



THE UK MONETARY & FINANCIAL SYSTEM

An Introduction

John Gilbody

The UK Monetary and Financial System

An introduction

John Gilbody



ROUTLEDGE
London and New York

First published in 1988 by
Routledge
a division of Routledge, Chapman and Hall
11 New Fetter Lane, London EC4P 4EE
Published in the USA by
Routledge
a division of Routledge, Chapman and Hall, Inc.
29 West 35th Street, New York NY 10001

© 1988 John Gilbody
Phototypeset by Input Typesetting Ltd, London
Printed and bound in Great Britain by
Mackays of Chatham PLC, Chatham, Kent

All rights reserved. No part of this book may be reprinted or reproduced or utilized in any form or by any electronic, mechanical, or other means, now known or hereafter invented, including photocopying and recording, or in any information storage or retrieval system, without permission in writing from the publishers.

British Library Cataloguing in Publication Data
Gilbody, John, 1939–

The UK monetary and financial system: an introduction.

1. Great Britain. Monetary system

I. Title

332.4'941

ISBN 0-415-00435-7

ISBN 0-415-00095-5 Pbk

Preface

The origins of this book lie in a first-year course that I was drafted to teach at the University College of Swansea, the group involved constituting both intending Honours students in economics and a variety of non-specialists reading some economics in the context of other schemes of study. The existence of this course stems from a belief that the monetary and financial system is of sufficient interest and importance in its own right to warrant a somewhat more detailed treatment at an introductory level than is possible in the standard course on macroeconomic theory which students pursue in parallel. Thus the goal of this textbook is to provide the reader with a broad introduction to the operation, mechanics, and structure of the monetary and financial system within the United Kingdom, emphasizing its institutions, markets, and instruments.

Although the book contains a brief survey of some relevant monetary theory in the context of a discussion of monetary policy, it is intended as a complement, rather than a substitute, for the many excellent introductory texts available which deal primarily with macroeconomic theory and policy and the book will be read most profitably by undergraduates with some knowledge of basic economic principles. The level of exposition is such, however, that aspects of it may appeal to students pursuing the standard A-level economics curriculum in schools, to students pursuing business studies courses in colleges of further education and to part-time students studying monetary economics as an element in professional examinations.

As is well known, in recent years the financial services sector has been one of the fastest growing sectors of the economy and, at the same time, has undergone fundamental institutional change. A further objective in writing this book has been to provide a reasonably up-to-date account of such changes, but the reader should perhaps be warned that the sheer pace of institutional change presents problems for any would-be textbook writer

Preface

hoping to present a snapshot picture of the financial system at a point in time. While certain general principles underlying the operation of the system remain fairly constant, the continuing process of competition and structural adjustment may render certain descriptive parts of this book obsolete within a very short space of time.

In writing this book I have benefited considerably from the discussions I have had with three generations of students in tutorial situations; their perceptive questions have prompted me to clarify my own thoughts in a number of areas and I am extremely grateful to all of them. I have also benefited from the comments made on an original draft of the manuscript by two anonymous referees who, apart from picking up errors, suggested ways in which the exposition might be strengthened and clarified. Any errors which remain are, of course, my sole responsibility. Most of all, I am deeply indebted to Miss Siân Davies and to my wife Judith who both cheerfully deciphered some extremely illegible handwriting and produced the typescript with what can only be described as superb efficiency. Finally I apologize to all my family – to whom this book is dedicated – for a great deal of neglect that they suffered during the course of this enterprise.

*J. H. Gilbody
March 1988*

Contents

Preface	vii
<hr/>	
Part I: Introduction	
1 The nature of a monetary economy	3
Appendix: Financial claims	29
<hr/>	
Part II: An Overview of the Monetary and Financial System	
2 Banks and the creation of money	41
3 Monetary circulation and financial flows of funds	64
4 The role of financial intermediaries and markets	89
<hr/>	
Part III: Institutions and Markets	
5 The organization of the financial system	109
6 Organized financial markets	124
7 The Bank of England	148
8 Retail banking	163
9 Wholesale banking	178
10 Building societies	194
11 Investing institutions	209
<hr/>	
Part IV: Monetary Policy	
12 The role of monetary policy	227
13 Techniques of monetary control	257
<hr/>	
Index	285

Part one

Introduction

The nature of a monetary economy

Money and exchange

The United Kingdom economy in common with practically all other economies is a monetary economy. The importance of money for the everyday business of life may seem to be self-evident, but an appreciation of the precise role which the institution of money performs in the workings of the modern economy requires initially some consideration of certain fundamental characteristics of economic organization.

