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Sovereign Debt Management and the Transformation from Keynesian to Neoliberal Monetary Governance in Britain

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Private financial markets are central to the implementation of monetary governance. This necessary integration of public and private finance means the way states govern must evolve with developments in financial markets. This article examines how the rise of liability management underpinned a shift to market-based banking and transformed the operation of monetary policy in Britain. It assesses the period of reform between 1967 and 1981 and what this meant for monetary governance. Political economy literature depicts this period as a shift to depoliticised, deregulated governance with public authority giving way to market power. This paper challenges this perspective on the grounds that it misconstrues the problem policymakers faced. The shift from Keynesian to neoliberal monetary governance came in response to the change in banking practice with the rise of liability management and a parallel money market. This underpinned an explosion of credit creation that the old system of monetary policy, organised around the Base Rate and ‘primary’ discount market could not fix. As a result, the monetary authorities had to render this new financial environment governable. The period should therefore be reassessed in terms of the capacities the state attempted to construct to conduct monetary governance.

Keywords: Liability management; sovereign debt management; monetary governance; monetary policy.

Introduction

The global political economy has been transformed by the rise of market-based banking (Hardie and Howarth 2013, Tooze 2018). The change in the way banks access and manage their liabilities led to an explosion of credit creation in the last four decades that

has fundamentally reshaped the terrain upon which political economic life takes place. In doing so it of course altered the practice and politics monetary governance.

It is widely believed that over the last four decades there has been a steady marketisation of monetary governance, and with that a creeping depoliticisation as policymakers prioritised the monetary stability favoured by financial markets over the full employment wishes of electorates (see, for example, Blyth and Matthijs 2017, p. 209). In political economy literature this shift is often explained in two broad ways: the capture of state institutions by financial interests or ideologies (Davis and Walsh 2016, Pagliari and Young 2016, Oren and Blyth 2019), or the structural dependence of the capitalist state on the verdicts of financial markets (Clarke 1988, Burnham 2014).

Mark Blyth, for example, argues that since the mid-1970s state administrators became convinced of the idea that democratic intervention into the private economy would inevitably bring inflation (Blyth 2013, p. 156) so chose to let market investors guide policy instead. Looking to the British case, Davis and Walsh (2016) examine how the growing cadre of economists in the British civil service and power of the Treasury within the government skewed macroeconomic policy in favour of financial interests. In practice this meant limits to state intervention, a focus on price stability and a strong currency. As they write (2016, p. 8), ‘The Treasury made a series of changes that were designed to free up markets generally (see also Cairncross 1992, Jenkins 2006, Pollard 1992, Toynbee and Walker 2010) but often worked to benefit financial markets at the expense of UK industry.’

Alternative, structural accounts like Peter Burnham (2014) look less at the ideological and institutional capture of public authorities and more to the way a capitalist state is necessarily forced to impose palliative remedies to underlying problems in capitalist profitability. Confronted by low growth, high inflation and large government

and trade deficits, state managers used public legislative authority to help restructure domestic economies in support of capitalist market profit (Clarke 1988). This meant overseeing a redistribution from labour to capital.

Both these perspectives depict the shift from Keynesian to neoliberal monetary governance as a move from state-led and politicised governance, to market-led, liberalised, competitive, and depoliticised governance (for example, Clarke 1988, Gamble 1994, Nesvetailova and Palan 2010, Burnham 2011).

This depiction of neoliberal monetary governance as a ‘marketisation’ risks occluding the constitutive role and political significance of public institutions in what was constructed through this period. Rather than a general question of marketisation of the state, an alternative understanding of the politics of monetary governance can be reached by inquiring about capacity: how do states generate the capacity to think up and implement policy?

This focus on state capacity provides a narrower lens through which to capture the specific politics of how the monetary authorities had to react and adapt to the emergence of liability management and market-based banking in what proved to be a major period of political economic upheaval.

While many accounts take the stagflation crisis and demise of Bretton Woods system as historical anchors for the shift from Keynesian to neoliberal monetary governance (see for example Oren and Blyth 2019) I argue we should look elsewhere. The growing problem facing the monetary authorities by the end of the 1960s was the rise of the parallel money markets and private sources of liquidity that flourished through a new practice of banking, termed ‘liability management’ (see Knafo and Beck 2019). This involved financial houses lending to customers first, before borrowing corresponding liabilities from private money markets. New private money-market instruments like

Certificates of Deposits initially, and later repurchase agreements (repos), supported this development and underpinned an explosion of liquidity¹ in the decades that followed. Importantly, it was this rise of liability management on the Euromarkets that helped erode the Bretton Woods apparatus.

This was a credit revolution, and it was in this context that the British monetary authorities undertook a sequence of changes to monetary governance between 1967 and 1981. These included the 1971 Competition and Credit Control (hereafter ‘CCC’) policy that removed direct controls on bank lending, the Minimum Lending Rate (hereafter ‘MLR’) policy of the same year that changed how the Bank of England set base interest rates, and the 1981 Medium Term Financial Strategy (hereafter ‘MTFS’) that committed the government to fixed targets for aggregate broad sterling money creation.

CCC, MLR and the MTFS are often presented as part of the response to the broader, periodic capitalist crisis (see, for example, Clarke 1988, Burnham 2014). Given the inability of British industry to generate sufficient profits and export income, state managers had to devise ways to ‘depoliticise’ monetary governance, granting themselves the electoral space to deliver the deflationary restructuring programme demanded by financial investors.

