

3. Monetary Control Consultations

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HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

COMMENTS BY THE CO-OP BANK

Note by the Secretaries

The attached comments on the Green Paper by the Co-operative Bank Ltd are circulated for information.

M D K W FOOT

M L WILLIAMS

H M Treasury

GREEN PAPER - MONETARY CONTROL -
A VIEW BY THE CO-OPERATIVE BANK

It should be said initially that there have been so many views expressed in the City since the publication of the Paper (together with the loosely associated Paper on the "Measurement of Liquidity") that it is unlikely that anything new can be contributed to the discussion. Many of the Papers issued have been a critique of the Bank's attitude, particularly by academics and other members of the monetarist school. Such critics have argued that the Bank is still seeking to control the "demand" side of the equation by controlling interest rates rather than controlling the money supply directly. It seems unlikely that the Bank will make so fundamental a move to "supply" management and, indeed, in the Paper the Indicator System is the one preferred by the Bank. As Bankers we would not wish to see controls on the supply of credit which would involve restrictions on banking activity in the same way as the quantitative controls on lending in the 60's and the more recent Corset controls.

As a general introduction it seems to us that the present discussion over the adequacy of the techniques of monetary control has inevitably drawn on the wider debate over Keynesian and monetarist economic philosophies; however, we have examined issues from a pragmatic viewpoint. Whilst the major consideration in the operation of monetary control must be the effectiveness in contributing to the smooth running of the Government's overall economic policy, the effects of the different techniques of monetary policy on the banking system should also be taken fully into account. If the banks are to operate efficiently they must be given the flexibility to meet customers' requirements for financing, and, equally importantly, they must be allowed to operate in an environment of free and fair competition. It is within this framework that we now elaborate our comments on the Green Paper.

As a Green Paper should, this document contains more questions than answers. Therefore we do not fully share the disappointment in some quarters about the lack of concrete proposals and recommendations, but rather welcome the opportunity for reflection and comment.

Having said this, however, we would argue that there is a serious flaw in the Paper, and this is the absence of reference to the funding of Government borrowing through sales of gilt-edged securities. Given the scale of funding activity in the U.K., a paper on monetary control without reference to these procedures is greatly weakened. This is even more the

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case when the extremely close relationship of the funding system to the two major policy instruments for controlling the growth of the money supply - fiscal policy and interest rates - is borne in mind. In fully accepting the primary importance of fiscal policy and interest rates, it follows that operations on the monetary base (however defined) are seen as being relegated to the subsidiary role of achieving "a smoother path in the growth of the money supply from quarter to quarter". Therefore consideration of alternative systems of monetary base control becomes of less crucial importance. Nonetheless, we would welcome unequivocally the Paper's explicit and firm recognition that direct quantitative controls are not a satisfactory alternative means of achieving the stated policy objective.

As previously stated we would not wish to see controls on the supply of credit which would involve restrictions on banking activity in the same way as the quantitative controls on lending in the 60's and the more recent Supplementary Special Deposit Scheme. The authors of the Paper were, in our view, quite correct in outlining the various alternative systems of monetary base control, to place emphasis on the perceived difficulties connected with introduction of such systems. When considering alternatives to an established system, a fundamental consideration must be the merits of the alternative; this is more important than the disadvantages of the 'status quo'.

The authorities have quite properly played the role of 'devil's advocate' in outlining the demerits of the various alternatives. In substance, we believe that the criticisms advanced in the Green Paper are valid.

a. Monetary Base Control

(i) Schemes without a Mandatory Cash Requirement.

The Bank indicates that this system would only work if banks were induced to hold the bulk of their prudential liquidity requirements in the form of balances at the Bank rather than in the form of primary liquid assets. This would require fundamental changes in the structure of the London Money Markets to restrict the ability to transform such assets to cash. In the case of Clearing Banks, where a cash balance is already required, our own experience shows that the expected level of cash requirement and the out-turn of our cash balance(s) are extremely volatile and could not be taken as an indicator of the level of our own deposit liabilities. Additionally, the overall trend of cash requirements will undoubtedly change as new payment systems are developed. We would agree with the Bank's comments that the level of balances held would tend to equate more to the level of our transactions rather than to the size of our

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balance sheet. Again, in our own circumstances, having regard to the nature of our business and particularly the effect of certain types of customers on our cash flows, we would probably have to hold larger balances than other banks. This would be especially so if, as indicated, lender of last resort facilities were ended. Such actions would put us at a disadvantage to our competitors. The position vis-a-vis the Clearers and non-Clearers generally is even more important as the non-Clearers do not really have any need at all for cash balances and there would be no control over the size of their balance sheets other than those of prudent and responsible banking. They would be able to lend as freely as they could obtain deposits. It could be expected that any shortage of cash amongst the Clearers would be transmitted to the non-Clearers as the Clearers ran down their lending in the inter-bank market, so increasing the marginal cost of funds to the non-Clearers. It seems unlikely however, that there would be a constant ratio between the banking system cash and its total deposits. The non-Clearers could turn to alternative, non-banking, sources of deposit.

