THE RADCLIFFE REPORT

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WITH the return of a Conservative Administration in 1951, Britain re-activated monetary policy as an instrument of economic control after a lapse of twelve years. At first, the relatively mild measures adopted in November 1951 and in the early months of 1952 seemed to justify the high hopes of the protagonists— the inflationary trends of the Korean boom year were rapidly reversed; there was considerable de-stocking, and Britain's balance of payments on current account improved sharply. In fact, as is now recognized, these were repercussions of the changing trend of world prices after the short speculative boom engendered by the Korean War and had little if anything to do with the monetary measures adopted by Britain. The turn of events, however, had certainly enhanced the belief in the efficacy of a "flexible" monetary policy, and when there was a renewed threat of domestic inflation and of a balance of payments crisis in February 1955, much sharper restrictionist measures were taken. But on this occasion the hoped-for consequences did not materialize. Despite the pressure on liquidity, bank advances continued to rise, inducing a whole series of further measures of quantitative and qualitative credit restriction, including an unprecedented request by the Chancellor of the Exchequer to the clearing banks (in July 1955) "for a positive and significant reduction in advances over the next few months." Nonetheless, the level of demand and the pressure on domestic resources continued to rise even after the volume of bank advances was at last stabilized. By the time the Suez crisis supervened (in September 1956), opinion was fairly general that there was something wrong with the way monetary controls operate, and that if any reliance were to be placed on monetary measures in future, there had to be a thoroughgoing review of the mode of operation of financial institutions and of the controls exercised by the Bank of England. Hence the appointment, in May 1957, of a Committee "to inquire into the working of the monetary and credit system and to make recommendations" under the chairmanship of Lord Radcliffe.[1] The Committee (the first of its kind since the Macmillan Committee reported in 1931) sat for two years, questioned over 200 witnesses, received some 150 special memoranda, and finally issued a unanimous report of some 340 pages.[2]

The really remarkable feature of this *Report* is that it manages to maintain complete unanimity (without a single note of reservation by any of its members!) whilst putting forward views that are far from the traditional or the orthodox. The Report contains a detailed review of the history of monetary measures since 1951 and an exhaustive analysis of the nature of British financial institutions which brings to light many important and interesting features not hitherto known, as well as a number of statistical compilations concerning the assets and liabilities of various types of institutions that were not previously available. But for American readers, and for students of monetary theory generally, the 60 pages devoted to "the influence of monetary measures" which deal with the fundamental issues will undoubtedly provide the main interest of the Report.

It is not an easy task to summarize the Committee's views without danger of misrepresentation — partly because some of its conclusions are expressed in rather guarded terms and partly because the conclusions stated in some of the paragraphs are contradicted (or at least seemingly contradicted) in others; thus, it is not possible to distill a consistent set of principles without a certain amount of interpretation. The reasons for this are to be sought, not in any lack of expository talent in the Committee, but in their desire for unanimity, which could only be secured at the cost of vagueness at critical points and the omission of important links in the chain of argument. From the point of view

[1] The other members of the Committee included two economists (Professors A. K. Cairncross and R. S. Sayers), two bankers, two trade unionists, and two businessmen.

[2] *Report of the Committee on the Working of the Monetary System*, London, Her Majesty's Stationery Office, Cmd. 827, Price 15s. net. The meetings of the Committee were held in private, but its hearings (as well as all the memoranda submitted to it) are to be published in three volumes.

of the usefulness of the Committee's work for future policy, it would undoubtedly have been better to abandon the search for unanimity and to set forth the divergent views, where divergences existed, in a clear and systematic manner. (In the report of Lord Radcliffe's previous commission of inquiry, the Royal Commission on Taxation, the haziness associated with unanimity was fortunately avoided.)

Subject to this element of uncertainty inherent in the Report's peculiar manner of exposition, the Committee's views on the main issues of monetary policy may be summed up as follows.[3]

1. The purpose of monetary action is to regulate the total demand for goods and services, but this cannot be achieved by controlling the "quantity of money," meaning by "money" (in the British context) notes and bank deposits. The Committee rejects the view (a doctrine which "in its extreme form . . . is perhaps not widely held in this country") that if only the central bank keeps a tight control on the supply of money and "either keeps it fixed or allows it to increase only with the growing needs of a growing economy, all will be well." The Committee would not go so far as to say that "the supply of money is an unimportant quantity" but they "view it as only part of the wider structure of liquidity in the economy" (388–89).