All economic activity involves the use of resources, such as labour time, land, machines, and buildings, to produce a variety of goods and services which are consumed or used by individual members of society. The process of production is organized within an institutional framework which varies in detail between different countries, but a fundamental characteristic of all economies is that, to a greater or lesser extent, the ownership and control of resources is dispersed among those individuals, or groups of individuals, who collectively comprise society; each individual (or family unit) at any point in time can be considered as having a given endowment of human and non-human resources over which he or she possesses private property rights. The institution of private property usually depends on the existence of some governmental authority to guarantee and enforce private property rights within a clearly defined system of law, but within the framework of law that is established individuals have the freedom to use their endowments as they themselves choose.

Within the basic framework of private property rights each individual is free, if he so chooses, to use the resources he controls primarily to produce goods and services for his own direct use and, to some extent, elements of direct production for own consumption are observed in modern society, as is evidenced by

the unpaid services of housewives and numerous 'do it yourself' activities such as gardening, house decorating, or car maintenance.

However, whenever economies have progressed beyond the stage of primitive subsistence agriculture, the institution of private property has been accompanied by a further dominating characteristic of economic life, namely that of specialization or the division of labour. Individuals do not attempt to use their resources to produce goods and services directly for their own immediate use – rather they specialize as producers of certain goods and services and then obtain the wider range of goods and services they desire to use by voluntary exchanges with other individuals. Generally speaking, as societies have developed in the economic sphere, the degree of specialization has intensified and most production is undertaken not for the direct satisfaction of the wants of the producers themselves, but for the proximate purpose of exchange with other individuals.

It is the phenomenon of voluntary exchange which gives rise to the use of money in the economy. As a general rule, in any economy where voluntary exchange is prominent, barter trades – where goods are directly exchanged or swapped for other goods – are not typically observed. The producer of a specific good or service, say good A, who seeks to obtain another good or service, say good B, through trade, will rarely exchange A directly for B; instead what usually happens is that the individual concerned exchanges, or sells, A in return for the receipt of something we generally term money and then subsequently uses his money receipts from this sale to buy B. A single direct exchange of goods is decomposed into two separate transactions involving the use of money. This method of conducting voluntary exchange is so ubiquitous that one can state formally a further fundamental feature of most economies which leads to their characterization as 'monetary economies': as a general rule in such economies 'goods buy money and money buys goods – but goods do not buy goods in any organized market.'¹

As with most generalizations there are usually exceptions and it is true that a limited amount of barter trade does take place in modern economies. For example, it is a common practice for sellers of new cars to accept used cars in part-exchange, and it also is common for employers to remunerate employees for labour services rendered in part by various non-monetary 'perks' such as the private use of company cars, telephones, etc. However such barter exchange constitutes only a minute fraction of the total transactions that are mediated via an exchange of money.

Why money not barter?

The dominance of monetary exchange can be explained in a general way by consideration of the difficulties which would arise in conducting exchanges in a hypothetical barter economy.² The simplest system of barter one can envisage would be a system where each individual attempts to obtain in exchange goods to which he attaches some immediate value in use. The problem with such a system, however, is that the basis of any successful transaction rests on what is called a 'double coincidence of wants' between any two transactors; this is the necessity for the two parties to an exchange to want simultaneously that which the other party is offering.