In contrast, I reinterpret this period of monetary change from the vantage point of sovereign debt management (SDM). Since monetary governance needs public monetary authorities to work with a mix of public and private institutions, and public and private financial instruments, the management of sovereign securities provides a useful angle to see how governance takes place. I demonstrate how the monetary authorities were important constitutive agents in a new form of a politicisation of the infrastructure of monetary governance. I do this by exploring how public institutions struggled to generate the capacity to undertake monetary governance. In particular, I argue that the CCC, MLR

and MTFs should be understood as attempts to control private sector credit creation in the age of liability management, something that the International Monetary Fund (IMF) had first demanded after its 1967 bailout of the British state (Clift and Tomlinson 2008). In their unsuccessful attempt to ‘muddle through’ they ended up unifying a bifurcated money market and providing an alternative basis for conducting monetary policy, though it was decades later that the possibilities this created were realised.

I make two central contributions. First, I bring a hugely important monetary history of the rise of liability management and market-based banking to bare on the way political economy literature has conceptualised the switch from a so-called Keynesian to neoliberal monetary governance in Britain. Second, through the notion of state capacity, I establish an important perspective on the relationship between public power and monetary governance in the age of neoliberalism.

This paper is divided into four sections. I begin by demonstrating the limitations of the marketisation framing for analysing changes in monetary governance. I show how the existing literature depicts the period of transition from 1967 to 1981 as one where the British state imposed a market-directed discipline. In the second section I examine the place of public debt securities in the financial system and their relation to the private banking system in the undertaking of monetary governance. The third section analyses the changing financial landscape with the rise of the parallel money market and how that necessitated a change in approach to monetary policymaking. The fourth section then takes each of the CCC, MLR and MTFs in turn, recasting the changes in light of concerns around SDM. The conclusion argues that these reforms have politicised new aspects of private finance, intertwining public and private financial instruments and institutions, and generating a new capacity for the state to undertake monetary governance.

The State in Monetary Reform

Monetary policy is a central site of the neoliberal revolution (Krippner 2012). The rhetorical importance of monetarism in the classic neoliberal cases of Britain, America and Chile earned the ‘Chicago Boys’ a place in popular political discourse, while academic analysis has focussed on central bank policies as key to the transition from postwar Keynesian to contemporary pro-market neoliberal governance (Hall 1993, Walter and Wansleben 2019, p. 3) Monetarism itself was a technical analysis about the interrelation between fiscal policy, credit creation and general price inflation. Though always presented as a technocratic solution to an inflation problem, critics (for example, Clarke 1988, Blyth 2013) longed argued that it was highly politicised, instilling an economic order ‘that made neoliberal, anti-inflationary policies a priority rather than employment or growth’ (McNamara 1998, pp. 5–6 in Clift 2019, p. 1) and ‘paved the way for the modern understanding of austerity by making markets always efficient and the state always pathological’ (Blyth 2013, p. 154).

It is why critical literature has long argued the transformation of monetary governance in the 1970s and 1980s was political, not economic. As Simon Clarke (1990, p. 27 in Burnham 2014, p. 192) put it:

The driving force behind this [monetarist] restructuring is not so much the attempt to provide a resolution to the economic crisis, as the attempt to solve the political crisis for the state by trying to disengage the state politically from the economy so as to de-politicise economic policy formation.

From this perspective, monetarist reform saw policymaker discretion over fiscal policy replaced by fixed rules of monetary policy. Burnham (2011, p. 476) argues that ‘Britain’s monetary policymaking between 1972 and 1978 is best understood as an example of internal “rule-based depoliticisation”’, something that he saw the continued in the 1981

MTFS (2011, 478).

Within this literature there are often two strands of explanation for the British shift in policy between 1967 and 1981. First is the idea that there was a broad ideational and institutional shift that saw policymakers align with financial interests. Policymakers came to believe that inflation could only be contained by cutting private and social wages. In the words of Mark Blyth, state administrators grew convinced that ‘inflation is the ... inevitable outcome of democratic governments trying to interfere in the economy’ (2013, p. 156). As such the solution was to use monetarist rules to ensure markets, rather than policymakers, guided government policy. Looking more particularly at struggles within the state apparatus itself, Davis and Walsh (2016, p. 4) examine the triumph of the Treasury’s ‘finance-linked economic worldview’ over the Department for Trade and Industry’s ‘wide industrial vision’. In these more institutionalist studies, there is an idea going back to Ingham (1984) that Britain’s political economy is skewed by the overlapping interests of the City of London, Bank of England, and Treasury. They have a shared preference for price stability, which meant the British state was historically reluctant to intervene for industrial strategy, and instead worked to support ‘sound finance’ and ‘market forces’. ‘[T]he Thatcher government is not explicitly or intentionally pro-City’, wrote Ingham (1984, pp. 220–21). ‘[R]ather economic liberalism and monetarism are – as they have been since the early nineteenth century – at the core of commercial and wholesale banking capital’s ideology.’ In this way liberalisation, marketisation and monetarism are all tied together in Ingham’s framework. This is reflected in Green, whose hugely important work depicts the trajectory of monetary governance through the 1970s–90s as a creeping neoliberal deregulation, with the City taking on a distinctly Anglo-American shape. The American influence is crucial because it was when confronted by American competitors, Green writes (2016, p. 246), that

‘British banks moved towards universal banking and away from traditional divisions between merchant and commercial banking.’ For Green, it was not pro-market ideology that drove deregulation and marketisation but rather the institutional makeup of the British political economy. Marketisation derives from the City-Bank-Treasury nexus that has for centuries bent the British political economy to the interests of finance. The monetary authorities are thus institutionally captured to support those interests.