2. The "haziness of the connection" between the supply of money and the level of total demand "lies in the impossibility of limiting the velocity of circulation" (523). "We have not made more use of this concept because we cannot find any reason for supposing, or any experience in monetary history indicating, that there is any limit to the velocity of circulation; it is a statistical concept that tells us nothing directly of the motivation that influences the level of total demand" (391).

3. "An analysis of liquidity, on the other hand, directs attention to the behavior and decisions that do directly influence the level of demand" (391). The meaning of the notion of the "overall liquidity position" is nowhere explicitly defined, but it is clear from the argument in several places that it is meant to include easily realizable financial assets — deposits in the savings banks, shares in building societies, bonds of relatively short maturity, etc. — as well as the "methods, moods and resources of financial institutions and other firms which are prepared (on terms) to finance other people's spending" (389 and 392).

4. The Committee rejects the view that central banking policy could be made more effective by substituting "for the traditional control of the supply of money a complex of controls over an indefinitely wide range of financial institutions." This would be "unwelcome . . . not mainly because of its administrative burdens, but because the further growth of new financial institutions would allow the situation continually to slip from under the grip of the authorities." However, the over-all liquidity position can be controlled by action taken by the central bank to manipulate "the entire structure of interest rates" (as distinct from action "confined to the short-end of the market") because "a movement of interest rates implies significant changes in the capital values of many assets held by financial institutions; a rise in rates makes some less willing to lend because capital values have fallen, and others because their own interest rate structure is sticky. A fall in rates, on the other hand, strengthens balance sheets and encourages lenders to seek new business" (393 and 394).

5. It is for this reason that the Committee "follow Professor Kahn . . . in insisting upon the structure of interest rates, rather than some notion of the 'supply of money,' as the centerpiece of monetary action" (395). They do so not because they have any sanguine expectation concerning the incentive effect of changes in interest rates upon the willingness to invest or to save. They are skeptical of the effects of changes of interest rates upon the incentives to save (450); and they have not been able to find that the credit squeeze (of 1955–58) had "any marked effects on holding of stocks of commodities" (460), whilst as regards long-term investment, the evidence suggested that any effect was "not on projects already in train but on capital projects in their earliest planning stages — implying an effect on spending not immediately but many months later" (460).[4]

[3] Numbers in parentheses refer to the paragraph numbers in the Report.

[4] A more substantial, though purely temporary, effect was secured through hire-purchase controls (the increase in

Nonetheless, the manipulation of interest rates, extending over the whole range of the financial market, should have some effect by creating a "diffused difficulty of borrowing" (472) through its effect on the liquidity position of financial institutions of all kinds.[5]

6. Accordingly, the main function of central bank policy should be not just the setting of the Bank rate (which has a largely "symbolic" significance, 441) or open-market operations in the short-end of the market, but the management of the national debt, which they regard as the "fundamental domestic task of the central bank." "It is not open to the monetary authorities to be neutral in their handling of this task. They must have, and must consciously exercise, a positive policy about interest rates, long as well as short, and about the relationship between them" (982). In a separate chapter on debt management the Committee reveal, however, that in connection with the large and continuous re-financing operations of the Treasury handled by the Bank of England, the monetary authorities do already exert a much more powerful direct influence on the long-term bond market than is commonly realized. Their plea, one presumes, is therefore for a more conscious and deliberate attitude in setting long-term interest rates at levels thought desirable on general economic considerations.