A moment's reflection reveals that such a system would be unlikely to accommodate many of the exchanges we observe in a modern economy which has developed intricate forms of specialization. How could the modern business firm specializing in the production of a certain specific commodity, say sulphuric acid, employ workers by offering commodities of immediate use value in return for the use of their labour? Is it likely that a stockbroker could strike a bargain with the average taxi-driver by offering stockbroking services in exchange for the provision of transportation? Clearly a direct barter system is likely to be feasible, if at all, only in very primitive economies where a fairly small number of basic subsistence goods are being produced, but even in such an economy an individual attempting to trade would be likely to incur substantial costs simply in locating a trading partner with exactly matching requirements and in reaching agreement about the precise quantities of commodities that are to be exchanged; these costs might be so substantial as effectively to prohibit trade (the costs involved in exchanging goods and services, as opposed to the costs involved in producing them, are generally termed in economics as 'transactions costs').

Probably if a barter economy were to function at all in any way compatible with voluntary exchange, it would have to involve a certain amount of indirect barter, where individuals would accept in exchange intermediate commodities, i.e. commodities not required for their immediate use value to the individual concerned, but which have possible value in subsequent exchange. By then engaging in a sequence, or chain, of transactions individuals might eventually acquire their desired commodities. To illustrate, suppose we had four individuals A, B, C, and D who, at a given time, were offering to trade certain commodities for other commodities in the manner depicted in Table 1.1. If each indi-

Table 1.1 Desired trades of four individuals

<i>Individual</i>	<i>Offers</i>	<i>Wants</i>
A	Butter	Wool
B	Apples	Butter
C	Bread	Apples
D	Wool	Bread

vidual attempted to trade by direct barter there would be a double coincidence of wants problem and no trade would be feasible. However, the problem can be resolved if individual A, for example, was prepared to accept intermediate goods in exchange. A can trade with B accepting apples in exchange for butter, he then trades with C exchanging apples for bread and finally with D exchanging bread for wool (his desired good). While such a system might overcome the double coincidence of wants problem, it would again be formidably expensive in terms of transaction costs; the required exchange chains might be very long and every link in the chain would involve the cost of searching out trading partners with specific requirements, reaching agreement on the volume and terms of trade, etc. Moreover, some individuals, in this example A, are subject to the risk that the arranged sequence of exchanges does not in fact take place as planned, so that they are left holding commodities not desired for their own sake.

It is fairly obvious that a significant saving in transaction costs can be effected if, by some process, a single commodity (or other entity such as a banknote) becomes generally accepted by all traders as an intermediate good in exchange for the delivery of all other commodities, i.e. if some entity can perform the role we have ascribed to money. In this instance the longest exchange chain faced by any individual seeking to transform one commodity into another by trade is reduced to just two transactions; the ultimate requirements of the opposite party in any transaction become an irrelevant consideration and the costs and risks involved in long exchange chains are greatly reduced. The general explanation for the use of money is, therefore, that individuals perceive the advantages of money in the facilitation of voluntary exchange, with its attendant advantages of increased specialization and productivity, and somehow come to adopt the convention that certain entities become socially sanctioned as exchange intermediaries.

It is, of course, rather more difficult to explain the exact process whereby particular things become adopted as money. If one considers the generality of historical experience an amazing

variety of specific objects have been used as money in different times and in different places. The list would comprise amongst others, cowrie shells, stones, salt, olive oil, copper, tin, silver, gold, bales of tobacco, cigarettes, and brandy.³ The main thing that all these objects had in common, apart from certain convenient properties such as durability, ease of transmission between individuals, fairly homogeneous quality and divisibility, was simply the fact of their general acceptability in exchange, the foundations of which lie in a rather peculiar interdependence between the subjective beliefs and expectations of all the individuals comprising the population at large.

Consider for example the present Bank of England £5 note. In terms of intrinsic value (value in immediate use) the note is virtually useless and the promise enshrined on it in the words 'I promise to pay the bearer on demand the sum of five pounds' is now meaningless; all one is likely to get in exchange for a £5 note would be another, perhaps newer, note or some coins which, if illegally melted down, would sell for considerably less than £5 as metal. Why then should Bank of England notes be accepted in exchange when similar bits of paper are not? The brief answer is that an individual will accept a £5 note because he expects with more or less complete certainty that everyone else will – £5 notes are accepted because everyone believes they will be accepted, and everyone believes they will be accepted because according to their past experience they invariably have been accepted. Thus money can be described as a pure social convention; once firmly established such conventions are remarkably durable, but it has to be admitted there is an element of mystery regarding how they develop from their original usage by a few individuals into widely held conventions.