An alternative strand of critical literature challenges this depiction of monetary reform. Simon Clarke, Peter Burnham and most incisively Jack Copley instead see Britain’s monetary reforms in terms of the British state’s structural dependence on financial markets. Locked into global financial markets, policymakers could not yield to the demands of their electorate without risking investor backlash in the form of capital flight and higher borrowing costs. To placate financial markets and ensure the continued viability of capitalism, the state needed to deliver unpopular deflationary programmes.

For much of the literature, legitimacy of the state, in the eyes of both the electorate and financial market investors is a big theme (for example, Best 2018). This structural dependence literature traces the institutions and techniques state managers developed to ‘depoliticise’ economic policy and distance themselves from the electoral consequences of their policy choices. The broader aim of this literature is to stress how a liberal national state form will necessarily end up sacrificing democratic interests for those of the dominant capitalist class, because of its subordination to the global rule of money (Konings 2005, p. 102).

In the context of the 1970s stagflation crisis in Britain this structural tension was felt in the way the British state needed to cut imports, consumer spending and wages so as to avoid a loss of confidence from international financial markets. Copley (2019, 2017) conclusively demonstrates how a range of reforms from the CCC in 1971 to the dissolving

of capital controls in 1979 should be understood as state managers attempting to support and enforce industrial competitiveness so as to boost exports. Because state-led deflation risked democratic backlash, state managers needed to shift the blame and monetary reform should be seen in this light. As Peter Burnham (2014, pp. 196–97) argues, the reforms involved the state off-loading responsibility by finding ‘an anchor (and justification)’ for ‘deflation strategies’, ‘tying policy to statute or clearly identifiable (and therefore constraining) targets’.

In this case, state power is meaningful insofar as it helps the transition to what is demanded by capitalist financial markets. Elsewhere, Copley (2017, p. 7) argues that state managers were pushed by the stagflation crisis into shifting from direct control on bank advances to market-led credit allocation, with the Treasury ‘accept[ing] CCC as way to redistribute credit from labour to capital in a depoliticised fashion’. As he shows state managers hoped this regressive reallocation of credit would at once help give big business ‘breathing space’ at a time of declining profitability, while at the same time reduce consumer spending that was thought to be worsening inflation and the trade deficit. By shifting blame onto ‘the market’ policymakers hoped to shield themselves from the unpopularity of these moves. As it turned out CCC was unable to stem the general excess of liquidity that drove inflation and the policy was soon abandoned and replaced by the MLR. Again here, Burnham (2011) argues state administrators recognised how interest rates would have to be substantially higher to slow the pace of credit creation. As such ‘the MLR was devised to “defuse” the political implications of Bank Rate policy and thereby shield the government from the consequences of frequent upward shifts in interest rates’ (Burnham 2011, p. 463). Fast forward to Thatcher’s MTFs, where the chancellor set and announced fixed targets for monetary growth and let interest rates climb to whatever was required to achieve those targets, the idea was to lock in a deflationary

policy programme. The imposition of rules way was a ‘lynchpin of economic policy’ according to Burnham (2014, p. 197). ‘When this strategy [of depoliticisation] is successful’, writes Copley (2019, p. 5), ‘the authorities can hope to attain credibility in the eyes of global financial markets’.

In both the state capture and structural dependence perspectives, the politics of monetary governance is analysed in terms of the extent of marketisation. Public institutions – be it the Treasury, the Bank of England or the Prime Minister’s office – use legislative authority to either challenge financial markets, as is thought to characterise the Keynesian era, or to secure the favour of financial markets, as is thought characterise neoliberalism.

These accounts suggest there has been a marketisation of monetary governance under neoliberalism. This entails the state acting primarily to uphold market interests by fostering competition, liberalising banking and attempting industrial renewal. All of which to secure financial market favour. For all the institutional detail involved, the implication is that the transformation from Keynesian to neoliberal monetary governance is fundamentally an abdication of state control for the needs of the market.

By contrast, I suggest moving away from the marketisation framework. Monetary governance should not be always conceptualised in terms of whether public authority is used either to constrain financial markets, or to work in their favour. Rather, to understand the politics of monetary governance we can examine not only who it serves – as is common – but how. In particular, the infrastructural question of how public authorities develop the capacity to act on financial markets; what institutions, instruments and techniques are mobilised and what impacts this has. Monetary policy operates primarily through three channels: Collateral framework, where the central bank designates which securities will be accepted to meet banks’ reserve requirements, lending through the

discount window, and open market dealings on the money markets. In doing so monetary policymaking and monetary governance necessarily involves mobilising public and private financial institutions and instruments.

For this, SDM provides an important vantage point. It provides a different perspective on the problems the monetary authorities were confronting through the sequence of monetary forms that took place between 1967 and 1981. As I will demonstrate, the related developments the parallel sterling money markets and the practice of liability management fundamentally altered the terrain upon which public and private financial institutions acted. They allowed the financial sector to ramp up credit creation by bypassing the primary sector where the Bank Rate had an influence over the cost of liquidity (Revell 1973). With its primary policy lever broken, state managers scrambled for solutions, and the repeated experiments in monetary governance should be read in this light of muddling through, as Jacqueline Best (2019) has recently put it. That the state now is thought to govern through markets (Braun et al. 2018) speaks of the new capacities that were established over this period.

Sovereign Debt Management: A Matter of Statecraft

There is a deep and necessary entanglement between the public and private in financial markets. The banking mechanism, ultimately, requires public-sector liquidity creation to settle payments; while public authorities must act through private sector money markets to undertake monetary governance and influence interest rates.

Alongside familiar concerns about the legitimacy of monetary policy in the eyes of both citizen voters and financial market investors, and the macro impacts of changes in interest rate policy, any examination of monetary governance must explore the infrastructural basis of public power. That is the institutions, instruments and practices by

which public authorities construct the ability to determine, implement and evaluate policy objectives.

