Cheap Money: The English Experiment of 1945-47

by DAVID ROWAN

Introduction.

The purpose of this paper is to describe and evaluate the post-war attempt of the Chancellor of the Exchequer (Rt. Hon. Hugh Dalton, M.P.) to produce cheaper money — that is to lower the rate of interest (1). From July 1945 until August 1947 it was the principal preoccupation of the monetary authority to force the rate structure downwards until it became possible for the Government to borrow at 3½% per annum on long-term securities. Our task is to describe the campaign by which this objective was temporarily achieved; to record the failure to consolidate the new rate; and, finally, to attempt an assessment of the desirability or otherwise of the policy followed. The paper then falls naturally into three main sections devoted to description, explanation, and evaluation. Before, however, we embark upon the first part of our task it is necessary to say something about the economic background against which the Chancellor operated. We must therefore discuss, though only very briefly, the main changes produced by the war.

War Finance.

During the war the power to borrow from the market was rigorously controlled by the Capital Issues Committee. Only those organisations whose applications were approved by the Committee were permitted to make issues. Approval by the Committee meant, of course, approval by the Government. The main function of the Committee became the finance of the war effort. Some measure of this change can be shown by comparing the total change in the deposits of the clearing banks from 1938 with the total change in their indirect and direct lending to the Government.

Change in Deposits, from £ m.

Change in lending to the Government:

(i) Increase in Money at Call + 65 (best via the Discount Market)
(ii) Increase in T.D.R.s. + 181 (best directly)
(iii) Increase in Investments + 519 (best directly)

Total = +2465

The close correspondence of the two figures tells its own story. During the same period Advances declined by £206 million. The experience of the banks was broadly that of the other main financial institutions. All were engaged in the business of financing the Government and financial institutions in general absorbed a large proportion of the increase in the national debt (2).

The increase in bank deposits from 1938 to 1945 was over 100%. Since this increase would have been far smaller had the public's desire to hold money been less, the magnitude of the increase gives a measure of the public's desire for liquidity. Since the public, at the prevailing rates of interest, preferred bank deposits to securities the banks absorbed the securities and the public held the corresponding deposits. The liquidity (3) of the

Footnotes:

(1) There is, of course, no single rate of interest. Dr. Dalton's objective was the long rate which may be defined as that on Government securities having a life of 10 years and more. The rate is measured, in this paper, by the return on Consols, which are, in fact, irremunerable.

(2) It has been estimated that the national debt formed over 40-45% of the value of private property in the country.

(3) We define a liquid asset as one which can be

National Reserve
system as a whole increased from 1936 to 1944 — as a glance at the Table III reveals. During the same period the rate of return on Consols, and the rate on three months bank bills, were steady. These facts taken together seem to indicate a trend towards an increased general desire for liquidity (4).

In its capacity as a lending borrower, the Government attempted to provide securities to suit every taste. Nevertheless, as can be seen from the Tables I and IA and indeed can be inferred from the growth of Treasury Deposit Receipts, the greatest growth was in the very short and medium securities (5).

### Table I

<table>
<thead>
<tr>
<th>Least Date of Repayment</th>
<th>1921-9</th>
<th>1934-4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under 1 year</td>
<td>1352</td>
<td>8.8</td>
</tr>
<tr>
<td>1-5 years</td>
<td>458.5</td>
<td>6.2</td>
</tr>
<tr>
<td>5-10 years</td>
<td>358</td>
<td>4.9</td>
</tr>
<tr>
<td>Over 10 years</td>
<td>511.5</td>
<td>7.5</td>
</tr>
</tbody>
</table>

**Average Annual Interest Rates**

<table>
<thead>
<tr>
<th>Total Interest</th>
<th>Total Treasury Bills &amp; Treasury Deposit Receipts</th>
<th>Proportion 2/1 as %</th>
</tr>
</thead>
<tbody>
<tr>
<td>1944</td>
<td>1856.03</td>
<td>4.533%</td>
</tr>
<tr>
<td>1945</td>
<td>13155.8</td>
<td>5.533%</td>
</tr>
<tr>
<td>1946</td>
<td>12418</td>
<td>6.082%</td>
</tr>
<tr>
<td>1947</td>
<td>10534.7</td>
<td>6.344%</td>
</tr>
</tbody>
</table>

**Sources:** Annual Abstract of Statistics.

There were two principal results from this expansion. In the first place it studied the jobbing facilities in the bond market. This was partly off balance by the expansion of the resources of the discount houses who provided a valuable stabilising influence in the case of bonds with relatively short periods of life (7). Secondly, the growth in the total volume of debt, and particularly in that held by banks and financial institutions, that relatively stable bond prices had become a fundamental requirement for the liquidity of these institutions (8). The nature of the expansion shows the demand for relatively shorter dated issues. The Government's success in providing what was wanted rather than attempting to force the absorption of long term securities was probably an important factor in keeping interest rates low and thus providing cheap war finance.

