's reserve assets requirement is onerous, business may be driven elsewhere. In the UK, the only requirement, that banks hold 0.45 per cent of their eligible liabilities in the form of a non-operational balance with the Bank of England, is much smaller than other countries' reserve requirements and has no monetary policy functions. Nevertheless because the central government's short-term claims on the banking system (mainly bills held by the Bank of England) have exceeded its short-term liabilities to the banking system in recent years as a result of official operations, the banking system has generally been short of funds, which the authorities have been able to supply at a rate of their own choosing. Because of this the UK authorities have been able to maintain effective control over interest rates without a substantial reserve requirement.

Share ownership

The 1989 Budget contained a number of important measures aimed at further widening and deepening share ownership in Britain. These included changes to the personal equity plan rules; increases in the limits for employee share schemes; tax reliefs for employee share ownership plans; and changes to personal pensions. This article looks at the measures, and their likely impact. It also sets out findings of the 1989 Treasury/Stock Exchange share ownership survey.

Benefits of share ownership

Government policies have actively encouraged individual share ownership. The benefits include:

- giving individuals a personal stake in the success of British companies;
- improving incentives and industrial relations through employee share ownership;
- reducing the cost of new equity to companies, so encouraging them to expand and invest.

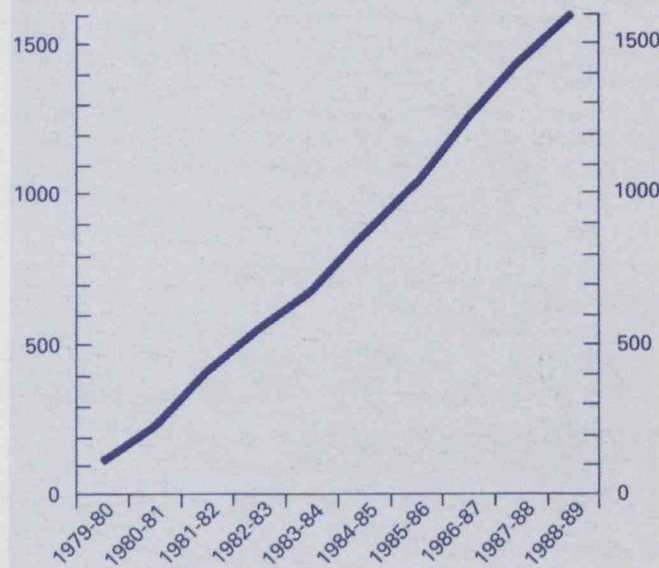
Share ownership survey

The 1989 joint Treasury/Stock Exchange share ownership survey shows that the individual investor remains firmly committed to direct investment in shares, despite the market downturn that followed the 1987 crash:

- there are now about 9 million adult share owners (about 10 million if unit trust holders are included);

Years to March

Approved all-employee share schemes



Source: Board of Inland Revenue

population than the others. Output per head of population is affected by, among other things, international variations in participation and unemployment rates, by differences in the length of the working week and by different annual holiday entitlements. The centre column of the table shows estimates of *output per person employed*. On this basis, Japan's relative position is lower and those of France and Germany higher. The right-hand column shows estimates of *output per hour worked*. On this basis the other countries' advantage relative to the UK is reduced and the UK is shown to have a significantly higher productivity level than Japan.

Table 2 shows that part of the reason why the US and Japan have a higher gross domestic product (GDP) per head of population than the UK is that they have a higher proportion of the population in employment. It also shows that in the other countries the average hours worked by employed people per year are higher than in the UK. In part this reflects the relatively higher level of part-time female employment here. Additionally, the number of hours worked per year in Japan is much higher because of smaller annual holiday entitlements and widespread Saturday working. Allowing for this, Japanese output per hour worked appears to be little more than two thirds the UK level. It is probable that a high level of productivity in Japanese manufacturing is offset by relatively low productivity in some other sectors of the economy, such as agriculture.