7. The implication of this major conclusion is greatly weakened however (if not altogether destroyed) by the Committee's repeated insistence that they do not regard a policy of deliberate variation in the level of long-term interest rates as at all desirable. "An argument for more effective use of the interest rate weapon is an argument for widely fluctuating rates, not just for movement in one direction. If the wide fluctuation could usefully be confined to short rates, the case might be strong. But we have found that stocks of commodities are extremely insensitive to interest rates, and in any case they are often financed with long-term capital, and could be much more widely so if firms found this much cheaper. It is at fixed capital that the rate of interest must strike if it is to have any direct impact, and for this purpose the longer rates are relevant . . . we have therefore to consider whether it would be advisable to contemplate much larger swings than hitherto in long-term rates of interest. . . This course appears to us as probably impracticable and certainly so disadvantageous as to warrant our ruling it out as a general line of policy. . . There is no doubt that at present deliberate manipulation of long interest rates in sharp degree would be distrusted as an artificial juggling with markets . . . a stronger and more universal objection to widely fluctuating rates of interest [is that] the intricate and highly developed network of financial institutions bases some of its strength on the existence of a large body of highly marketable Government bonds whose market values are assumed to have a considerable measure of stability. . . Their capital and reserve strength would be regarded as gravely weakened if they did not usually hold large blocks of bonds of reasonably stable value. One of the sources of strength in the nineteenth century development of British financial institutions was undoubtedly the existence of an absolutely secure National Debt; some of this advantage would be thrown away if the market values of bonds were subject to very sharp variations. For these reasons we reject any suggestion that the rate of interest weapon should be made more effective by being used much more violently than hitherto" (488–491). But if this is so, what remains of their contention that monetary policy is only effective through its effect on the liquidity (i.e., the "reserve strength") of financial institutions; and that *therefore* manipulation of the structure of interest rates must be "the center-piece of monetary action"? And how is it to be reconciled with their claim (514) that the "one positive recommendation" they are able to make is that the authorities "could make a more deliberate use of interest rates"? If the "consciously exercized positive policy" of the central bank in the bond market is not to be understood as deliberately inducing variations in bond prices,

minimum down payments), a form of regulation which the Committee dislikes owing to its important "directional" effect — in concentrating the impact of the change of demand upon a relatively narrow range of industries.

[5] This is in apparent contradiction to their conclusion regarding the policy of the credit squeeze in the latter half of the 1950's (which had substantial effects on long-term interest rates as well as short, apart from the quantitative control of bank credit) that "the obstructions to particular channels of finance had *no* effect on the pressure of total demand, but have made for much inefficiency in financial organization" (469; italics supplied).

but as stabilizing them, this is the equivalent of saying that monetary action should play a purely passive rôle in the regulation of the economy, at any rate in relation to short-term variations in the pressure of demand.[6]

8. This last conclusion — that monetary policy should play a purely passive rôle in the (short-term) regulation of the economy — is nowhere explicitly put, though the *Report* contains plenty of passages indicating that something like this was at the back of the Committee's mind. Their whole review of the monetary policy of the late 1950's amounts to a severe condemnation, partly because of its ineffectiveness, partly because of its jerkiness, and partly because of its "directional effects," in concentrating its impact on particular industries or firms, which is undesirable from the point of view of the economy.[7] "We are driven to the conclusion that the more conventional instruments have failed to keep the system in smooth balance. . . It is far removed from the smooth and widespread adjustment sometimes claimed as the virtue of monetary action; this is no gentle hand on the steering wheel that keeps a well-driven car in its right place on the road" (472). And, as for the future, "we envisage the use of monetary measures as not in ordinary times playing other than a subordinate part in guiding the development of the economy" (511). "We do not find any solution to the problem of influencing total demand in more violent manipulation of interest rates; we find control of the supply of money to be no more than an important facet of debt management; we cannot recommend any substantial change of the rules under which banks operate; we do not regard the capital issues control as useful in ordinary times; and we believe that there are narrow limits to the usefulness of hire purchase controls . . . when all has been said on the possibility of monetary action and its likely efficacy, our conclusion is that monetary measures cannot alone be relied upon to keep in nice balance an economy subject to major strains from both without and within. Monetary measures can help, but that is all" (514). The Committee is skeptical also of the effect of monetary measures on international capital movements and thus on the balance of payments position on which the Macmillan Report laid such stress (439–41) and looks to an enlargement of international reserves through a reconstituted IMF as a solution to short-period balance of payments crises (675–78).