Outside the money market the principal result was the increased liquidity of industry. This was due to three causes. The first was the war time postponement of investment; the second the degree to which industry, in the main working on war contracts, was financed by the Government; the third was the piling up of credits via excess profits taxes. We shall come to the importance of these conditions later.

So much for the general background against which the post-war drive for cheaper money must be seen. We come now to the drive itself.

### The Drive to Cheaper Money

Any attempt to cheapen money rests fundamentally upon two weapons. The first of these is control over the volume of credit. The second is the ability to influence the market's outlook. There are two aspects of the latter problem. The short run, when the problem is that of getting the rate structure down to the authorities can, if they succeed in persuading the market that rates in the future will be lower than those obtained today, enlist the support of speculators in their scheme. In the longer run, the problem is one of persuading the market that the new rate, once attained, is likely to be a "safe" or a "normal" rate. Failure in the latter task will involve the constant creation of credit since the absence of any fundamental confidence in the new and lower rate will mean that any change in the internal or external political and economic outlook will stimulate a general demand for liquidity. If this occurs the authorities must either provide the extra cash or acquiesce in a general rise in rates — i.e. an upward shift in the rate structure.

This is a general statement of the problem. The particular problems facing Dr. Dalton were complicated by the fact that he was attempting to force rates down at a time when more people expected that they would have to rise. This was so because it was widely visualised that in the immediate post war period most firms would be anxious to undertake investment. As a result the demand for funds would be great and the price correspondingly high if the rate of interest was to be allowed to perform its traditional function of determining the volume of investment.

There was, however, no intention of allowing the rate of interest to decide either the quantity or quality of investment. Both functions were to be performed by the authorities. This much is clear from the statement of the war time coalition Government made in a White Paper on "Employment Policy" published in 1944 (9):

> "the use of capital will have to be controlled to the extent necessary to regulate the flow and direction of investment. Here any excess of capital expenditure on buildings, plant and equipment have to be overridden, and construction on new development must begin. Without control therefore there would be a scramble to borrow, leading to a steep rise in rates of interest. The Government are determined to avoid these dangers for those urgent reconstruction needs. In this period, therefore, access to the capital market will have to be controlled in order to ensure the proper priorities".

This was the agreed policy of all three major political parties.

**For the control of investment Dr. Dalton relied upon powers originally granted under the Defence Regulations and subsequently extended under the Supplies and Services (Transitional Powers) Act of 1945 which gave the authorities power to allocate the existing real resources by means of licences and permits. These powers were hitherto used by the extension of the Capital Issues Committee into the transition period (achieved by the Investment Control and Guarantees Act of 1946) the nationalisation of the Bank of England, and the Acts continuing the existing provisions for exchange control.**

Thus, in attempting to force rates still lower when, in the absence of control, they might reasonably be expected to rise, Dr. Dalton was able to deploy a considerable number of weapons. He was assured (at least theoretically) of controls over investment. He was able, through the Capital Issues Committee, to restrict access to the capital market for the purpose of making new issues. He had, of course, complete control of the creation of credit in the system. He was able to vary the supply of securities through the "cap" whenever to do so seemed economically advisable. Finally, he could count as an ally the existing tax structure which, while possessing no tax on capital gains, taxed additional income at rates which rose as high as 19/6d. in the £ (10). This last point was of considerable importance since it raised the relative attractiveness of capital. Indeed for those in the highest tax bracket, a capital gain of sixpence was the equivalent of an additional 1 1/2d. of income. If speculators could be brought to believe in his ability to lower rates (11), the Chancellor might, in view of this condition, be assured of considerable support — at least in the short run.

In addition to this favourable technical and institutional apparatus, Dr. Dalton was possessed of considerable personal skill in the art of persuasion and was by no means lacking in determination. He did not shrink from the creation of credit on large scale in order to obtain his objectives. As a result, in early 1947 he was able, after a campaign of some fifteen months, to issue 25% Treasury Bonds 1975 at par. He succeeded in getting the long rate

(4) By liquidity in general we mean a preference for holding money or investments yielding low income at short notice as against any form of Government or private stock of indebtedness.

(5) Cf. F. E. V. Howson, The Policy of Interest Rates, in The Economic Journal, Vol. XII, December, 1926. This growth was partly due to the need to provide securities suitable to institutional lenders.

(6) Sources: F. E. V. Howson, loc. cit.

(7) Cf. W. T. G. Knox, The Changing Money Market, in The Investor, March, 1945. This is certainly the view of bankers, but it is probably not accurate. A rise in interest rates involves the banks in large paper losses, since they value securities at cost or market price whichever is the lower. These losses, however, only become real if the securities are realised and in practice banks tend to hold their securities until maturity.

