

PRIME MINISTER

NEW TECHNIQUES OF MONETARY AND CREDIT CONTROL

I attach a Treasury paper on new techniques of monetary and credit control, with a covering minute from the Chancellor.

The paper covers:

- A. Measures to constrain the growth in credit.
- B. Possible new approaches to monetary control.

The section on credit is split into administrative controls and tax measures.

A. Credit: Administrative Controls

Page

Treasury have reviewed seven possible measures as follows:

- ~~and possible~~ (a) controlling the balance sheets of lending institutions; 4
- (b) credit controls e.g. on instalment periods; 6
- (c) controls on credit cards; 6
- (d) the Jack report restrictions on marketing consumer credit; 8
- (e) other measures to restrict marketing; 8
- (f) new information requirements before entering credit agreements; 10
- (g) restricting "equity withdrawal" from mortgage lending. 10

These measures can be split into three groups. The first three are designed to restrict credit by limiting the supply directly or by setting conditions on the supply of credit. Such ideas are rejected by the Chancellor as against the spirit of Government policy; they are essentially interventionist. They would also be ineffective in the longer term. The freedom in financial markets is now largely irreversible: unlike the early 1980s it would be very difficult to avoid at least the more sophisticated

seeking and obtaining credit from overseas sources.

In effect the Chancellor rejects credit controls, while acknowledging they could have a short-term impact.

Instead he focuses attention on the second group of measures (d) to (f). These do not set conditions on the supply of credit but restrict the marketing efforts of those wishing to supply credit. Specifically the Chancellor favours a high profile campaign, and the promise of early legislation,

- banning free gifts with new credit offers;
- banning unsolicited increases in credit limits;
- banning zero per cent finance devices;
- introducing more effective cooling off periods, information requirements, etc.

Such an approach has a large element of commonsense: it is likely to command wide support. An additional effect of the zero per cent finance proposal is that it would exert a useful downward impact on the RPI. How far it would genuinely restrict the demand for and thus growth in credit is unclear.

You will recall that there was particular concern over the third category (g) so-called equity withdrawal: that is the practice of obtaining a mortgage loan on the security of the property above the levels necessary for house purchase. In essence this form of borrowing offers relatively cheap consumer credit.

The Treasury analysis suggests that this is a reasonably serious problem: but that restricting such activity is fraught with difficulties. It would be interventionist. It would need to distinguish between purpose of loan and category of borrower. There would be large leakage abroad as people borrowed for mortgage money directly or indirectly overseas. And there is a danger of avoidance through so-called securitisation - the practice, as in the USA, of building societies taking the

mortgage lending off their books, packaging it and selling it as an asset to another party.

The Chancellor concludes that direct action in a unregulated financial market is not practicable.

A. Credit Growth: Tax Measures

The Treasury paper reviews:

- (a) limiting mortgage interest tax relief;
- (b) a consumer credit tax;
- (c) extending national insurance contributions (NICs) to income from subsidised mortgages.

This first group would seek to restrain the consumer demand for credit by raising its post-tax cost to the user. The second group below would attempt to restrict demand for credit by reducing the post-tax return to financial institutions.

- (d) tightening the rules for tax reliefs by disallowing relief on doubtful, as distinct from bad, debts;
- (e) as in (d) but also disallowing relief on bad non-sovereign debts;
- (f) as in (e) but also tightening on sovereign debt.

The Chancellor argues that none of the first group is particularly promising. Abolishing or restricting mortgage interest tax relief is politically unattractive. A consumer credit tax has been considered and rejected before - not least because it would raise mortgage costs and penalise UK lenders relative to their overseas competitors. Only the third - a modest measure which could be defended on grounds of equity and cleaning up the tax system - looks like a possibility. But it could not be implemented until next year.

