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British Monetary Policy and the Banking System in the 1950s

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Throughout the 1950s the British government practised demand management through the banking system by issuing a series of requests that they should control the levels of credit in the economy. Such an approach to economic management can be justified on two grounds [17, pp. 157-60]. From a macroeconomic point of view, the restraints on lending can be seen as a way of controlling monetary expansion and the growth of aggregate demand while avoiding prohibitively high interest rates. At the microeconomic level, qualitative advice and guidance can be used to influence the allocation of scarce resources towards those sectors deemed to be in the best interests of the government or the economy.

The extent to which these justifications hold, however, is uncertain. The macroeconomic objectives may be quickly thwarted by the process of disintermediation; while the banks are restrained, other financial intermediaries will take advantage of lending opportunities. Secondly, the idea that the government or other monetary authority is best placed to dictate the optimal allocation of scarce resources may have some merit in a period of emergency, but to pursue such a policy over anything other than the short term will clearly have considerable secondary effects on the working of the credit market. This paper will outline the policy of credit restriction as it was imposed in Britain in the 1950s, discuss its macro- and microeconomic impact, and consider some of the implications of its use throughout the decade.

The bare outlines of British demand-management policy in the period 1945-60 are well known and documented [10]. It is also well-understood that the extent of the authorities' freedom to pursue monetary policy was constrained by the discipline of the fixed-exchange rate system [15, pp. 90-92]. The post-war Labour government relied on low interest rates to minimize debt-servicing costs and to encourage investment in what they feared would be a depressed economy. Restraint of inflation relied on a tight fiscal policy,

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budgetary surpluses, and physical controls. By the election of the Conservatives in 1951, it had become clear that the biggest threat to the economy was the external balance of payments problem coupled with domestic inflationary pressure and that, in line with other countries, the government would have to take a more active role in framing policy. The remedy adopted involved a package approach, which included the raising of short-term nominal interest rates (including Bank Rate), the discontinuance of the Bank of England's willingness to provide funds to discount houses at 1/2 per cent (which had acted as a freely-available supply of cash to the economy), a funding operation, and the imposition of controls on hire-purchase.

Official guidelines on the need to restrain bank lending to "essential" purposes had been in force since the outbreak of war in 1939 and the need to impose ceilings on advances had been discussed in the Treasury in 1948-9 but had been rejected by the Bank of England [3]. The policy of the new government, however, involved a greater reliance on both the stringency of the Capital Issues Committee (which had power of sanction or refusal over proposals to raise capital through an issue of new securities) and on the government's advice to the banks regarding the nature and extent of their lending.

The inflationary crisis associated with the Korean War abated from the third quarter of 1952, a more relaxed attitude towards restriction and demand restraint prevailed and interest rates were reduced. In the latter half of 1954, however, the external situation once again began to deteriorate and domestic inflationary pressure mounted. In January 1955 a further package of restraint, including both orthodox monetary measures and the qualitative guidance to the banks, was imposed. These, however, failed to check the rise in bank advances, which the authorities had come to regard as the prime engine of domestic inflation, and in July 1955 the Chancellor made an explicit statement of the need for the banks to "reduce the amount of credit below what they would be glad to give in less difficult times" [19].

In February 1956, Bank Rate was further raised to 5.5 per cent, hire purchase restrictions were tightened, public expenditure economies were announced and the Chancellor appealed for continuous efforts from the banks to hold advances down. This appeal was reinforced in July. Pressure on the domestic economy was kept up and by the beginning of 1957 some success was being achieved, although this was reversed by the Balance of Payments crisis in the summer of that year. Bank Rate was raised to 7 per cent, public investment further reduced and quantitative restrictions were imposed on bank lending for the first time, the banks being instructed to hold advances to the level of the preceding twelve months.

In July 1958, the Chancellor announced relaxation of the restrictions on bank advances, instructions to the Capital Issues Committee were also relaxed, and in 1959 the restraints on hire purchase operations were finally removed.

Figure 1 shows the path of total classified advances by members of the British Bankers Association over the period 1946-1959. This graph indicates that some success was achieved in reducing, or at least holding steady, bank advances in the years of greatest restriction. The steadily rising graph in the early post-war years (to 1951) appears to have been checked by the antiinflationary measures taken in 1951. The series of advances then recovers through 1953 and 1954, only to be sharply pegged back once more in 1955. The package introduced in September 1957 appears also to have had a restraining effect and the raising of restrictions in 1958 is reflected in a strong growth of advances.