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(11) In the short run.
down. As we shall see, he failed to keep it there.

There is not space available to deal in any detail with the actual technique by which Dr. Dalton accomplished his purpose (12). We shall deal only with one operation. It may, however, without any grave risk of error, be taken as typical.

The Technique of Cheaper Money.

The intention of the Labour Party to promote cheaper money was, of course, well known. To some extent it had been an issue in the 1945 election. Labour took office at the end of July, and Dr. Dalton may be said to have opened his campaign when, on the eve of the "Thanksgiving Week" savings campaign, he announced that it was his intention to examine ways and means of lowering interest rates. The yields on representative Government securities reacted as follows:

<table>
<thead>
<tr>
<th>Period</th>
<th>Consols 5% July 1847</th>
<th>Exchequer 1921-22</th>
<th>Savings Bonds 1911-12</th>
</tr>
</thead>
<tbody>
<tr>
<td>1945 - August</td>
<td>3.99</td>
<td>4.05</td>
<td>3.99</td>
</tr>
<tr>
<td>September</td>
<td>3.63</td>
<td>3.67</td>
<td>4.13</td>
</tr>
<tr>
<td>October</td>
<td>3.89</td>
<td>3.98</td>
<td>3.97</td>
</tr>
</tbody>
</table>

There was clearly some switching from both "shorts" and "mediums" (12) to the longer securities. The fact that the gap between "shorts" and Consols narrowed is hardly surprising but the rise in the yield on "shorts" is, and probably indicates the inability of the jobbers to absorb the sales of speculators who were either switching to Consols, or absorbing the existing "tap" issue of 3% Savings Bonds.

In October the Chancellor moved against the ultra-short rates. He reduced the return on Treasury Deposit Receipts from 1% to 5 1/2%. The rate on Treasury Bills declined to 3% and the banks reduced their deposit rate accordingly. On November 28th the Chancellor announced that the issue of securities through the tap would cease on December 15th.

As can be seen, the peak of the cheaper money drive was reached in January 1947 with the issue of 2 1/2% Treasury Bonds (1975). In February of that year came the fuel crisis. Gifted-edged and industrial records losses, but both markets recovered by May.

In August 1947 came the failure of convertibility. Once again both markets reacted sharply. By the 15th of August 2% Consols were yielding £3 0 0 per cent as against £3 0 0 per cent in July 1945. The index of industrial share prices reached 105 19 by October while Consols showed a slight recovery to yield 2 9/10. Thus, inside the first twenty seven months of the Labour Government's administration the interest wheel had turned its full circle. The situation was practically that which existed before Dr. Dalton's drive as can be seen from the comparison below:

<table>
<thead>
<tr>
<th>Month</th>
<th>Bank Rate</th>
<th>Yield on Consols</th>
<th>Index of Industrial</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 1945</td>
<td>2.0%</td>
<td>2.5%</td>
<td>150</td>
</tr>
<tr>
<td>Jan. 1947</td>
<td>2.0%</td>
<td>2.5%</td>
<td>151</td>
</tr>
<tr>
<td>Oct. 1947</td>
<td>2.0%</td>
<td>2.5%</td>
<td>166</td>
</tr>
</tbody>
</table>

Since December 1947 the yield on 2 1/2% Consols has not fallen below 3% per cent. It can thus be seen that Dr. Dalton's success was purely temporary. He succeeded in driving down rates to the required level. But he was unable to convince the market of the survival value of 2% at long term once it had been reached. Consolidation proved to be beyond (Monthly averages of weekly Annuities)

<table>
<thead>
<tr>
<th>Month</th>
<th>Treasury Bills Outstanding (£ millions)</th>
<th>T. D. R. Outstanding (£ millions)</th>
<th>Bank Deposits Outstanding (£ millions)</th>
<th>Commercial and Industrial Rates</th>
<th>Industrial Index (1920-25=100)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1945</td>
<td>1,000,000</td>
<td>1,000,000</td>
<td>1,000,000</td>
<td>2.0%</td>
<td>150</td>
</tr>
<tr>
<td>July</td>
<td>1,500,000</td>
<td>1,500,000</td>
<td>1,500,000</td>
<td>2.5%</td>
<td>150</td>
</tr>
<tr>
<td>August</td>
<td>2,000,000</td>
<td>2,000,000</td>
<td>2,000,000</td>
<td>3.0%</td>
<td>150</td>
</tr>
<tr>
<td>September</td>
<td>2,500,000</td>
<td>2,500,000</td>
<td>2,500,000</td>
<td>3.5%</td>
<td>150</td>
</tr>
<tr>
<td>October</td>
<td>3,000,000</td>
<td>3,000,000</td>
<td>3,000,000</td>
<td>4.0%</td>
<td>150</td>
</tr>
</tbody>
</table>

(12) Nor do we discuss the theoretical considerations regarding the nature and degree of official intervention, whether or not certain extra budgetary funds were used and so on.