Sovereign debt securities are a key part of private financial markets. The management of sovereign debt instruments is, as such, central to the operation of private sector actors, making it fertile ground for considering questions of governance and statecraft. As I demonstrate, one key challenge of governance is establishing the capacity to make policy. Doing so requires the mobilisation of a vast swathe of public and private institutions which necessarily means there is a disjuncture between the intentions of policymakers and the outcome of their policies. For this reason, the politics of monetary governance can be understood not only in terms of *cui bono* but also the infrastructural problem of what makes governability possible.

This is especially apparent in the period I examine, where policymakers' repeated attempts to control financial markets, credit creation especially, failed so spectacularly. In particular, I highlight how the big shift that took place between 1967 and 1981 should be cast as an evolving, often chaotic response to a radical transformation of the money market with the development of practices of liability management by US banks operating on London's parallel money markets. This dramatically altered the relation between retail and wholesale banking in Britain, with the retail, deposit-taking banking sector – which revolved around the discount houses and Bank of England – being rapidly disintermediated as wholesale money markets grew in size and significance. Along the way state-created Treasury Bills were replaced by private sector Certificates of Deposits (hereafter 'CDs') and later Repurchase Agreements (hereafter 'Repos') as the dominant liquid asset in the banking system. The rise of the parallel markets necessitated a shift in the way the monetary authorities conducted financial governance and is what drove the repeated experiments in monetary reforms that are today considered so crucial.

In focussing on SDM, I take up Fastenrath et al.'s (2017) challenge to look less at the aggregate level or cost of sovereign debt and more about the makeup of sovereign debt. However, I differ from their approach (and others like Lemoine 2016) because my interest is not in the distinction between 'marketable' and 'non-marketable' sovereign securities. Rather it is about how different sovereign securities relate to the broader banking system and what this means for monetary governance.

In what follows I demonstrate how both the state capture, and structural dependence accounts of the evolution of monetary governance in Britain can be complimented by a focus on state capacity. From a historical vantage point, it becomes possible to see that these literatures risk both exaggerating the agency of the state before the neoliberal revolution, and downplaying it after. It is precisely why many authors (for example, Nesvetailova and Palan 2010, Pettifor 2014, Braun 2018) depict Keynesian governance as 'active' and 'state-led' and neoliberal governance as 'rule-bound' and 'market-led'. The capacity of public and para-public monetary institutions to influence financial markets is not a given and not simply a question of policymaker desire. Instead I show how the history of monetary governance has always involved a struggle for the public institutions to render private finance governable, in the sense of developing the techniques and organised practices through which finance and the economy could be governed (see Braun 2018).

A Struggle for Capacity: The Prehistory of Postwar Monetary Policy

The key shift that took place was a transformation in the money markets. It shifted the way banking operated, who the key operators were and necessitated a change in the infrastructural basis for monetary governance. As I demonstrate, the way state-created liquidity relates to private liquidity instruments has always been crucial to the question

of monetary governance and the possibilities of macroeconomic policy. This is central to the changing politics of monetary reform witnessed in the neoliberal period. This section analyses how these changes laid the foundation for the policy experiments that took place between 1967 and 1981.

Establishing the Discount Market

By the end of the second world war the English monetary system centred on the relationship between the Bank of England, the Discount Market, and the joint-stock clearing banks. These clearing banks had risen to dominance through the second half of the nineteenth century and it was through these banks that the payments function of the banking system operated. Individuals and businesses could accept payment in cash or by transferring deposits between the clearing banks. The capacity of these bank deposits (liabilities) to be accepted as a means of payment depended on bank customers feeling confident that they could withdraw their deposits as cash whenever they pleased. Clearing banking worked by turning state-backed liquidity – coins, cash, and deposits at the central bank into clearing bank deposits, and back again. To ensure confidence and stability in this process the clearing banks were subjected to rules that, by 1967, meant they had to hold 8 per cent of their deposits as cash and 28 per cent of their total assets as approved ‘liquid assets’ (the cash and liquidity ratio, respectively) (Revell 1973, p. 144). The sector was highly concentrated with the big five clearing banks holding a vast share of retail deposits throughout much of the postwar period. To balance the need to hold large liquid reserves with the desire for an interest rate margin for profit, the clearers used the discount houses. Here they could make deposits in call money or Treasury Bills and earn a slim interest. But if any one clearer had a sudden customer demand for cash, they could retrieve this money ‘at call’. If the entire clearing bank sector had collective withdrawal of their deposits, and the discount houses were themselves left short of cash, the Bank of England

would make cash available as the lender of last resort. The Bank was therefore at the apex of the short-term liquidity provision. Though it would always extend cash, the rate at which it was lent – the Bank Rate – was the anchor rate for short-term liquidity provision in the discount market. As it was the transmission for monetary policy and, in combination with the cash and liquidity ratios, was the key infrastructural architecture of monetary governance.

Under this arrangement, though deposit banks could grow the broad money supply when issuing loans, they operated much more so on a ‘loanable funds’ practice than contemporary banks. The effort had been made through the nineteenth century to grow the branch network and deepen the deposit base, which is why the clearing bank system was so well equipped for the payments function, but there were clear impediments to credit creation.

Until the first world war Bank of England reserves were extended to the discount houses secured against private commercial bills of exchange. Yet wartime financing dramatically altered this balance between public and private liquidity. Government short-term borrowing was £16 million in August 1914 and £1.5 billion by November 1918, most of which came from the clearing banks (Mitchie 2004, p. 254). It was financed primarily through forced sales of Treasury Bills to the clearing bank system, rapidly growing the presence of short-term public sector securities in providing liquidity to the financial system. The trend continued through the second world war, leaving £2.73 billion of Treasury Bills circulating by 1946 (Allen 2014, p. 36).

