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Variable Requirements for Special Deposits With the Bank of England by British Banks

A. B. Hersey

During the past three and a half years -- the period from early 1955, when boom conditions were beginning to develop in most of the industrial countries of the world, up to mid-1958, when inflationary pressures had subsided or been subdued -- the aim of central banking policy in Great Britain as in many other countries was to restrain credit expansion. The ultimate goals in Britain were to maintain equilibrium in the external balance of payments, and to check the development of a slowly creeping inflation of prices which, if not checked, would have eroded confidence at home and abroad in the stability of the pound sterling. The tools on which the Bank of England chiefly relied were three: increases in Bank rate; the placing of ceilings on bank advances; and open market operations of the "funding" variety, designed to reduce the volume of the Government's floating debt in the hands of the banks. Also, from the beginning of this period onwards, reliance was put on a rule adhered to by the London clearing banks that they would not allow their liquid asset holdings to fall below 30 per cent of their total deposits.

At the beginning of July, it was announced in London that quantitative ceilings on bank advances, such as have been in effect for the London clearing banks since 1955, would be terminated at the end of this month in view of the lessening of inflationary pressures. At the same time, the Bank of England announced that a new tool of general credit policy may be employed in the future when credit restraint again becomes necessary. The London clearing banks and the Scottish banks (i.e., virtually all domestic banks in the United Kingdom) may in the future be required to make special deposits at the Bank of England.

These special deposits would bear interest based on the Treasury bill rate. They would apparently have a uniform relationship to deposits within each class of banks, and monthly adjustments in the amounts would be made to maintain the relationship prescribed at the time. The deposits would not be considered as liquid assets for the

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purpose of satisfying conventional requirements regarding minimum holdings of liquid assets in relation to deposits. It was explicitly stated by the Bank of England that these conventional requirements would continue to be observed. 1/

In its essence this new device of calling for special deposits, taken together with the long-standing 8 per cent cash reserve convention, might be said to constitute a variable cash reserve requirement. But to understand how this mechanism would work in Britain it is necessary to see its relation to the other existing convention with regard to reserve assets, namely the convention that the banks' total short-term liquid assets (including cash reserves and also Treasury bills and certain other short-term liquid earning assets) should be equal to at least 30 per cent of their deposits at the seasonal low point each year.

1/ The central part of the text of the letter of July 3, 1958, from the Governor of the Bank of England to the Chancellor of the Exchequer is as follows.

"When it appeared necessary, in support of other monetary measures, to restrict the liquidity of the banking system and thus the ability of the banks to extend credit, the Bank of England would call for special deposits to be made with them by the banks. Such deposits would carry interest based on the current Treasury Bill rate. They would not qualify for inclusion in the banks' liquid assets. There would be provision for partial release by agreement with the Bank of England when justified by special considerations.

"The banks would continue to maintain their usual minimum ratios between liquid assets and total deposits.

"Calls would be made on each group of banks separately, the amount being related to the total gross deposits of each group at a specified date with monthly adjustments to take account of variations in the deposits of each bank. The ratio of a call to total deposits would not necessarily be the same for each group.

"Initially the scheme is being discussed with the Clearing and Scottish banks, but it might later be more widely applied in the light of experience.

"The scheme would serve to reinforce the existing monetary instruments and would be employed as a general control of credit in the same way and after the same sort of consideration as Bank Rate."

The following discussion takes up in succession three types of situations in which the new mechanism of action might be used. The first case is of purely "defensive" action by the central bank to forestall an unwanted increase in bank liquidity from a favorable external balance of payments. The second case is of action to minimize the expansionary consequences of bank financing of a Government deficit. The third is of "offensive" action to reduce bank liquidity in order to restrain or halt an expansion of bank loans.

1. Forestalling an increase in bank liquidity from a favorable external balance of payments

It will be useful first to review present practices for dealing with the effects of a rise in the gold reserves, and to contrast the final effects with those achieved in the United States.