(13) Shall we repeat the story of a boy 5 or 10 years or so to run before maturity; a medium, from 5 to 30 years.

(14) The authorities dissolved both sides of the short market. They are the principal buyers and, through the Bank of England, their control over the clearing banks and the discount houses is strong. A fall in short rates thus involves an enormous volume of switching by banks or discount houses. Moreover, the special buyer stories need to refer to any temporary gaps in the market. These authorities were even more effective. In fact, within the limits of reasonable differential, the rate on Treasury and other bills was almost completely insulated from the rates on long term securities.

his scope. The active drive for cheaper money collapsed with convertibility. Cheap money, however, remained (17).

The Reasons for Failure.

In order to see the reasons for Dr. Dalton’s failure, it is useful to discuss briefly the course of the earlier cheaper money drives that initiated the policy in 1923.

During the whole period, with the exception of 1923 itself, the capital market was in general free from control. Control was imposed for a short time in 1922 in order to effect the conversion of £2,000 millions of 5% War Loan which were put on a 3½% basis.

From February 1922 to November 1923 the deposits of the clearing banks increased by £1,742 millions. Of this increase £1,625 millions took place by the end of 1923.

<table>
<thead>
<tr>
<th>Year</th>
<th>National Income £ Mill.</th>
<th>Cig. Stock Deposits £ Mill.</th>
<th>Notes in circulation £ Mill.</th>
<th>Total £ Mill.</th>
<th>Liquidity</th>
<th>Consols 5%</th>
<th>Bonus Rate %</th>
<th>% of Consols</th>
<th>Index of Industrials</th>
<th>Wholesale Price Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>1929</td>
<td>1,075</td>
<td>1,075</td>
<td>581</td>
<td>2,727</td>
<td>51.1</td>
<td>1.66</td>
<td>5.70</td>
<td>115</td>
<td>112.6</td>
<td></td>
</tr>
<tr>
<td>1930</td>
<td>1,076</td>
<td>1,076</td>
<td>581</td>
<td>2,727</td>
<td>51.1</td>
<td>1.66</td>
<td>5.70</td>
<td>115</td>
<td>112.6</td>
<td></td>
</tr>
<tr>
<td>1931</td>
<td>1,076</td>
<td>1,076</td>
<td>581</td>
<td>2,727</td>
<td>51.1</td>
<td>1.66</td>
<td>5.70</td>
<td>115</td>
<td>112.6</td>
<td></td>
</tr>
<tr>
<td>1932</td>
<td>1,075</td>
<td>1,075</td>
<td>581</td>
<td>2,727</td>
<td>51.1</td>
<td>1.66</td>
<td>5.70</td>
<td>115</td>
<td>112.6</td>
<td></td>
</tr>
</tbody>
</table>

The Chancellor of that time (16) began his operations after a period of financial crisis, and exchange deterioration. The structure of the main rates moved as follows:

- Bank Rate
- Bank Bill Rate
- Price of Consols

The table above shows the evolution of these rates over the years.

The more easily obtained in terms of credit creation. A reduction of the Bank Rate and a 3½% increase in the liquidity ratio produced a satisfactory decline in the short rate and a decline, though a less satisfactory one, in the long rate.

In 1933 the liquidity ratio was virtually static while from 1933 to 1924 the liquidity ratio declined by 4.4%. Nevertheless, in both years rates declined while from 1933 to 1938 the average rate on Consols fell to a below 2½% and that on bills to 0.5%, while the liquidity ratio remained constant.

The inference is obvious. While the risk premium demanded in respect of the additional uncertainty of longs remained constant, or roughly so, the recovery from the bottom of the depression greatly reduced the general preference for money rather than near moneys. From this shift in the liquidity preference schedule as a whole, all rates benefited.

The continued fall in the rate structure unsupported by any increase in the liquidity of the economy and accompanied by no marked change in the relative rate structure can easily be explained if it is reckoned that the unusually high rates obtaining in early 1932 reflected official policy designed to check capital outflows. They were therefore above the market’s idea of the “normal” level of the rates. Consequently, once the temporary uncertainty associated with the crisis disappeared, speculative stocks regained some of their customary elasticity and the influence of long run concepts of the “normal” rate was restored itself (18).