The Chancellor also rejects any tightening up of the rules on tax for financial institutions with regard to bad debts. They are a very indirect way of attacking the growth in credit; they would probably not make much difference to lending; and they would go against the assurance given by Nigel Lawson in 1981 that there

would be no further special tax treatment of bank profits.

B. New approaches to monetary control

Monetary policy works by raising the price of credit and thus reducing the demand for credit. Policy is thus focused on interest rates, as the price of credit. Any approach to improve monetary control must either:

- make the demand for credit more responsive to a given interest rate change (very difficult to do); or
- exercise some non-price influence on supply: in short, it must ration or keep down the supply of credit without raising interest rates.

The Treasury paper considers three new approaches:

- monetary base control (control of high-powered money)
- reserve asset ratios
- over-funding.

Monetary Base Control

This works by controlling the liabilities in Central Banks' balance sheet - in particular the balances (assets) which commercial banks are required to hold with the Bank of England. The mechanisms are:

- i) measures which require commercial banks to put more of their assets with the Bank of England (thus restricting the growth in our balance sheets and hence other lending); or
- ii) measures which make the "cost" to commercial banks of these balances more expensive, e.g. by making them non-interest bearing (this tends to raise interest rates).

Three different routes are considered in the paper: mandatory monetary base control, operates by requiring banks to hold a fixed proportion of their deposits in the form of balances held

at the Bank of England. The Bank can control growth in these balances. But, in a free market, banks would seek to transfer business abroad e.g. in Euromarkets. This was what created Euromarkets in the first place. This approach is understandably rejected.

More promising is a non-mandatory route, which works by restricting the supply of high quality reserve assets to banks. But the Chancellor is not attracted to this route because the relationship between commercial bank balances at the Bank of England and the size of their balance sheets is uncertain; so is the sensitivity of these balances to changes in requirement; the possible volatility of interest rates and hence exchange rates; the loss of ultimate control (the lender of last resort facility); and the concern about circularity.

This last point seems particularly telling; the present approach to monetary policy fixes interest rates and the monetary base adjusts. Monetary base control reverses this process by fixing monetary base requirements and interest rates follow. It is not clear that on a week by week basis this would provide a better more stable path for interest rates and hence exchange rates.

Gordon Pepper's scheme is a form of non-mandatory monetary base control. As the Treasury admit, they have not got to the bottom of his analysis. He suggests that, in addition to the effects on lending through interest rates, there will be an indirect quantitative restraint on the supply of credit. The genesis of the latter is unclear (indeed he failed to satisfy a wide audience of City and other experts on this ten days ago).

#### Reserve Asset Ratios

These can be seen as a reinforcement of traditional Bank of England control. Sophisticated financial markets usually create market shortages by forced sales of debt e.g. Treasury bills; the other route is to call for compulsory deposits with the Central Bank. The only possible advantage of the latter is if it introduces some non-price rationing in the supply of credit - and there are those who believe it would do so (though it is unclear

why).

The Chancellor considers this might be if only to underline the firmness of the authority's reserve.

#### Overfunding

In present circumstances of fiscal surpluses, this means not repaying gilts or national savings as they fall due, so as to withdraw money from the banking system. Though over-funding was discredited by over use in 1985, there is considerable support in the City for managed over-funding. It would raise long term interest rates: but that may be advantageous in flattening the shape of the yield curve and discouraging various forms of round-tripping (including that indulged in by local authorities).

Accordingly the Chancellor favours a switch to a policy of modest over-funding. You may well consider this makes sense.

#### Other matters

At the previous meeting you remarked that national savings remains a useful weapon in the armoury. The Chancellor proposes new national savings instruments designed to tie up savings for a longer period. This is a sensible measure which I suggest you support.

Finally, the Chancellor suggests that the proposal from the Saatchi brothers for a Government advertising campaign to encourage savings should be rejected. Instead they should speak to banks and building societies, perhaps about a generic campaign

BHP

(BARRY H. POTTER)

18 May 1990

a: Credit (MJ)