Under present practices, when gold and foreign exchange reserves are rising, the Exchange Equalization Account (the owner of those reserves) sells bills to the market -- or to the Bank, replacing bills the Bank sells to the market; or to the Exchequer, which in turn offers additional bills to the market at the weekly tender. Whatever the precise procedure, the market has to absorb additional bills equal to the increase in official gold and foreign exchange holdings. Similarly, if a favorable balance of payments is producing a decline in sterling liabilities (in the form of U.K. Treasury bills held by central banks in the Commonwealth or in foreign countries), the domestic segment of the market has to absorb the bills given up by those holders. In either case, the market's purchases of bills produce drains on the banks' cash reserves 1/ that offset the accretions to those reserves caused by official purchases of foreign exchange (or caused by net sterling expenditures in Britain by residents of other countries who are purchasing sterling from their own central banks).

Thus, under present practices, the banks' cash reserves are not increased by a favorable balance of payments. This result is precisely the same as is obtained in the United States if the Federal Reserve makes open market sales to offset the effect on member bank free reserves of Treasury gold purchases.

1/ Their balances at the Bank of England together with their holdings of currency and coin.

In the United States that is generally all there is to it. The loan-and-investment policies of member banks are influenced by their free reserve position (excess reserves less borrowings from the Federal Reserve), and by their loan-to-deposit ratios or other broad indicators of their liquidity position, but only incidentally by their short-term liquid earning assets position. As a rule, the short-term liquid earning assets position of a member bank tends to vary in the same direction as its free reserve position, playing the buffer role of a secondary reserve. Total member bank holdings of Treasury bills, though much larger than their excess reserves, are considerably smaller than their required reserves. If a bank is gaining reserves, it tends sooner or later to expand its loans and investments other than Treasury bills; in the process there may be an expansion of bill holdings too, but the level of bill holdings is rarely a basic determinant of bank asset expansion. (An inadequate market supply of bills available to banks may at times have retarded expansion, but the opposite case of superabundant bill holdings leading to loan expansion in the absence of free reserves has been unknown in this country.) So, when the Federal Reserve keeps member bank free reserves from increasing at a time of surplus in the U.S. balance of payments, that is all it needs to do to prevent credit expansion based on a gold inflow.

In England, the problem is more complicated because the main determinant of the banks' loan-and-investment policies is not their cash reserve position but their short-term liquid earning assets position. While the mechanisms described above do facilitate the maintenance of a no-excess-cash-reserves position at a time of surplus in the external balance of payments, they do not guarantee the avoidance of a significant increase in bank liquidity that could lead in turn to expansion of bank loans and holdings of securities other than bills.

In fact, the banks have sometimes absorbed directly or indirectly (i.e., through their liquid short-term loans to discount houses) a large part of the additional supply of bills generated when the balance of payments has been favorable. Why this tends to happen is a complicated matter, and could be analyzed at length. On a superficial level of analysis, the key factor is the ability of the discount houses to obtain large amounts of credit from the clearing banks and the Bank of England. But the arrangements and practices that make this possible would not have persisted up to this time had it not been for two other basic circumstances. The first of these circumstances is the

chronic over-supply of Treasury bills, which makes it a matter of chronic concern to the Bank of England that the weekly bill tender be successfully absorbed by the market (even if by the discount houses and clearing banks) in order to avoid direct central bank lending to the Treasury. The second of these circumstances is the highly integrated structure of the British banking system, which makes the banks and discount houses keenly aware that nothing but Bank of England action (either loans to discount houses or purchases of bills) can quickly relieve a general shortage in the banks' cash reserves, and, by the same token, keenly aware that individually or collectively they cannot themselves quickly adjust from a position of generally insufficient cash reserves by shifting their bill holdings to bank depositors.

Thus the arrangements and practices of the London money market are such as to encourage absorption by the banks and discount houses of any marginal addition to the bill issue, and not to encourage its diffusion into the hands of bank depositors. The banks are able to keep their cash reserves very close to the conventional standard of 8 per cent of deposits even when they are absorbing a marginal addition to the Treasury bill issue (and thereby are increasing the deposits on which their reserve requirements are based), because the Bank of England can not risk the consequences for Treasury finance of subjecting the discount houses to the severe pressure that would be involved in refusing to supply a marginal amount of reserve funds either through loans to the discount houses at rates they could afford or through small marginal purchases of Treasury bills. For the same reason, once the banks have gained short-term liquid earning assets that bring their total liquid assets above the conventional requirements, their tendency to expand loans and investments proportionally can not easily be resisted by action attempting to hold down their cash reserves.