Once we look at the matter in this light, Dr. Dalton’s experience becomes immediately explicable. There is little reason to suppose that general political and economic uncertainty in the post-war period is less than it was in the thirties. It is therefore improbable that the gap between the short and long rates will be any less. On the contrary, in view of the high degree of uncertainty prevailing in the present decade there seems every reason to suppose that the risk element will have increased and where the differential between the two rates was formerly from 2½% it will probably in the future, unless political conditions improve greatly, be nearer 3% (19).

Thus, given the Chancellor’s ability to manipulate the short rate, the market, on our assumptions, would expect the long rate to settle at about 3½% — the actuarial or “safe” rate reflecting the expected short rate plus risk premium (20).

But the influence of these long interest rates was probably masked, during the earlier part of the campaign, by the existence of short run expectations regarding the long rate based upon the market’s estimate of the Chancellor’s ability to reach 2½%—even temporarily. The Chancellor’s ability to take advantage of these short expectations ensured his reaching 2½%. Conversely, his inability to alter fundamental ideas with regard to the “normal” long term rate created his final failure. With his virtual retreat from the market after the conversion crisis, long run expectations reasserted themselves and the rate on Consols, with minor fluctuations, climbed steadily towards 3½%.

The Case of the Crisis.

One of the more surprising features of the drive for cheaper money carried out by Dr. Dalton was the volume of criticism it provoked from journalists, finance writers and economists (21). Before we proceed further with the case for the prosecution we must make it quite clear that there is a distinction between cheap money in general and the cheaper money campaign. Criticism of cheap money in general would imply unwillingness to accept the principles laid down in the White Paper on “Employment Policy”. In other words it implies that post-war inflation must be fought by the use of monetary policy. This argument, in turn, would carry with it the assumption that the falling rates do not mean that it may not influence expectations regarding the economy in the long run. (22)

(17) The fact that the bill rate is largely landlocked from the remaining rates does not mean that it may not influence expectations regarding the economy in the long run.

(18) It is the reason for the move to a 3½% bill rate, however, that the Chancellor was able to make a significant impact on the market.

(19) Cf. also note (18) above.

(20) Cf. also note (18) above.

(21) Cf. Professor Lonsdale, “Is it a Lloyd Bank Re- view”, October 1924 and the general statement of the Chancellor of Lloyd’s, Barclays, National Provincial and District Banks for the end of 1924.
fact, is for a return to allowing the rate of interest to determine the demand for investment. In other words, given full employment during the transitional period, and given the fact that investment demand would tend to exceed the available savings of the community, higher interest rates should have been used as a means of checking the former and stimulating the latter (22). In some forms this argument rests upon the a priori proposition that the authorities with their controls would tend to misallocate resources between conflicting uses, whereas, conversely, if the allocation was decided by the rate of interest it would be better (in some sense).

If we consider the functions of the rate of interest in a full employment economy we shall see that it has two. By deciding the volume of investment it reflects the community's preference for present as opposed to future consumption. Secondly it allocates resources between the various investment projects. That is it supplies both a qualitative and quantitative control over investment. The case of the authorities as revealed in the White Paper and expressed in the House of Commons was that it should do neither. Once this case is conceded, the dear money argument which implies complete reliance on the interest weapon is waivered. In practice most of the critics appear to have accepted the official argument that investment, both as regards total volume and type, must be decided by administrative controls.

This brings us to the second argument. This proceeds as follows. Since the rate of interest by assumption, is to be below the rate which would equilibrate savings and investment at full employment then the economy must be subject to inflationary pressure. This is plainly undesirable. Moreover the lower the rate the greater will be the volume of inflationary pressure. Hence to push the drive to full employment is only likely to intensify inflation, strain the capital apparatus, promote the misallocation of resources, produce bottle-necks in production, and, finally, handicap the export drive. Hence Dr. Dalton's policy was the equivalent of pouring petrol on an existing blaze.

This is a different argument from the first. It is quantitative and empirical rather than a priori. What is being asserted in fact comes to this: that both the consumption function and the investment function are significantly interest elastic. And that downward changes in the rate of interest within the practicable range, would have unfortunate effects. This is, of course, an empirical proposition. There is a second proposition implied in the argument—namely, the alleged imperfection of controls. This second proposition is necessary because even if the first were true inflation would not follow if the control system were perfect. This latter proposition is, however, obviously true. The real bones of contention are the two propositions with regard to the consumption and investment functions. We shall examine each in turn beginning with investment.

Investment Demand.

The investment demand of the community may be conveniently divided into two categories: originating from the private sector and that from the public sector. We shall discuss the private sector first.

There are, in general, three channels through which a fall in the rate of interest may affect a business man. In the first place it may produce more and less optimistic expectations with regard to future profit. In the second place it may lower his cost of borrowing. In the third place it may substantially increase his liquidity.