This made Treasury Bills the central liquidity instrument in the discount market when peacetime began (Radcliffe report 1959). It is no coincidence that after the war Keynes found such purchase with his arguments that the terms by which the state made

liquidity available to the financial system could be of crucial importance to pulling the country out of recession (Tily 2010).

The Rise of Parallel Money and the Crisis of the Discount Market

The great shift that takes place is the rise of a secondary banking system that developed in parallel to the established, Bank of England backed, system. The secondary market had its own secondary banks – that initially did not accept retail deposits – and crucially its own parallel money market that developed separately to the discount market.

The secondary banks were largely international houses (from the United States predominantly) and were consortium, universal banks. They came to the City of London largely on the Euromarkets which the British monetary authorities had passively and actively nurtured. The rise of the market in Eurodollars and other money market instruments in ‘parallel’ to the discount houses had a revolutionary impact on banking practice, credit provision and monetary governance.

The distinctions between primary and secondary banking systems are crucial. The primary system was, as I’ve described, forged on deposit-taking clearing banks whose primary role was the payments function and who organised their liquidity management through widening their branch network and relying on the discount houses. The secondary system was largely wholesale banks, taking few but large deposits and making few but large loans. Their primary problem was one of ‘matching’ their assets to liabilities and they made active use of the emerging parallel money markets to do so. This active liability management flipped traditional banking on its head. As one senior clearing banker told Margaret Reid (2003, p. 59): ‘Almost for the first time in banking history you found your lending business then scurried round for deposits.’ What this meant was that rather than passively build a pool of deposits and use the discount market, banks would lend first – issue assets – and then find the liabilities by borrowing short-term on the newly

developing private, parallel money markets. As Gardner notes this helped move banking in the UK from being largely ‘deposit driven’ to ‘advances driven’: ‘No longer did banks have to wait for deposits to flow in before they could expand loan volume. They now had the managerial option of deciding, first, to expand loans and, secondly, actively securing the needed deposits’ (Gardener 1985, p. 2).

The rise of the parallel wholesale money market was, in that sense, the rise of market-based banking in the UK and it took place in an American image. It was US banks leading this charge and fundamentally shifted the practice of credit provision. Liability management was a high-stakes tightrope walk. Banks needed to ensure that the many loans they advanced could be financed with equivalent liabilities they shopped round for on the parallel markets. Ideally, their balance sheets would be self-liquidating, with loans of various risks and maturities being ‘matched’ with equivalents. Yet in practice liability management meant lending long and borrowing short, with a regular turnover of liabilities being needed to meet their financing needs (Gardener 1983, 1985). Flexibility in money market instruments was, as such, crucial to the developing parallel market, and in particular was skewed to being able to access short-term, liquid instruments. The key innovation that underpinned the success of liability management and the capacity for private banks to rapidly extend liquidity was the development of CDs (Degen 1987, p. 131). This of course had profound implications for any hopes of establishing controlling credit creation, but it is something that is often overlooked in the literature on the monetary reforms that took place over the 1970s and early 1980s in Britain. 2 The secondary banks needed to be able to offer deposit instruments that were almost as liquid as clearing bank deposits but with marginally higher interest rates – and CDs were also a way of doing this. ‘Introduced in the banking system in the early 1960s’, as Minsky later identified (1986, p. 85), ‘[CDs] soon became a favourite vehicle for the investing of large-

scale holdings of short-term funds. The growth of CDs in the early 1960s enabled bank credit to expand substantially faster than the reserve base.’ It was as such new money market instruments, the new parallel money market and the emergence of a new practice of liability management that allowed the financial system to extend credit well beyond what any notion of reserves or deposits might imply.

A Bifurcated System and the Problem of Monetary Governance

By the end of the 1960s there were two banking systems in place in Britain. The monetary authorities faced the problem that the traditional banking system over which they had both traditional qualitative authority and technical regulatory control (via cash and liquidity ratios and Bank of England liquidity provision) was being rapidly disintermediated by new secondary banks on the parallel money markets. Clearing banks had operated as a cartel offering fixed and low interest rates to depositors and only ever shifting rates together. The secondary houses, however, offered better terms on deposits and this led to a reduction in the Big Five clearing banks’ share of total deposits (Channon 1977). Unless the cartel ended, and banks were forced to compete for deposits by offering higher rates to savers, the disintermediation of the traditional financial system would continue. Moreover, the rise of CDs meant private liquid assets had replaced Treasury Bills as the dominant money market instrument. The transformation was clear. Treasury bills had made up 67 per cent of total short-term sterling instruments in 1957, but by 1979 accounted for just 6 per cent (Collins 1988, p. 361). This decline in state-rationed liquidity began in the 1950s and 1960s and coincided with the emergence of privately issued CDs. It was a rapid transformation as well. The first sterling CDs were issued in 1968, a year later total holdings stood at £442 million and by 1971 had grown to £2242 million (Revell 1973, p. 280). While the clearing banks settled their payments

in state-created cash and Bank of England reserves, the secondary banks settled in deposits, generating the capacity for credit creation to stretch well beyond reserves.