The acceptability of certain forms of money may be enhanced by the fact that they are fiat monies issued by a government and designated as legal tender (the legal tender property means that the government has decreed that certain entities be regarded by the courts as an acceptable method of settling debts of unlimited amounts). However, the legal tender designation is not a necessary characteristic of money, many forms of money have not been a result of compulsion by the state but have evolved in a spontaneous fashion through the actions of private individuals. Similarly there are numerous historical examples where individuals have rejected legal tender money for private transactions and have invented their own money, or used other countries' money.

The role ascribed to money in acting as an intermediate instru-

ment in transactions is traditionally summarized by the phrase that 'money acts as a medium of exchange'. Recently however some writers have drawn a distinction between the role of money as a medium of exchange and a somewhat narrower role of money as a means of payment.⁴ The argument here is that there are other instruments which are often provisionally acceptable by individuals in exchange, and an offer of such instruments may allow a transaction to be conducted; however only when an exchange of money has taken place will the two partners involved regard the transaction as being settled, or finalized, in the sense that it can be relegated to past history with neither of the partners having a claim on the other.

The distinction being drawn can be illustrated with reference to a modern innovation in the practice of shopping, namely the use of credit cards. If an individual possesses a credit card, he or she can enter many shops, choose an article for purchase, produce the card, sign a form and then leave the shop with the chosen article – clearly an exchange has been conducted. What happens is that in issuing a credit card, the credit card company simultaneously issues a promise to shopkeepers that it will ultimately pay them money for goods acquired by the card-holder. Because of the reputation of the credit card company, many shopkeepers are prepared to accept such promises in exchange for the delivery of goods to customers so that, in effect, these promises are serving as a medium of exchange. The initial exchange, however, is obviously not the end of the story. The shopkeeper will subsequently present the signed form representing his claim on the credit card company for settlement in terms of money and only when payment is received will the transaction be regarded as finalized. Likewise, the purchaser has incurred a debt to the credit card company which eventually he must liquidate by a payment of money, if he wants to avoid prosecution in the county courts. The general point is that many exchanges proceed via the use of credit arrangements of various types, where purchasers explicitly or implicitly make promises to pay later and sellers are prepared to accept such promises as the basis for a delivery of goods and services. Such credit represents a medium of exchange and in this sense money is not unique. Credit, though, does not lead to the completion of a transaction, it merely serves to postpone completion which will be accomplished only when payment has been made by an actual transfer of money.

Other functions of money

While the existence of money can be generally explained by its role in facilitating voluntary exchange, once the institution of money is established in an economy it also performs certain other distinguishable joint functions.

Money as a store of value

The use of money as a means of payment necessarily implies that money also acts as a store of value. In a money economy, transactions are decomposed into separate selling and buying transactions – individuals receive payments for goods and services sold at particular moments in time and then subsequently make payments for goods and services purchased at succeeding moments in time. Receipts and payments are thus non-synchronized and it therefore follows that for certain time intervals money is acting as a store of value of the goods and services sold, prior to the realization of this value in terms of the purchase of other goods.

This point can be illustrated by considering the position of most workers in the modern economy. Workers render labour services to employers on a credit basis and receive payments of money in arrears as wages or salaries at discrete intervals of time, typically weekly or monthly. These money receipts are then used to make payments for goods in the time intervals between wage or salary dates. Admittedly, if a worker receives his wages on a Friday afternoon and is in the habit of visiting supermarkets and other shops in 'late night' shopping excursions on a Friday evening, the average delay between receipts and payments might not be very long, but nevertheless for finite time intervals, however small, money is acting as a store of the value of the labour services that the worker has supplied. Clearly, if money did not serve as a store of value, nobody would accept it in payment for delivery of goods and services.