There seems no a priori reason to expect one psychological change rather than another. It is perfectly true that a sharp rise in Bank Rate plus a contraction of credit may dampen business enthusiasm. On the other hand it may, if it is seen as an orthodox and therefore a sound way of dealing with the problem of inflation, even increase confidence (23). In the context of this paper what is being discussed is not a large rise or fall in the rate structure.

We are dealing with movements of the order of 3% 3%. It therefore seems unlikely that business men's profit expectations would be substantially improved by Dr. Dalton's operations. Indeed if business men pay much attention to the opinions of financial writers they can hardly have avoided deterioration. Cautious judgement would regard this factor as neutral.

The cost of borrowing to a business man takes one of three forms. It is either the cost of a new issue; the cost of an overdraft; or the opportunity cost of using his own funds for investment rather than purchasing securities. All three will tend to fall when the rate of return on relatively riskless assets falls. In general, due to income effects operating through the portfolios of such institutional lenders as insurance companies there is some presumption that risk bearing funds will fall further in price (24). In practice, during the Dalton period, all three costs fell. Overdrafts rates may have fallen rather more than the return on gilts (25), and costs of new issues rather more yet.

The effect of this fall in the cost of borrowing on a businessman's desire to invest depends, however, partly on the length of the period which he expects to elapse before the investment pays for itself. It is thus difficult to believe that the fall of 15-16% actually recorded during the Dalton period increased investment to any great extent. We take this view for two reasons. In the first place the dominant idea in the minds of most businessmen in the post-war period must have been to replace and modernise their existing capital as soon as possible and thus ensure an early start in the race to the waiting seller markets. Secondly, a change in the discount factor of the order under discussion is not likely to be important, even assuming constant prices, unless the planning period is very long. Moreover, prices were not constant. They were rising and were probably expected to continue rising which, again, was a strong incentive to undertake investment immediately if possible and not to worry about any over nice balance of less or more. Finally, it is only true that the changing of investment activity in which the planning period is necessarily long, e.g. housing, the state was in either direct control or possessed of the dominating influence.

On balance there seems little to be said in favour of expecting a high interest elasticity of the investment demand schedule due to the cost effect.

When we turn to the liquidity effect, however, the picture is more promising. There is no doubt that business in general ended the war holding large quantities of Government securities. Even the small fall in rates which Dr. Dalton achieved must have substantially increased the liquidity of many firms. Indeed the capital gain on a long term security paying 3% purchased at £100 would be £30. Not a negligible change by any means. Again, if we refer back to the absorption of securities by the clearing banks during 1945, 1946 and, to a lesser extent, 1947 we must say that it was the main advantage that industry was happy to take its capital gains, or part of them, in cash. Thus some effect, in an inflationary scene, is probable; but to give it a quantitative estimate is impossible particularly since industry would have, almost certainly, sold large parcels of securities anyway whether rates had fallen or not.

In sum there seems little reason to suppose that the quantitative effect on private investment was large. Indeed, when we consider the available evidence provided by the researches of the econometricians (26) and the questionnaire surveys (27) of pre-war periods, we must regard the liquidity effect as an interesting, if not decisive, influence on investment decision making.

(26) The Keynesian Revolution
(27) Professor Stuart MacAuley and Mr. P. W. S. Alexander, commenting on the results of the well known Oxford Survey, come to the conclusion that the Keynesian economic view was in the majority (of firms) decided that the long run rate of interest influences investment directly through its effect of which it is of importance to stress. The Oxford Economic Survey, No, 2, 1958.

(28) There is an interesting agreement that short term rates of interest do not often influence either in stocks or fixed capital, but that the liquidity effect is particularly important in the latter.

(29) There is, however, some evidence that a fall in long term rates would have favorable indirect effects. It is difficult to see, however, how this could be expected to influence the range of output on a significant scale.
conclude that the investment demand schedule of the private sector was likely to have possessed a lower, rather than a high interest elasticity in the Daltonian period.

**Public Sector.**

Evaluation of the public authority demand for investment is probably a task for the political theorist as much as the economist. It is difficult to believe that this component in investment demand shows, in any period, much response to changes in interest rates. Public investment is largely policy determined and such factors as political pressure, recent access to offer by a Government, and the state of public opinion as revealed by the Press are likely to be far more important in determining the volume of investment demand. There is some hope that the investment decisions of local authorities might be influenced by the interest weapons in normal times but little reason to suppose that this condition existed in the immediate post-war period.

Since there is little empirical evidence available and since on a priori grounds we should expect little effect, the safest procedure seems to be to regard this item as interest inelastic.

**Private and Public Consumption.**

The savings of the private sector of the economy consists in three components: personal savings, depreciation allowances, and undistributed profits. The two variable components being the first and last. Since the policy of industry with regard to dividend distribution was subject to a number of official hints and pressures, it seems that any large effect must be sought through the first component. The first point which needs to be made here is that net personal savings are, in general, of diminishing importance in the finance of capital formation. The figures of Table IV are from Cmd. 7933.