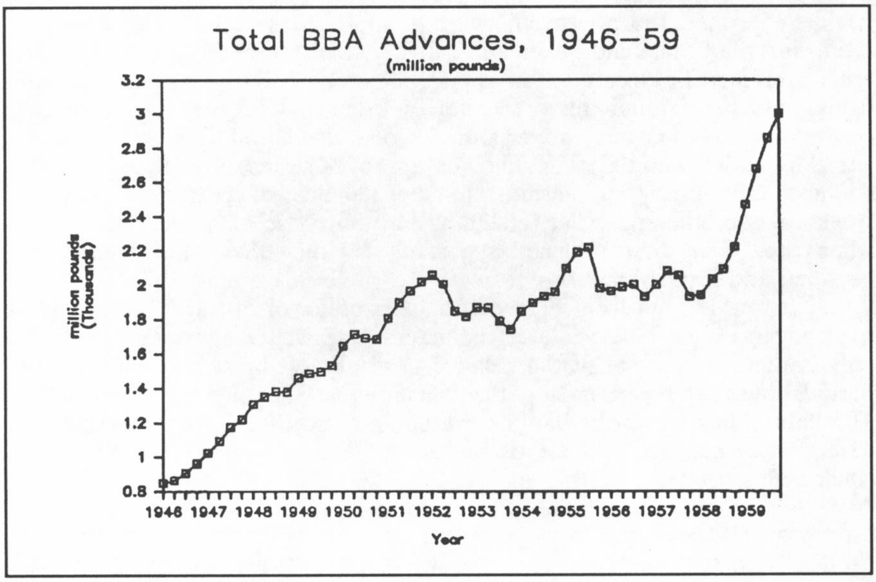

Figure 1

The basic problem in the approach adopted by the authorities, however, is that monetary policy, and especially bank advance restriction, is essentially a blunt weapon. In a situation where the balance of payments considerations were paramount, the fundamental conflict between the need to target the credit restrictions against specific sectors and encourage others, and the political impossibility of instructing the banks in such a manner, was a recurrent frustration for successive Chancellors of the Exchequer. The official guidance to the banks, therefore, had to include some indication of the government's priorities. Domestic inflationary pressure was to be avoided, lending to hire purchase companies, for inventory investment, to retail and distribution companies and to finance companies was frowned upon. On the other hand, alleviation of the balance of payments problem was a pressing need, so investment in and lending to those industries which could contribute to exports, import substitution or industrial growth were to be encouraged. These priorities -- the establishment of approved and non-approved sectors -- remained fairly constant throughout the 1950s (although defence production was briefly top of the priority list in 1951) and they were imposed, as outlined above, with varying degrees of urgency.

The success of this microeconomic goal of diverting scarce resources into identified priority sectors is difficult to measure. Most borrowers could easily make a case for accommodation on the grounds that they were either saving imports or boosting exports, and it was extremely difficult for the banks to identify clearly the distinction between the domestic and the export economy. A rough picture of the movements in lending can, however, be gained from analysis of the returns of the British Bankers Association. Figure 2 shows the percentages of total lending which were accounted for by what could be termed the approved and non-approved sectors. The approved group included those industries and activities that the authorities felt should receive preferential treatment in applications for advances -- agriculture and fishing, manufacturing industry (chemicals, iron and steel, non-ferrous metals, cotton, wool, leather and rubber and the food, drink and tobacco industries) and shipbuilding and shipping. The non-approved series shows those activities deemed inflationary or harmful to the balance of payments -- retail, stockbrokers, other financial (including hire purchase companies from 1954 when they were first returned separately by the BBA) and lending for personal and professional businesses.

It can be seen from Figure 2 that the policy of selective restriction of bank advances may have achieved the outcome desired by the authorities. Not only is there a reversal of the relative positions of the two series over the period, but the shifts are most noticeable in the periods of greatest restriction. The data indicate that the banks were being responsive to the government's wishes and requests, at least as far as the direction of their lending was concerned.