Money, of course, can also serve as a store of value for periods of time much longer than the usual interval between periodic receipts of money income. The possession of money provides individuals with purchasing power, or a stock of claims on goods and services, but they can delay the immediate exercise of such claims by accumulating money balances over time. Money can thus act as a convenient instrument for saving, i.e. a means of transferring consumption of goods and services from the present to the future. Money in this sense may therefore be described as a financial asset, in contradistinction to real or tangible assets.

Introduction

Real assets are material entities, such as houses, machines, vehicles or consumer durables, that are specialized in form and whose value is derived from a capacity to yield streams of specific goods and services in future periods. A financial asset, in contrast, is a claim to the consumption, or utilization of, goods and services in general; it gives its holder the potentiality of consuming an unspecified good or service at an unspecified time and can be described as generalized wealth. In a barter economy, saving on the part of an individual would have to involve the storage of real assets which, given the difficulties of storage and the fact that many material entities deteriorate with age, would constitute an inconvenient method of holding wealth.

Money as a unit of account

The functions of money in acting as a means of payment or a store of value result from the existence of money in 'concrete' or tangible form. An additional function of money which can be distinguished is the abstract function of acting as a unit of account. This refers to the use of money as a common denominator, in terms of the units of which the prices of all other goods and services can be expressed. Normally the units in which the circulating concrete money is embodied will also serve simultaneously as the abstract unit of account: prices are expressed in terms of pounds and pence, dollars and cents, etc.⁵

The advantage of using a common unit of account is that it greatly reduces the number of prices that have to be explicitly formulated to allow economic decision-takers to make pairwise comparisons of the exchange ratios of particular goods. With n commodities, one of which is acting as a unit of account, there will need to be only $n-1$ explicit prices to allow for pairwise comparisons between all commodities; thus for 1,000 commodities there need be only 999 prices. Without a common unit of account there would need to be a separate explicit exchange ratio between each pair of commodities; for n commodities there would be $\frac{1}{2}n(n-1)$ exchange ratios, thus for 1,000 commodities there would be 499,500 separate exchange ratios.

The existence of a unit of account immensely simplifies the appropriate buying and selling decisions of consumers and producers. Armed with knowledge of the various money prices of commodities, a consumer, for example, can subjectively translate the money price of any particular commodity into an alternative bundle of commodities which must be foregone if the commodity in question is to be purchased. The money price of a commodity

can thus serve as an abstract summary measure of the exchange value of a commodity in terms of all other commodities. The use of money in acting as a measure of exchange value is readily appreciated if one considers the mental thought processes of UK citizens when travelling abroad; in deciding whether commodities whose prices are quoted in francs or pesetas are 'cheap' or 'expensive', we often subjectively convert the foreign currency prices back into pound prices, the standard with which we are more familiar, at any rate, initially, until we have acquired more information about the foreign currency prices of various commodities.

In addition, of course, all the numerous aggregate measures employed in practice in economic life, such as income, wealth, profits, costs, value added, etc., depend on the existence of a common unit of account.

Forms of money in the United Kingdom

Probably the most common way of distinguishing entities that serve as money from other assets is to define money with reference to its role in facilitating voluntary exchange, i.e. money is usually defined as 'anything that is generally acceptable as a means of payment, or in complete and final settlement of a debt'. This definition, of course, is somewhat imprecise – how 'general' does the acceptability of an entity as a means of payment have to be in order to classify it as money? The fact is that not all entities that are accepted by some individuals in some transactions at any point in time will be accepted by all individuals for all transactions. At the present time, for example, low-value coins struck by the Royal Mint are legal tender only up to certain upper limits and can, and probably will, be refused by sellers as a means of settlement of high-value transactions. Moreover, the means of payment used in various countries evolve through time; new means of payment are adopted and the transition from a stage where a certain means of payment is used by a relatively small group of individuals, to a stage where it is used by the majority of the population may take a long period of historical time. The point at which the acceptability of a particular means of payment is deemed to be sufficiently general to warrant classification as money is, therefore, a subjective matter on which different observers will often disagree. We can illustrate some of the problems involved in making definitive statements as to what money actually is by a brief survey of the historical evolution of means of payment in the UK.