The consequence is that the banks, having neither excess cash reserves of any significant magnitude nor liabilities to the central bank, do not regard their cash reserve position as a determinant of their loan-and-investment policies, but (in the absence of quantitative ceilings on advances such as those that were in force from July 1955 to July 1958) feel limited only when there is tightness in their <u>short-term liquid earning assets</u> position.

Thus, at a time of surplus in the external balance of payments (other things being equal) they are able to expand their short-term liquid

earning assets because the supply of Treasury bills has been expanded, and this tends to lead to proportional expansion of their loans and holdings of securities other than Treasury bills.

In this type of situation the new mechanism of requiring deposits at the Bank of England has the important virtue that its use would allow the Bank of England to hold down not only the ordinary cash reserves to their usual 8 per cent, but also the banks' short-term liquid earning assets to whatever level it wished. The Bank of England itself would be able to absorb all the extra Treasury bills coming from the Exchange Equalization Account (or from Commonwealth and foreign central banks), and would be able to require the banks to transfer to the new special deposit accounts, without obtaining any Treasury bills in return, the entire increment of reserve funds created by central bank financing of the external surplus.

2. Minimizing the expansionary consequences of bank financing of a Government deficit

It is a general rule that government expenditures produce increases in commercial bank cash reserves only when they are financed by central bank lending to the Government. But in England, even when government expenditures are not financed in this way, if they are financed by enlarging the bill issue the result is likely to be an increase in the banks' short-term liquid earning assets. This in turn, as we have seen in connection with the external balance of payments, is likely to lead (in the absence of ceilings on loans) to proportional expansion of bank loans and holdings of securities other than Treasury bills. This is one reason why great emphasis has been put in British financial policy in recent years on funding the government debt and on avoiding expansion of the bill issue for financing government expenditures.

In the future, whenever it proves impossible to cover increased government expenditures immediately by taxation or sale of bonds, the new mechanism of action would permit the Bank of England to increase its own holdings of Treasury bills without adding to the cash reserves of the banks. By averting in this way an expansion of the market supply of bills beyond amounts that bank depositors would readily absorb, the authorities would be able to avert an expansion of the banks' short-term liquid earning assets.

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Conceivably this use of the new mechanism of action might be applicable even to seasonal deficits. (We have seen no mention of this possibility, and it is therefore possible that the following analysis has no immediate practical applicability.)

The yearly swing from surplus in the Exchequer accounts in February and March to deficit during the rest of the year is quite wide in England, and produces wider swings in bank assets and liabilities than occur in the United States. In the United States, the Treasury's seasonal deficit is financed partly by drawing down Treasury deposits at commercial banks and to some extent also by timing the issue and redemption of various types of securities in such a way as to get maximum holdings of government securities by bank depositors during the seasons of deficit. In England, a very large part of the seasonal deficit is financed with Treasury bills absorbed by the banks (and discount houses).

Because the banks know that their extra holdings of bills in the summer, autumn and early winter will be retired with the proceeds of taxation in February and March, the standard by which they measure the adequacy of their liquid assets varies with the season of the year. This use of a variable standard ought to minimize the expansionary consequences of bank financing of the seasonal deficit. Nevertheless, it is uncertain whether in fact the banks would not tend to be easier in their loan and investment policies during the easy season (if not constrained by a ceiling on their loans). The "30 per cent" liquid asset convention has never been numerically defined so far as we know except as a minimum of 30 per cent once a year at the tight season. Even if the banks were to observe the convention strictly once a year, loose observance of this "30 per cent plus" at other times of the year might contribute on balance to cumulative inflationary tendencies. It might therefore become desirable to moderate the seasonal swing in liquid assets and deposits.

If the seasonal swing in bank assets and liabilities can not be moderated in other ways, conceivably the new mechanism of central banking action might be useable for that purpose.

3. Reducing bank liquidity in order to restrain or halt an expansion of bank loans

In the past several years, the tool for restraining or halting expansion of bank loans has been the blunt tool of an absolute quantitative

ceiling on bank advances. This is now being given up. During the first half of this year, however, the banks' liquid asset ratio was brought down steadily until in May and June, allowing for seasonality, it was only about two points above the "30 per cent plus" standard. 1/ Deliberate use of this minimum standard as a means of controlling an expansion of bank credit now opens up as a possibility.