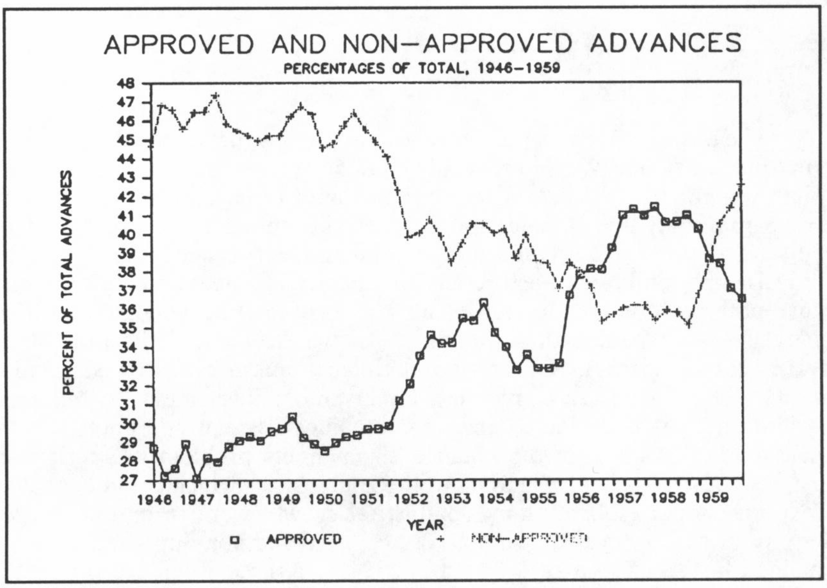

Figure 2

Further data on the the credit squeeze can be found in the evidence of the Association of British Chambers of Commerce to the Radcliffe Committee. They circularised their members about the impact of the credit-squeeze and tabulated the results for presentation to the Committee. Table 1 presents a summary of the replies from 3404 companies.

Table 1. Effects of Restriction on Bank Borrowing, 1957 (Numbers of Firms)

	Yes	No	N/A	%Yes
Asked to reduce overdraft	437	2193	774	13
Had overdraft limit reduced	396	2215	793	12
Tried to reduce overdraft because of increased costs	1036	1509	865	30
Borrowing requirements met	1258	890	1256	37

Source: Association of British Chambers of Commerce; evidence to Radcliffe Ctte, vol. 2, p. 93.

This table, it should be pointed out, refers only to the period after the introduction of intensified restrictions in 1957. It indicates, however, that even after credit restraint had been in operation for a number of years, the squeeze made only a limited impression on firms' ability to borrow from their bankers.

Table 2 provides a slightly more detailed analysis of the squeze.

Table 2. Summary of Replies from the ABCC Survey, 1957 (% of Replies Indicating Agreement)

	Industrial Group					
	Tot	A	B	C	D	E
Turnover reduced	53	47	66	66	39	58
Stocks or work reduced	37	37	43	28	41	39
Fixed investment reduced	24	28	25	22	18	30
Fixed investment postponed	32	36	33	32	24	41
Asked to reduce overdraft	13	11	13	12	16	14
Had overdraft limits reduced	12	9	12	12	15	12
Tried to reduce overdraft	30	25	32	28	28	31

Key: Industrial Groups A - metals and engineering; B - Textiles; C - Other manufacturing; D - Retail and Wholesale; E - Other services. Source: Association of British Chambers of Commerce, evidence to Radcliffe Committee, volume 2, p. 92.

A number of issues are raised by this table. First, it is clear that the most favoured sector, that represented by industrial group A, fared better than the other groups in the allocation of credit, although, again, this table refers only to the impact of the credit squeeze after 1957, and so the differential impact of the restrictions will be less pronounced than in the earlier period. Nevertheless, the table supports, on the whole, the observation that the banks were receptive to the wishes of the government and that they channelled their lending in the appropriate directions.

The second point of interest in Table 2 is the small percentage of firms in all industries which either had their overdraft limits reduced or were asked to restrain their actual level of borrowing. This can be explained by a number of factors. The long term relationship which most banks had with their industrial customers meant that they would refrain, as far as possible, from forcing reductions on their accounts. This attitude did not apply, however, to new applicants and it is in this sector that the credit squeeze had greatest impact. In the Midland Bank the proportion of all sanctioned overdrafts accounted for by new and increased loans fell from 43% in the second quarter of 1955 to 26% in the third quarter and 17% in the fourth. It should also be noted that the number of applications for overdrafts fell significantly over the period of the squeeze. Table 3 illustrates this for one bank.