<table>
<thead>
<tr>
<th>YEAR</th>
<th>1938</th>
<th>1945</th>
<th>1947</th>
<th>1948</th>
</tr>
</thead>
<tbody>
<tr>
<td>m</td>
<td>6 m</td>
<td>6 m</td>
<td>6 m</td>
<td>6 m</td>
</tr>
<tr>
<td>Gross Personal Savings</td>
<td>217</td>
<td>828</td>
<td>540</td>
<td>499</td>
</tr>
<tr>
<td>Net Personal Savings as a % of disposable income</td>
<td>129</td>
<td>658</td>
<td>476</td>
<td>374</td>
</tr>
<tr>
<td>Net Personal Savings as a proportion of Gross Earnings Earned at home</td>
<td>4.8</td>
<td>10.5</td>
<td>5.3</td>
<td>4.8</td>
</tr>
<tr>
<td>Households' Saving</td>
<td>18.3</td>
<td>50.2</td>
<td>19.3</td>
<td>8.0</td>
</tr>
</tbody>
</table>

The high figures for 1946 are easily explicable in terms of the continuing non-availability of goods. They represent enforced savings as opposed to genuinely desired savings. Given that the relative importance of personal savings is diminishing and that the levels achieved in 1946 and 1947 were primarily due to inability to find the goods on which to spend, it seems clear that small changes in interest rates were not likely to have a significant effect on the economy as a whole, even if they influenced personal savings.

Moreover, in the period under review much of the personal savings was a small savings. It seems intuitively unlikely that small savers are much influenced by minor fluctuations in the rewards obtainable on Government securities particularly since the Post Office Savings Bank rate remained unchanged at 3½% per annum.

This, however, is not to deny that the fall in rates may have encouraged consumption of resources by those who were either making actual or paper profits from speculation.

Against this we must set the influence of those whose demand for a given future income is completely inelastic. They would tend to increase their rate of saving.

The upshot of this discussion appears to incline towards the view that, though it seems intuitively possible that there was some increase in private consumption demand due to the fall in rates, it was in fact small. The evidence provided by the econometricists lends some additional support to this view. Dr. Klein (29) for example, is explicit and states

> "... no economist has ever found any significant correlation between consumption and interest rates when the correlation between consumption and income is taken into account."

He concludes

> "It must be concluded that the consumption function is interest inelastic; i.e., consumption is not sensitive to changes in the rate of interest."

**Public Expenditure.**

When we turn to the expenditure of the public authorities one effect of the fall in rates is clear. There is a reduction in the interest burden of the national debt. This comes about in two ways. The effect via the floating debt which makes itself apparent immediately, and the effect via the remaining debt which only comes later when conversion operations are carried out. These savings, however, can easily be exaggerated. In the first place the total debt figure is misleading since part of it is held by Government departments. Secondly the real saving to the authorities is less than the apparent saving by the amount of income tax foregone. Our estimates of the savings are as follows.

<table>
<thead>
<tr>
<th>YEAR</th>
<th>1945</th>
<th>1946</th>
<th>1947</th>
</tr>
</thead>
<tbody>
<tr>
<td>£m</td>
<td>£m</td>
<td>£m</td>
<td></td>
</tr>
<tr>
<td>Gross Savings on Floating Debt.</td>
<td>7</td>
<td>30</td>
<td>25</td>
</tr>
<tr>
<td>on other debt.</td>
<td>—</td>
<td>6.5</td>
<td>7.2</td>
</tr>
<tr>
<td>Net Saving after adjustment for tax.</td>
<td>3.7</td>
<td>20.2</td>
<td>18.9</td>
</tr>
</tbody>
</table>

Tax at 9/- — in the £ is assumed. These estimates almost certainly overstate the savings effected.

We have already remarked that public expenditure is largely politically determined. Therefore we can provisionally assume the budget surplus or deficit to have been decided in these years quite independently of the level of interest rates. This being the non-inflationary effect of a fall in rates on the economy as a whole depends upon

(a) the magnitude of the increased private investment demand,
(b) the magnitude of the increased private consumption demand

relative to the saving effected via the reduction in debt servicing costs (x). Any estimate of which way the net effect went in the Dalton period is guesswork. A reasonable guess is that (a) the net effect was inflationary (b) that it was quantitatively insignificant.

If this last view is accepted much of the case against the experiment collapses. Further accusation can be made and that is to the effect that, by increasing the liquidity of the system, the Chancellor was putting the public in a position to finance an inflationary spending spree if it so desired. This is true but the point which matters is the magnitude of the risk, about which dispute would be pointless.