A real test of the solidity of the liquid asset convention as a fulcrum on which to exert the leverage of a policy of credit restraint will of course not be possible until the next time policy shifts from ease to restraint. But before the announcement of the new mechanism of action it was not even clear what force could be applied to exert leverage on this fulcrum. In published discussions of credit restraint, it has been generally assumed that pressure can often be exerted by funding policy (i.e., by sales of bonds by the Treasury or Bank of England to reduce the amount of Treasury bills available to the market), but it has also been widely recognized that successful funding can not be commanded at will irrespective of the state of expectations existing in the market.

Funding policy, helped tremendously by Bank rate at 7 per cent and the changes in expectations that that brought about, deserves the credit for keeping the clearing banks' liquid asset ratio from rising any more than it did after September last year when the balance of payments tended to add to the market supply of bills. And funding operations, involving Bank of England actions as well as those of the Treasury, have this year reduced more than seasonally the amount of Treasury bills available to the banks. But it is hardly to be hoped that success in curtailing the supply of Treasury bills available to banks can be quickly achieved by this means every time in the future when restraint on bank credit expansion may be needed.

1/ The aggregate ratio for the London clearing banks on June 30, 1957, was 33.4 per cent, as compared with a seasonal minimum standard of something like 31 per cent. At the end of December it was 38.4 per cent, having increased somewhat more than seasonally,but at the third Wednesday of March 1958, it was down seasonally to 33.9 per cent, against the conventional minimum of 30 per cent. In April and May, when the usual seasonal tendency is for an increase, it fell further, to 32.4 per cent on the third Wednesday of May. On June 30, 1958, it was 32.8 per cent.

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The new mechanism of action supplies a tool that certainly can exert pressure, whatever its defects may be. So long as the banks adhere to the "30 per cent plus" liquid asset convention, it will be possible for the Bank of England to put restraint on bank credit expansion by forcing the banks down to, or near to, the minimum ratio through calling on them to make special deposits at the Bank. (Obviously these deposits must not count as "liquid assets" so far as the "30 per cent plus" convention is concerned; the official announcement makes a special point of this.) In order to make the deposits, the banks will have to shift to the Bank of England a corresponding amount of Treasury bills, and that will leave them with a reduced liquid asset ratio.

If the ratios of some or all of the banks are pushed below "30 per cent plus," the banks will have to dispose of investments. If the Bank of England then abstains from buying securities other than bills, severe pressure will be put on the banks and on the securities markets until absorption of securities by bank depositors has been enough to restore "30 per cent plus" liquid assets via deposit shrinkage. Clearly, the new mechanism if used in a vigorous way could be very powerful.

The new mechanism may appear to be not only a powerful but also a blunt instrument. Clearly it would not be used every day or every week to iron out minor fluctuations in the banks' excess liquidity. Even for less frequent use, it seems likely that the Bank of England would prefer the more sophisticated and impersonal tool of open market operations of the "funding" variety -- that is to say, sales of bonds to the general market offset by purchases of bills from the banks and discount houses -- which, if bond sales were going well, would equally well deprive the banks of liquid short-term earning assets. It may be that the mere knowledge of the Bank of England's power to use the new tool would have a significant effect in restraining bank credit expansion, causing the banks (which are few in number) to try to maintain a surplus of liquid assets beyond their "30 per cent plus" conventional requirement in order to have a cushion to absorb the shock of a call for increased special deposits.

One sentence in the official announcement suggests an element of flexibility in the new mechanism, and may be of considerable significance. "There would be provision for partial release [of special deposits] by agreement with the Bank of England when justified by special considerations." In the context, this sentence appears to

refer to releases for individual banks that might be temporarily short of liquid assets. No authoritative interpretation of the statement is available, but it seems reasonable to think that this may mean something akin to the Federal Reserve arrangements for member bank borrowing. A London bank excused temporarily from maintaining its prescribed amount of special deposits would thereby be enabled to meet its "30 per cent plus" requirement, just as a member bank borrowing temporarily is enabled to meet its reserve requirement; presumably the London bank, just like a member bank, would remain under some moral and administrative pressure to adjust its position.