Table 3. Applications for Facilities Received by Lloyds Bank, 1953-55

	Jan-June	July-Dec
1953	22 718	22 254
1954	22 763	22 981
1955	22 340	18 298

Source: Lloyds Bank Archives, Winton Files, Advances.

This pattern of a reduction in applications for loans was felt throughout the banking sector, and the Chairmen of the clearing banks all reported a decline in the period immediately after the July 1955 measures, the feeling being that "it is no good asking for them" [8].

The third explanation for the small numbers of firms that had their overdrafts reduced lies in the attempts of the banks to protect their liquidity ratios. From January 1955 they tried to circumvent the orthodox squeeze on their balance sheets by selling investments. Lloyds Bank, in particular, was fairly open about the fact that they had staved off contraction as long as possible by selling their assets. Their reasoning was that they suffered less by selling capital assets at a loss in the glutted market than they gained by taking on profitable new business [20].

The third important issue to emerge from Table 2 is the impact that the restrictions had on current and future expenditure. The reductions in the levels of turnover and stocks are an indication that the squeeze had some success if for no other reason than its cumulative impact. The differential nature of this impact is important. Industrial group D, which was one of the prime targets of the squeeze, appears to have suffered least in terms of both current business and investment plans (while, as was the aim of the policy, reducing their stocks). This observation is indicative of the general perception that the credit squeeze had very little impact on the level of domestic demand. The Radcliffe Committee noted that after the 1955 measures, the external situation began to improve in early 1956, "but at home demand continued to press against the limits of capacity" [25].

The impact of the credit squeeze on future investment plans is, however, of considerable importance since it is here that the impact of long-term government interference in the allocation of resources can be seen. The major effect of the credit restrictions throughout the period was to introduce a high degree of uncertainty into the relationship between banker and customer. While little impact was made on domestic inflationary pressure or on levels of current demand in the economy, the credit squeeze, by reducing the banks' freedom to grant new loans, greatly increased uncertainty in the lending market. The ABCC argued that "doubts as to the availability of bank credit have led to the abandonment of schemes for capital extensions" [2]. Most companies were able to divert all their sources of internal funding to the maintenance of current operations, while doubts about the future and continued availability of external funds forced them to postpone long-term investment plans. The damage done to the bank-customer relationship in this period (as well as to the investment performance of British industry) must have been considerable.

There are other factors which contributed to the maintenance of current levels of expenditure during the squeeze. The first was the high level of liquidity which many companies were able to take advantage of. The Treasury, in its submission to Radcliffe, argued that;

> the liquidity of business was so great as to make it almost impervious for a time to the credit squeeze. The financial position of business enterprises weakened in 1955, but only from a position of great strength [18].

The second explanation for the failure of the squeeze to achieve its macroeconomic objective lies in the process of disintermediation. Restriction of bank advances meant that there existed considerable potential for other institutions to move into the market for the provision of funds. This was one of the main findings of the Radcliffe Report; "it is clear that the effects of the squeeze on actual spending have been weakened by the opportunities for resort to alternative sources of credit" [24]. This was the major conceptual flaw in the reliance on bank advances restriction as a policy instrument. Not only were the banks only one part of a fairly unitary credit market, but there were many institutions seeking to enter that market and take advantage of the artificial hindrances imposed on the banking system [12]. On this point, the Committee noted;

> The joint-stock banks are obviously the dominant source of short-term finance, and the insurance companies, pension funds and building societies, of long-term finance. But...there is no firm line of division, as is sometimes supposed to exist, between the market for credit and the market for capital...Pressure in one part of the market soon makes itself felt in other parts [23].

The Federation of British Industries agreed that the effect of the squeeze was blunted by the possibility of recourse to other sources of borrowing, which were both less conservative in their lending and less subject to directives than were the banks [1,16].

The authorities, then, held a very narrow view of the operation of the monetary system, rather than a wider definition of money supply. The single example of this kind of wider view came in February 1956, when the Governor spelled out the implications of the credit squeeze for insurance companies' investment decisions [6]. This was greatly welcomed by the banks, who had "long been very much irritated" by the differentially benign effects of the squeeze on insurance companies [7].

The conclusion appears to be, then, that the banks, under pressure from the authorities, did what they could in order to comply with the requests and restrictions. The macroeconomic impact of the credit squeeze, however, was blunted by the ease with which most firms could turn to other sources of funds for working capital, and the extent to which trade and inter-firm credit could be stretched. The microeconomic impact of the credit allocation nature of the policy was to disrupt the relations between bankers and their customers by introducing considerable uncertainty and doubt into the lending process.