The result of which was that the monetary authorities faced two related problems heading into the 1970s: First was how to stem disintermediation of the clearing bank sector. Second was how to make monetary policy effective in a context where the rise of liability management meant there appeared little possible avenue for credit control. As Early & Evans put it (1982, p. 55) liability management broke ‘the three-way link that once connected the volume of bank reserves (monetary base); the volume of demand or checkable bank deposits (money) and the level of bank lending’. With short-term liquidity being managed through the parallel money market and often through interbank deposits or short-term instruments like CDs and later repos, the Bank Rate set on the discount market no longer anchored the cost of short-term liquidity.

In order to solve these two problems, the monetary authorities needed to render governable a banking system that was increasingly organised around liability management. The issue of what monetary governance looked like in conditions of unlimited credit was to become a pressing problem that drove the series of reforms that took place over the 1970s and 1980s: CCC (Copley 2017), the MLR (Burnham 2011), and the MTFs (Thain and Wright 1995).

Monetary Reforms: A History of Failed Discipline

By revisiting how the changing financial landscape affected SDM and the state’s capacity to undertake monetary governance and implement monetary policy, I have established an alternative foundation to analyse the monetary reforms that followed the 1967 IMF bailout and the emphasis on monetary control it introduced. Though this was a period of rapid change with the stagflation crisis and demise of the Bretton Woods regime, there is

utility in narrowing the analytical lens and examining the money market developments more closely. It was the development of liability management on the parallel money markets that undid much of Bretton Woods long before its formal demise and the problem of inflation stemmed more from the credit revolution than it did Keynesian fiscal policy.

In overlooking the transformation that had taken place on the money markets with the rise of parallel banks and the impact of liability management, and anchoring to the stagflation crisis and fall of Bretton Woods, the political economy scholarship of various stripes (for example, Blyth 2003, Gamble 1994 and Hall 1993) often ends up presenting neoliberal monetary governance as a story of competition, liberalisation and deregulation. In contrast, in what follows, I show how the monetary authorities were struggling with the problem of capacity building, namely how to render rapidly evolving financial markets governable and generate the capacity to even attempt to instil monetary control.

Control through Competition? The Competition and Credit Control Experiment

It is my contention that the monetary changes are best read in terms of the way the developments on the money market contradicted with the growing emphasis on monetary control. Once the IMF first mooted controlling credit creation with its suggested Domestic Credit Expansion targets in 1967, the idea became more deeply ingrained among the monetary authorities (Clift and Tomlinson 2008). It is why though monetary discipline was made more explicitly a macroeconomic objective post the 1976 IMF intervention, it had already been an issue for a decade by then.

The difficulty was that the rise of the parallel banks and secondary money market gave them very few levers to effect control. The more the Treasury tried to tighten the direct controls and lending ceilings it had used to direct clearing bank lending since the second world war, the stronger the hand of the parallel banks which did not face such

restrictions, and the greater the disintermediation problem (Goodhart 2014, p. 2, Hotson 2017, p. 126). The separation of retail banking around the discount market and wholesale banking around the parallel market was disintegrating and the monetary authorities needed a response.

The clearing bank sector, who had to meet the strict reserve and liquidity ratios, could not leverage and lend to the same extent as the nascent secondary houses. And this formal difference between the ‘two’ money markets was an issue that the CCC changes addressed. Heath’s stated aim of ‘disengaging the state’ meant a bonfire of direct controls on clearing banks assets and the imposition of a new plan for reserve requirements. Rather than solely clearing banks having been bound to hold 8 per cent of cash deposits and 28 per cent of liquid assets (which were established after the 1959 Radcliffe Report), the CCC changes shifted this to a single 12.5 per cent reserve asset ratio. This was to apply to all banks – primary and secondary – and eligible assets included Treasury Bills, money at call, gilts with less than a year’s maturity and some local authority and commercial bills (Hotson 2017, p. 136). These were all still predominantly traded in the discount market and could be seen as an attempt to push a certain re-intermediation of the traditional sector (Revell 1973, p.215). In addition, all banks were required to hold cash balances at the Bank of England amounting to 1.5 per cent of ‘eligible assets’.

The view of the monetary authorities was that changing the reserve ratios, and lifting the direct restrictions on clearing bank asset growth would mean Britain’s clearing bank cartel would end. Instead they would be forced to compete, and this would drive a growth in size and capitalisation (Goodhart 2014). This, it was hoped, would check the progress being made by parallel banks, who were raising liabilities from wholesale money markets from which to fund their rapidly expanding asset base. This would thereby restore the primacy of the discount market and Bank Rate (Moran 1983, p. 59). What this meant

in practice was letting the clearing banks lend as much as they wanted, and trying to impose monetary control solely through the Bank Rate instead (Davies 2012).

The CCC policy is often depicted as a great deregulation of banking. Evidence of either the emerging pro-market consensus developing in Britain, or the structural realities of a declining productive sector that necessitated the state take a less explicit and more depoliticised role in the way credit was allocated.

Yet I'd argue it is more revealing to see CCC in the opposite light. It was a reform that emerged in response to the impacts already unleashed by the credit revolution that I described in the previous section. CCC was an attempt to really try and make interest rates a powerful and flexible lever, in the place of direct controls that were no longer viable. As it happened the only lasting effect of CCC, with its emphasis on varying rates, was to radically destabilise the gilt market.