Clearly this means that attention has been given to the problem of how to avoid excessively blunt use of the new tool. However, the potential significance of this new adjustment mechanism may be even broader. If and when special deposits are once brought into being, the adjustment mechanism would apparently be available for use not only in connection with further calls for additional deposits, but also whenever for any reason a bank suffered drains on its liquid assets that threatened to put it below the "30 per cent plus" line in its next monthly statement. 1/ Thus for the first time in many years there would exist in London an "elastic" adjustment mechanism enabling a bank to avoid drastic sudden adjustments in its investments and loans, but nevertheless exerting continuous pressure on the bank to carry out adjustments so long as its liquidity position remained impaired. At present, arrangements do exist for relieving strains on the London banks' cash reserves, through Bank of England loans to discount houses. These arrangements, however, do not provide an "elastic" cushion with respect to the cash ratio because the banks are never forced to go into debt themselves; and they provide no cushion at all with respect to the liquid asset ratio because banks, in forcing the discount houses to obtain cash for them from the Bank of England, have to give up a corresponding amount of call loans.

The "30 per cent plus" convention furnishes the indispensable fulcrum on which any policy of credit restraint in England must depend, whether leverage is applied through funding operations or by the new tool of calls for special deposits. Two important questions about

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1/ It is not known whether the monthly adjustments of special deposits for changes in deposits would occur at the same time as the monthly publication of bank statements. The words of the announcement do not suggest that any monthly averaging is contemplated.

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this convention still have to be asked. Only future experience can give the answers. First, if funding policy in the future should turn out to be more successful than short-run monetary policy required (exerting perhaps very severe pressure on bank liquidity), would the fiscal and long-run monetary aim of drastically reducing the floating debt be given up, or would the 30 per cent standard be revised downward to make a new minimum of say, 25 per cent (or some day even 20, or 15, or 10 per cent), so as to avoid restraint when restraint were not desired? Second, whether or not the supply of Treasury bills (and call loans) available to the banks should in the future still tend to exceed 30 per cent of their deposits, if it should be pulled down to 30 per cent or below by Bank of England deposit requirements during a period of credit restraint would there be some danger that the banks would begin to view the 30 per cent convention lightly, and wish to revise it downward themselves?

Summary and conclusions

The greater flexibility in bank credit supply and the return to broader competition between banks and other lending institutions that are involved in suspending the ceilings on bank advances seem wholly desirable. Something was needed to take the place of loan ceilings to exert and maintain restraint when restraint may be needed, and it was clearly wise not to leave all the burden, in the short run as well as the long, on funding policy. But continuation of funding will be necessary if eventually the Bank of England is to get into a position to restrain credit expansion through open-market operations affecting the banks' cash reserves, rather than having to concern itself so greatly with the banks' short-term liquid earning assets position. How to preserve, in the meantime, the solidity of the essentially arbitrary 30 per cent liquid asset convention may prove a real problem.

The new tool of action is a blunt one, and its greatest value may be as a weapon held in reserve. However, a mechanism for "elastic" cushioning of shocks to the liquidity of individual banks is a part of the new arrangements; this should allow the Bank of England to act forcefully in restricting aggregate liquidity in the banking system, whether it does so through open market operations of the "funding"variety or through calls for special deposits.

There is no certainty that the new weapon of calls for special deposits will ever be used. It is, however, a weapon that may have to be

used in some future period when restraint is needed and sales of bonds are not going well. This consideration far outweighs the objections some observers have already expressed, 1/ on the ground that giving the Bank of England the ability to increase its own bill holdings without producing immediately adverse effects for monetary policy implies a weakening of the authorities' determination to make the fullest use possible of funding policy. Such objections had greater validity when they were raised in 1955-56 and concurred in at that time by the Bank of England and the Government, against proposals for mandatory increases in the clearing banks' minimum liquidity ratio upward from 30 per cent. Those proposals, if adopted at that time, might easily have led to an accentuation rather than an amelioration of the floating debt problem. The experience of the past twelve months clearly indicates the Bank of England's concern about the problem of the floating debt, and suggests that the new tool of action will not be used unwisely or unnecessarily.

1/ See, for example, The Economist, July 12, 1958, pp. 141-143.

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