The credit squueze also had a considerable impact on the banks themselves, evidence of which can be found in their response to the restrictions. It was noted above that, in order to maintain their levels of advances, the banks took to selling off their investments. This was an individual response, but at the aggregate level the policy hindered competition between the banks. At the end of 1949, under some pressure from the Labour government, the banks agreed to limit competition, adopting a 'self-denying ordinance', under the terms of which they

> agreed that no clearing bank will take an account from another clearing bank involving loan or overdraft facilities solely because such accommodation has been refused by that other bank in compliance with the directive of the Chancellor of the Exchequer [4].

This ordinance was effective until the raising of restrictions in 1958. Although accepted as necessary in the conditions of the credit squeeze, the restriction of competition between the banks was extremely unpopular. The view from the Bank of England was that the credit squeeze had a detrimental impact on the efficiency of the banking system, and on the relations between banks and their customers "so long as it entails requests and agreements not to compete" [5]. The attitude of the bankers was made clear shortly before the imposition of the 1957 squeeze.

> It was unanimously agreed that banking as a whole suffers when the element of healthy competition is withdrawn. Initiative and enterprise become stifled, and relations between banks and their customers suffer...the removal of the ordinance, though desirable, would lead to increased demand for bank advances and the committee cannot recommend that it be dispensed with [14].

The bankers' demonstrated propensity for cartelisation may have led them to view this ordinance with some equanimity, but the agreement not to compete for advances business meant that there was little to be gained from aggressively seeking out more deposits [21, p. 55; 26, p. 147]. This contributed to the poor showing of the banks in this period, which is revealed in Table 4.

Table 4. Three Main Institutions' Percentage of Total Financial Assets

	Banks and Discount Cos.	Insurance Companies	Building Societies
1950	42.3	16.7	6.2
1951	41.3	17.6	6.7
1952	41.0	18.3	7.1
1953	40.8	19.0	7.6
1954	40.6	19.5	8.2
1955	38.2	21.0	9.0
1956	37.0	22.0	9.4
1957	36.9	22.7	9.8
1958	36.3	23.1	10.1
1959	36.0	23.4	10.4

Source: D.K. Sheppard, *The Growth and Role of UK Financial Institutions, 1880-1962* (London, 1971) Table 1.1, p 3.

These data indicate that the banking system was under retreat in the period under discussion. While a monocausal explanation for this is not feasible, it seems likely that the restrictions placed on the banks throughout the post -- war years contributed to the weakness of their position. The banking system was affected by the credit squeeze in a way that other financial institutions were not -- not subject to the same level of control and restriction as were the banks, these other institutions made considerable gains at their expense. The second way in which the credit restrictions affected the banks was by making it extremely difficult for them to exploit new forms of business. Hire purchase and personal loan schemes were both considered in 1956-7, but had to wait until the removal of the controls in 1958 [13].

The long-term restrictions on the functions and alternative avenues of competition which were imposed on the banks encouraged apathy and blunted the sharpness of British banks' entrepreneurial and inventive thinking. American banks were able to make considerable inroads into UK corporate finance in the 1960s by carrying out aggressive marketing campaigns and helping their clients over the information hurdle. Considering the cartelised and uncompetitive nature of the British banking system in the 1950s and 1960s, one historian has noted "In large measure the responsibility lay with the authorities" [11, p. 41].

The conclusion regarding the role and impact of the particular form of demand management policy which the British authorities pursued in the 1950s must be that it was a failure. The inability of the government to recognise that bank advances were only one aspect of the supply of credit, together with the opportunities for disintermediation which it created, seriously hampered its macroeconomic impact on domestic demand in the economy. The way in which the policy was pursued, however, had serious repercussions for the banks themselves. The controls on bank lending introduced uncertainty into the relationship between banker and customer, and encouraged the latter to seek funding elsewhere. The policy also greatly reduced the banks' ability to compete for new advances and deposits business and this, by blunting their entrepreneurial spirit, had a detrimental effect on their ability to respond to the challenge from overseas banks in the 1960s. The Chancellor, in the formal raising of the bank advances restrictions, accepted the view that "the official requests hamper the efficient working of the monetary system" [9]. It seems that in particular, by using the banks as a tool of policy, it was their efficient working that was most hampered.

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