CCC could not contain the impacts of liability management and as such proved wildly ineffective at reining in credit creation. Yet it did have a profound impact on the clearing banks (Moran 1983, p.55). To recall, before CCC lifted caps on their asset growth, they operated as a cartel with a fixed spread between their lending and deposit rates. As Revell put it (1973, p. 156) two years after the reforms: 'By making use of the wholesale markets on both sides of their balance sheets the deposit banks have blurred the distinctions that formerly existed between deposit banks and secondary banks.' In the immediate aftermath a 'merry go round' developed between the two money markets. The more wholesale deposit rates increased the more that corporate treasuries could borrow from the retail sector (usually on overdraft) and deposit these in the wholesale secondary sector by buying sterling CD assets (Hotson 2017, p. 136). This borrow-to-deposit strategy came to be known as 'round tripping' and drove a huge increase in credit creation. It exposed the fundamental flaws in the reasoning driving CCC. To recall the

authorities were trying to bring credit creation under control through increasing interest rates. Though manifestly not the case, they ran with the idea that if clearing banks offered high enough rates, customers would save rather than borrow. This was based on a supposedly stable money demand function that was published in the 1970 Bank of England quarterly bulletin. But it proved a mirage and borrowed continued apace. By the time CCC was abandoned in 1973, the broad money supply (M3) had increased by an eye-watering 72 per cent, credit had spiralled, and asset-bubbles had blown (Needham 2014, p. 46).

One route to understand the politics of the shift in monetary governance that CCC involved is to see it as the early emergence of a deregulatory zeitgeist that had taken hold, particular in the offshore ‘zone’ of the Euromarkets. Another would be to depict CCC as a regulatory response to a broader, external crisis of capitalist profitability. The move away from direct controls to a more nebulous attempt at interest rate control was an attempt to divert capital allocation from consumers to a struggling industrial sector, while at the same time quelling the political disquiet. Instead, I argue that CCC should be read as an early attempt by the monetary authorities to rebuild the governance capacity that was being rapidly eroded by the rise of liability management.

Response to Failure: The MLR

The failure of CCC to deliver on the stated promise of monetary control emphasised how the Bank Rate had lost its position as the anchor of short-term interest rates. Of more relevance was the interbank short-term lending that took place on the secondary money market. Even as early as December 1970 secondary banks lent 50 per cent as much as clearing banks to non-financial companies, substantially shifting the common UK model of overdraft lending (Revell 1973, p. 243). CCC had worked to dissolve the separation

between Britain's two banking systems but, with quantitative controls on clearing banks rendered unsustainable post liability management, the question of how to undertake monetary policy remained live. What the monetary authorities needed was a way to bring wholesale rates in line with that set by the Bank on the discount market. In trying to bring them into line the authorities hoped to make the Bank Rate effective in setting the price of liquidity. As Burnham (2011) writes, the Minimal Lending Rate (MLR) was, then, the first move away from using the discount window to set the Bank Rate and instead set it in reference to the prices established in the weekly Treasury Bill tenders. To recall, the discount window set a ceiling on the price of liquidity but not a floor. In order to 'make the Bank Rate effective' (on the discount window) the Bank of England had always had to try and manufacture a liquidity shortage in the clearing banks. This it did by issuing Treasury Bills to discount houses, who were compelled to buy them, draining the discount houses of available cash, which in turn fed back to the clearing banks. The result of which was that liquidity could only be borrowed from the Bank of England via the discount houses on the discount window, at a decreed interest rate: the Bank Rate (Allen 2014). In that sense, there was nothing new about the Bank of England's interventionist dealings in Treasury Bills.

What did change with the MLR was where the official rate was set. In its Treasury Bill dealings, if the Bank chose only to buy back Treasury Bills at low prices, it was able to force short-term interest rates up, independently of the 'discounting' price for liquidity set by the old Bank Rate. It was, in this sense, the centring of Open Market Operations that has come to be the primary channel through which monetary policy is implemented. When in October 1972 the MLR policy was announced, it involved using this capacity more actively. In a general sense the change from Bank Rate to MLR did distance the

Heath government from interest rate changes in the way Burnham and others have since described. It implied this was a market-set rather than state-decreed official rate.

Yet the broader political impact of the MLR should be seen in terms of the way it brought open market operations more clearly to the centre of monetary policymaking. The nascent market-based banking that had emerged through the parallel money markets had undone the old transmission belt of monetary policy, the discount market. The MLR can be seen, in Revell's (1973, p. 216) terms as 'a final blow to the importance of the Bank Rate', formally recognising the infrastructural shift that had already taken place. The move towards a greater emphasis of open market operations and active intervention into short-term liquidity instruments would later become the basis for modern monetary policymaking in the era of market-based banking. Yet at this stage, the MLR had done little to quell the rampant growth of bank balance sheets.

Sado-Monetarism? The Curious Case of the Medium Term Financial Strategy

It is clear that driving this period of successive, failed monetary reforms was the credit revolution that arrived with US-bank practices of liability management on the parallel money markets. Monetary discipline was, in the sense of limiting credit creation, proving beyond the capacity of the monetary authorities. That did not, however, stop repeated governments attempting to do so. Turning to the case of the MTFs, it is worth recalling the history that preceded it. Britain's continued balance of payments problems saw it turn, once again, to the IMF in 1976. The infamous £3.5 billion loan package became highly symbolic because it came with 'monetarist' conditionality on targeted monetary growth (Clift and Tomlinson 2008). Yet for all its infamy, the targets and the policies that followed them, did not differ substantially from what had come in the previous eight years. As Burk and Cairncross (1992, p. 228) described: 'Apart from the continued issue

of monetary targets, which were rarely hit, economic policy in the last years of the Labour government differed little from what it had been before the arrival of the IMF.’ It is why the focus on monetary discipline should not be seen as a purely Thatcherite or even post 1976 development. Nonetheless, monetary targets and their accompanying rhetoric of ‘market-led governance’, formed a crucial plank of Thatcher’s rise to power and her early, brutal economic experiment, the MTFS (Clift and Tomlinson 2012).