As the note on PPPs explains, it is much more difficult to compare productivity levels within individual sectors of economies. The comparisons that have been published suggest that the UK's relative position is, if anything, less favourable in manufacturing industry than in the economy as a whole. This matches more qualitative evi-

Readers' enquiries

Economic Progress Report is normally published every other month, and is free of charge. Copies are available from *Economic Progress Report* (Distribution), Central Office of Information (COI), Hercules Road, London SE1 7DU. Readers who receive their copies direct from COI are asked to return their address label when notifying any change of address or number of copies required. They are asked to make a special point of including their post codes. Failure to do so adds to distribution costs.

It would be appreciated if readers would also make a point of notifying COI promptly if they no longer wish to receive copies, or could manage with fewer.

Communications about the contents should be addressed to the Editor, *Economic Progress Report*, Information Division, HM Treasury, Parliament Street, London SW1P 3AG.

© Crown Copyright, 1989. Extracts may be used, except for advertising, without specific permission, provided that the source is acknowledged.

dence, from the car industry for example, which suggests that much of the UK's improvement in the 1980s has been motivated by the need to improve efficiency and so close the productivity gap between UK manufacturing plants and those overseas.

Purchasing power parities

In comparing output and productivity levels in different countries it is necessary to deflate national output measures to a common base. One possibility is to convert the various national currencies into a single currency using market exchange rates. However, it is more appropriate to use purchasing power parity (PPP) exchange rates, which equalise the purchasing power of the different currencies in their home economies. So, for example, US \$100 converted into £ sterling at a PPP exchange rate shows the sum in £ sterling that would buy the same amount of a standard basket of goods and services here as \$100 does in the United States. As any tourist knows, market exchange rates rarely coincide with PPPs – goods and services seem cheaper in some countries than in others when currency is converted at market rates.

Comparisons of output in different countries using market exchange rates will overstate output in relatively expensive countries and understate output in cheaper countries. Market exchange rates also change quickly and by large amounts for reasons which have little to do with relative price levels. As an example of the difference between market exchange rates and PPPs, at 1986 market rates Japan's GDP per head was over 60 per cent higher than the UK's, while using 1986 PPPs it was just 6 per cent higher.

Both Eurostat (for the EC) and the OECD (for the industrialised countries) regularly produce estimates of PPPs*. These are based on the prices of a large sample of goods and services in different countries. The various individual prices are combined to form an overall price for a standard basket of goods and services in each country and hence a corresponding PPP exchange rate for each currency. Unfortunately, PPPs can be quite sensitive to the weights used in combining the individual prices. The esti-

mates in this article are based on the aggregate international weights produced by the OECD.

It is difficult to repeat this sort of exercise for individual sectors of the economy – PPPs calculated using economy-wide price and expenditure data are unlikely to be appropriate at an industry level. Estimates of relative productivity levels in manufacturing have been published by various researchers using comparisons based on whole economy PPPs, proxy PPPs derived from the whole economy numbers and market exchange rates (which may be less misleading in the case of tradeable than non-tradeable output). The various methods produce a wide range of estimates. For example, productivity in German manufacturing can be 20 to 100 per cent higher than in the UK, depending on which method of comparison is used. The most careful and reliable approach is probably the 'industry-of-origin' method which essentially deflates different countries' industrial output into physical volumes and compares productivity on that basis. Needless to say this is a very time consuming process and the currently available comparisons involving the UK are now very dated.

*See, for example, T.P. Hill (1986) 'International price levels and purchasing power parities', *OECD Economic Studies* no. 6, Spring and D. Blades and D. Roberts (1987) 'A note on the new OECD benchmark purchasing power parities for 1985', *OECD Economic Studies* No. 9, Autumn.

†See, for example, Smith, Hitchens and Davies (1982) 'International industrial productivity', *National Institute of Economic and Social Research* (which uses data from the late 1960s), and Davies and Caves (1987) 'Britain's productivity gap' *National Institute of Economic and Social Research* (which uses data from the late 1970s).