9. If monetary measures are not to be relied upon to maintain economic and financial stability, what is? The alternatives are direct controls (such as building licences, consumer rationing, etc.) or fiscal measures, but the Committee refuses to enter into the question how far these should be employed in preference to, or in combination with, monetary measures. "Our terms of reference do not permit us to evaluate the advantages and disadvantages of direct controls and fiscal measures or to consider the extent to which they might be used to supplement or substitute for monetary action" (515). Nevertheless the few paragraphs devoted to fiscal policy indicate that, in their view, fiscal measures, though effective in their impact, may lack the degree of flexibility required to deal with short-period fluctuations (517). On the other hand monetary measures are slow in their impact — in fact "the less objectionable they are in other respects the slower they are to achieve their effects" (519).

And here the matter rests. The Committee makes few concrete recommendations — the most notable among them is for more research and statistical information, to be organized and

[6] In a later passage, the Committee clarify somewhat the contradiction between their insistence on continuous and deliberate intervention in the long-term market and their rejection of a policy of fluctuating long-term rates by saying that "the authorities should think of rates of interest — and particularly long rates — as relevant to the domestic economic situation. The authorities should not aim at complete stability of rates, but should take a view as to what the long-term economic situation demands and be prepared by all means in their power to influence markets in the required direction" (498). But they do not explain, or even discuss, the question of how the "authorities" or anybody else can take a clear view of what kind of interest structure "the long-term economic situation demands." If the authorities succeeded in overcoming the inflationary trend, long-term interest rates should be set low to encourage capital development and growth. Given the continuance of inflation they should be kept relatively high to avoid undue pressure on resources. But there is no way in which monetary policy can simultaneously be operated so as to overcome inflationary or deflationary tendencies and to promote long-term stability on the assumption that they have been overcome already.

[7] Thus hire-purchase restrictions induce instability in the group of industries producing durable consumer goods (468); credit restrictions in general invariably discriminate against the fastest-growing firms which are alone dependent on outside sources of finance for their expansion (481).

published by the Bank of England, and for better continuous coordination between the Treasury and the Bank of England, through a newly set-up high-level committee. And they give their (reluctant) blessing to the use of various "emergency measures" in "emergencies" (such as a quantitative ceiling on bank advances and/or variable minimum reserve requirements; control over new capital issues and over hire-purchase credit) though the use of several of these controls in the recent "emergencies" was severely criticized in the Report for inappropriateness or inefficiency.

But on the major issue of how to prevent "emergencies" and how to keep the economy on an even keel, the Report has nothing, or almost nothing, to say. In their self-denying ordinance of holding strictly to their terms of reference (which, incidentally, on any reasonable interpretation, would have permitted a far more comprehensive inquiry into the problem of economic and financial stability), they have refrained from expressing a view, not only on the relative merits of various instruments of economic control, but on the real nature of the problem which necessitates the use of controls, whether of the monetary, fiscal, or any other kind. The British economy, like other Western economies, has suffered since the war from two major instabilities. The first consists in the chronic tendency of money incomes (both wages and profits) to increase at a faster rate than production, thus causing a continued upward drift in money costs and prices. The second consists in fairly violent short-term swings in the pressure of domestic demand, associated with corresponding swings in imports and in the balance of payments (as well as of domestic production and employment), which, in the case of Britain, can clearly be ascribed to swings in inventory accumulation caused (one presumes) by the volatility of expectations concerning short-period trends in commodity prices.

As to the first, the Committee completely abstains from any view or analysis, despite the fact that it is the problem of chronic inflation which most agitates the public mind. There is no reference to the question of whether this chronic inflationary trend is predominantly demand-induced or cost-induced; if the former, what causes the chronic tendency to excess demand; if the latter, how could the rise in money incomes be restrained, and how far are either monetary or fiscal measures appropriate instruments for dealing with this problem?