The MTFS was simply a framework for economic strategy that outlined fixed financial objectives for monetary and fiscal policy. It was supposed to signal a final move away from the ‘discretion’ of policymakers to fixed, publicly announced principles. And the implication of the MTFS was clear: while previous governments had squandered price stability by falling to the expansionary demands of the electorate, Thatcher’s administration would deliver pure deflation if it had to. There would be no political ‘interference’ muddying the quantified economic framework laid out by the targets (Kerr 2001). On the face of it, this was deflationary depoliticisation for the market confidence.

Yet these targets did not act as ‘an anchor’ in the way Burnham (2014, pp. 196–197) describes as a necessary aspect of depoliticisation. Rather, the rules and targets were entirely ignored (Cobham 2003). Not only were they incoherent and entirely unexplained but there was quite a contrast between the fanfare of the targets published in the MTFS, and the rest of the Thatcher administration’s economic policies. Certainly between 1979–1982 some of the choices on fiscal policy did not align with the MTFS aims on inflation targets (Prasad 2006).

More importantly, because of the way the monetary authorities treated M3 as a basic function of the government’s deficit spending (the Public Sector Net Borrowing Requirement, (hereafter ‘PSBR’)) it cast a monetary problem in fiscal terms. This is necessarily misleading because the dominant push for credit creation came from bank

created money. The credit revolution is the principle reason that monetary targeting was so particularly difficult. Yet its importance is overlooked because of the overly broad, fiscal-first framework through which the depoliticisation literature reads monetary policy. Banks could not only fund their asset expansion by acquiring liabilities from wholesale markets, but were now beginning to securitise their own assets and sell them to facilitate further lending (Smith 1987). The effect of the development of liability management was to drive credit creation. Moreover, the rise in the proportion of financial intermediaries' deposits that were interest-bearing reduced the interest-elasticity of the demand for money (Cobham 2003, p. 39). The contradiction between an incoherent fiscal policy programme, combining tax cuts with public sector spending cuts, and incoherent monetary and financial policy programme – promising to cut credit creation through nonsensical MTFS targets, while at the same time removing impediment to bank asset growth like the Supplementary Special Deposit 'corset' scheme. The result of this, unsurprisingly, was that all targets – on M3, on PSBR, on expected GDP growth – were missed.

Critical accounts of the period treat the creation of new public rules for policymaking through the MTFS as examples of the power of financial interests, the ideology of monetary discipline, or a state-led project for securing financial market liberalisation. The fact that the rules were ineffective and ignored is not confronted. If, instead, the focus shifted to a question of state capacity it is possible to see the MTFS in terms of the struggle to govern a radically changed financial sector where private credit creation dominated. It is clear that the monetary authorities had to respond. As Paul Tucker (in Bank of England 2004, p. 363), executive director for markets at the Bank of England, later put it: 'The Bank had to stop relying on a moribund market (the bill market) and atrophied institutions (the discount houses)'.

Moreover, it had to adjust to the reality that monetary discipline, in the form of controlled credit creation was never going to happen. Once the liability management genie was out of the bottle, it was not going back in.

History since has of course reiterated the point. Rather than resist credit creation, successive governments since the early 1980s have relied on rapid credit creation to uphold a debt-based model of economic growth in the British economy (see Green and Lavery 2018), the very opposite of any notion of monetary discipline that so much of the literature deems significant.

Conclusion: Repoliticising Monetary Governance

The purpose of this article was to use a focus on SDM as a foundation for rethinking the way political economy literature examines the transition from Keynesian to neoliberal monetary governance in Britain. I used the necessary intertwining of public and private institutions in the conduct of monetary policy to examine the way public institutions began the remaking of monetary governance in the era of liability management and market-based banking.

These changes are depicted in much critical literature as a marketisation of monetary governance. While channels of state action have changed, I argue monetary governance this has shift has not seen an abdication of state interventionary capacity in favour of a generic financial market interest. Rather, through the CCC, MLR and MTFS changes, alongside later regulatory reforms like the 1986 Big Bang (Dutta, 2018) and 1995 repo markets (Gabor, 2016), the monetary authorities established the basis of a modern form of governance.

The altered transmission mechanism of monetary policy has established a densely interconnected and mutually dependent relationship between the shadow banking sector and state financial securities, in particular through the repo market (Gabor, 2016). At once

this relationship has strengthened the ‘infrastructural power’ of finance (Braun 2018) but also opened up new opportunities for state action. The response of the state post-financial crisis was to undertake staggeringly large monetary interventions. The Bank of England has purchased £427 billion of the government’s own debt issues (Bank of England, 2018) to facilitate a form of monetary stimulus in the British economy that has benefited a narrow band of asset owners (Bank of England, 2012) and swap public securities for the financial assets of carbon-intensive corporations (Matikainen et al., 2017). Though clearly not progressive politics, it is very difficult to grasp this mode of power, and hold it to account, with the notion of ‘marketisation’ or ‘depoliticisation’. By demonstrating how new financial markets and instruments were politicised – that is rendered amenable to state influence – this article provides a foundation for conceptualising the politics of modern monetary governance.

Notes

1. Alessandri and Haldane (2009) show how return on equity for UK banks jumped from around 5 to 25 per cent between 1966 and 1972, the period I refer to broadly as the credit revolution, with banks rapidly reducing their ratio of liquid assets to total assets. Moreover, having declined since the end of the second world war, UK banking assets as a percentage of GDP began to grow rapidly in the late 1960s, crossing over 100 per cent of GDP by 1975.
2. Konings (2011) has examined the importance of CDs to American financial development and Revell (1968) made one of the first and most important analyses of the rise of secondary banking and CDs in Britain.
New paragraph: use this style when you need to begin a new paragraph.

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