**Conclusions.**

From the point of view of the authorities we may list a number of advantages to be obtained from cheaper money. They were:

(a) lower cost of National Debt service;
(b) reduced interest costs of the hoarding programme;
(c) reduced interest charge on nationalisation compensation issues;
(d) distributional effects.

The first of these we have already discussed. The estimates of net savings on this account do not appear to be large. But in this connection we must remember that the authorities must have thought that the savings, in the longer run, would be much greater since, if 2½% at long term had been capable of consolidation, conversion operations would gradually have spread the gain over the whole national debt.

There is no doubt of the importance which the Labour Government attached to the pro-

(29) Dr. L. Klein, op. cit.
vision of cheap finance for the housing drive. The whole housing policy was directed to providing, through the agency of local authorities, houses to let at low rentals. These houses were then allocated not in accordance with ability to pay but in accordance with individual need. In this context, "need" was usually defined in terms of criteria such as the number of children, years of war service, adequacy or inadequacy of existing accommodation, health of applicant and so on. There can be little doubt that even a saving of 5½% per annum on interest charges is significant in this context. At the time of writing the housing programme is, by Government action, still insulated from the rise in rates which has, in fact, taken place.

It can, of course, be seen that one peculiarity of the authorities was with distributional questions. One aim of the policy was to redistribute income away from the renter class. That is to begin the "euthanasia of the renter".

When we turn to the disadvantages two stand out. There is first the added inflationary pressure, with its concomitant misallocation of resources, bottlenecks and so on; second, there is the fact that speculators must have made large capital gains. In some cases these may have become losses later, but not in all. We do not feel that the volume of additional inflationary pressure generated by cheaper money drive can have been very significant. Indeed it is a matter of surprise that critics have concentrated on this aspect of the Chancellor's policy when the annual budget deficits were (Source: Cmd. 2771, Table 13):

| Year | Deficit
<table>
<thead>
<tr>
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<th></th>
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</thead>
<tbody>
<tr>
<td>1945</td>
<td>2300</td>
</tr>
<tr>
<td>1946</td>
<td>1564</td>
</tr>
<tr>
<td>1947</td>
<td>491</td>
</tr>
</tbody>
</table>

Dr. Dalton, however, cannot avoid the reproach that his policy generated speculative profits. Their magnitude, however, is a different question.

From the national point of view the balance of advantages and disadvantages is against the Chancellor. This is particularly so when the nature of Dr. Dalton's fundamental error is recalled. This was his failure to appreciate the probable nature of the long run expectations of the market. In our view, these expectations were (and are) such as to require a differential between the short and long rates of the order of 3%. If this is correct then the policy was a grave mistake since it had to end in failure (39). Moreover it seems likely that Dr. Dalton overestimated the efficiency of the existing controls which, when the cessation of hostilities removed the patriotic sanction, were subjected to severe strains.

Nevertheless, though the attempt to provide cheaper money was certainly a blunder the continuance of cheap money in a broad sense is probably sound. Monetary policy in the future must attempt to reconcile a number of conflicting claims. These are:

1. The claims of debt management and servicing;
2. The claims of income and price stabilisation;
3. The claims of particular financial institutions to stability in the value of their capital assets (37).

The first of these seems certain to put pressure on the authorities to maintain low rates. The last of these probably precludes all but small rate changes since large changes would involve banks, insurance companies and other financial institutions in enormous paper capital losses. On the other hand, the available empirical evidence seems to point to the conclusion that both consumption and investment expenditure are comparatively insensitive to small rate changes.

The authorities are thus faced with a dilemma. Small rate changes are feasible but ineffective. Large rate changes may be effective but involve severe risks (35).

The press claims of debt service and debt management, the wise course would appear to be to stabilise rates at around 3½% for short loans and 3½% for long term loans. Moreover, in addition to this, the authorities would be well advised to borrow in the main by means of medium length bonds carrying definite redemption dates. Securities such as these are particularly well adapted to the needs of financial institutions. If this policy is in fact followed, and the indications are that the authorities are moving in its direction, then the task of income and price stabilisation will fall upon fiscal planning (23). This is not the place to enter into a full discussion of the advantages and disadvantages of budgetary control. Nevertheless we must assert that, during the Chancelloryship of

Sir Stafford Cripps, fiscal disinflation was, broadly speaking, successful. The years from the end of 1947 to 1950 were, in general, years of considerable progress. During this period control of the economy by means of operating on the interest rate has been many times advocated but never attempted. In our view this reliance on fiscal planning should continue and much more thought should be given to the institutional and other problems which it raises. The use of the interest weapon should be avoided until much fuller empirical investigation has been undertaken to discover the precise way and the degree whereby changes in it over the practicable range influence people's decisions to consume, invest and save.