As to the second, the Committee has plenty to say but nothing to recommend. If monetary measures are incapable of preventing or offsetting the swings caused by fluctuating rates of inventory accumulation, are we to assume that these are inevitable? The classical theory of the Bank rate and of money-market operations regarded these instruments as the ideal weapon for stabilizing the demand for holding stocks despite varying inducements, or even for inducing compensatory variations in stockholding in response to instabilities emanating from other parts of the system. The Committee is emphatic in holding that variations in the Bank rate and in short-term interest rates generally, even when accompanied by other measures of credit restrictions, are ineffectual in preventing a bout of inventory accumulation or decumulation. If that is so, monetary policy loses most of its *raison d'être*, for it is not a suitable instrument for controlling short-period variations in long-term investment; nor is it clear why long-term investment needs to be controlled in this way, since, in recent British experience, it was only on rare occasions that the fluctuations in long-term capital outlay provided the primary source of instability. And if monetary measures do not provide an appropriate weapon, is there nothing else which can be put in their place?

Finally, whilst the Committee's rejection of the orthodox view concerning the relation between the money supply and the level of demand is greatly to be welcomed, their views would have commanded far greater attention had they been set out with more explicit reference to basic economic theory. The quantity theory of money which held the stage for so long is still the most commonly accepted hypothesis on the relationship between money and prices among the great majority of the world's bankers and a disconcerting number of its economists. To them, at least, the Committee owed a more thoroughgoing explanation why it rejects certain basic propositions which previous authorities (including the Committee's own predecessor, the Macmillan Committee) held so sacrosanct. The key to the Committee's views is to be found in their statements concerning the velocity of circulation of money. The basis of the quantity theory, and of the whole "monetary" approach to economic policy which follows from it, is the belief that there is some "normal" velocity, firmly grounded in long-standing habits and conventions, which brings it about that changes in the *quantity* of money in circulation enforce corresponding variations in the *flow* of monetary expenditure. The Committee, on the other hand, believes that the velocity of money is a "purely statistical concept" of no causal significance, which varies automatically with changes in the quantity of money in relation to total expenditure — how else to interpret their statement that "it is impossible to limit the velocity of circulation?" I believe that they are fundamentally correct in the view that the hypothesis of any independently given velocity, grounded on things like the frequency of various kinds of payments — i.e., that wages are paid weekly, salaries monthly, business accounts quarterly, etc. — is a mirage, and that velocity can be speeded up or slowed down to an almost indefinite extent without any alteration in the habitual frequency of various types of money payment. Moreover this speeding-up process follows automatically from even a slight delay in the settlement of accounts, which may be caused by a shortage of cash in any part of the system — in other words, the very "illiquidity" caused by a reduced money supply tends to communicate itself throughout the system, and, in its spread, to cause the daily average of cash balances to be reduced in relation to the flow of in- and out-payments (which of course is the same thing as saying that it causes the velocity to rise). But since this is the point at which a major break occurs with traditional thinking, the reasons *why* the old-established views on velocity (and hence on the critical rôle of money supply) are wrong, and what follows from it, should have been set out systematically and in detail.

In the same way the emphasis on the "whole liquidity position" in contrast to the "money supply" (and on the control of bank advances as distinct from bank deposits) must be puzzling to all those who believe that non-monetary financial institutions are merely channels in the investment of funds, incapable of "creating" money or credit in the manner of the clearing banks whose deposits alone provide media of payment. The Committee's whole position is in contrast to this view, and is evidently based on the assumption (nowhere properly explained) that financial institutions, whether or not they provide direct media of payment, do invariably create "liquidity" — since it is the peculiarity of all such institutions that their liabilities are considered as "liquid assets" by the lenders (i.e. their depositors) whilst their assets are not treated as liquid liabilities (or negative liquid assets) by their borrowers. Hence the growth of non-monetary financial institutions, by providing new substitutes for deposits with the clearing banks, has much the same effect as a spontaneous reduction in the desire to hold "money." (The main point about "money substitutes" is surely that they provide a substitute for holding cash, irrespective of whether such substitutes are customarily used as means of payment.) But if this is so, there is no significant difference between the case for controlling the activities of the clearing banks and that for controlling those of the so-called "non-monetary" financial institutions: indirect control through the "structure of interest rates" is neither more nor less powerful (or adequate) in the one case than in the other.