One result of this system could be the running-down of overdraft facilities as the Clearing Banks especially seek to stabilise their cash flows by "fixing" more loans. This would be a serious blow to industry, especially in today's economic climate. The bank overdraft is one of a Company's most flexible resources enabling it, for example, to meet and overcome temporary changes in its trading environment. If this effect did materialise it would seem to be counter to the regular exhortations we receive to assist industrial borrowers as much as possible. Businesses, especially small businesses, would certainly suffer under any system which brought with it a demise of the overdraft system.

(ii) Schemes with a Mandatory Cash Requirement

The difference between Clearers and non-Clearers is immediately apparent here. To require non-Clearers to hold cash when they have no practical need for it is, in reality, a tax on their operations in the same way that the current requirement for Clearing Banks to keep higher balances than we believe necessary is a charge against our profits. However, to have a cash ratio for Clearers but not non-Clearers would clearly be unjust. This could lead to a diversification of business to non-bank financial intermediaries and the off-shore banking system, in

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the same way that has happened to some extent in the United States.

The Bank has suggested that a mandatory requirement could be operated in one of three ways. Firstly, "lagged accounting" whereby the level of deposits at a point in time would give a requirement to hold a certain level of base assets at some time in the future. To make this effective in the control of money supply this would have to be accompanied by a progressive system of penal rates of interest if the Bank had to supply base assets to banks, or a penalty scheme (similar to the Corset) if banks did not meet the requirements. Such controls have not proved effective in the past as banks have disintermediated to good effect and would probably do so again under similar conditions. (this is the fundamental point argued by the monetarists who say that the Bank should not supply additional base assets but that banks would have to bid-up in the market when their liquidity was under pressure in order to get hold of base assets whose total is strictly limited. Interest rates would rise giving the banks a profit motive to undertake assets as well as liquidity management. This, it is claimed, could also lead to a more competitive banking system). Lagged accounting would be the easiest option to manage from our point of view but could be a severe restraint on growth and in our case could be as restrictive as the Corset.

The second system considered is "current accounting" operating similarly to the reserve asset ratio where base assets at a make-up date would have to equate in a given ratio to the level of deposits at the same date. We again concur with the Bank's view that Clearing Banks, including ourselves, would have difficulty in accurately predicting the requirement for base assets early enough to have the opportunity to bid for them so, probably resulting in excess amounts of such assets being held. This volume of excess base assets would fluctuate and the growth of these base assets would, therefore, not be a reliable guide to monetary growth. This system would also need penalties as in the case of lagged accounting above.

The third system "lead accounting" would to us be the most restrictive, although this has attractions to the Bank in that it would give an advance warning of the level of the future trend in the money stock. Under such a system the banks' deposits would be restricted to a multiple of their base assets at an earlier date. This would involve

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penalties for either shortage or excess holdings of base assets. Such a system would require very accurate cash flow forecasts in order that a base could be set at one date in order to support the level of deposits at a future date. Our own experience has been that such accurate cash flow forecasting would be extremely difficult, especially in an environment where large overdraft facilities were enjoyed by a small number of customers in any one sector, and in a rapid growth situation. As with a scheme without the cash requirement, lead accounting could force Clearing Banks to curtail use of overdraft facilities to the obvious disadvantage of its industrial/business customers. Such a system could also give rise to disintermediation or reintermediation operations as banks would try to ensure that deposits were built-up if they had been previously underestimated or that lending was diversified into non-controlled areas if they had been overestimated. Such adjustments would give rise to the same problems associated with the corset scheme.

b. Indicator Systems

Indicator Systems have been used in the recent past when Minimum Lending Rate was tied to the weekly Treasury Bill Rate (although there is no mention of this in the Paper). Such a system was obviously found to be unsatisfactory as the formula was often over-ridden and eventually discontinued. The problem could have been in some way due to the fact that it was tied to a 3 month rate whereas it was used to determine the interest rate for lending which was usually overnight only.

The envisaged Indicator System would have a pre-set level of rate changes geared to specific weekly movements in a monetary indicator. It would fix an "operative rate" for lending to the Discount Market the following week. This operative rate would be based on Minimum Lending Rate plus or minus any change triggered by changes in the indicator. The Bank may change Minimum Lending Rate itself if the operative rate persistently diverged from Minimum Lending Rate by an overall pre-set limit, and 3% has been suggested. The system would be coupled with a mandatory base requirement but lender of last resort facilities would be available. The Bank would also preserve the ability to over-ride the automatic rate changes.

It is possible that under such a system dealers would see the indicator nearing its trigger point and would, for example, divest themselves of longer term debt. (e.g. Gilts) if rates were to

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rise and would refrain from making loans at less than the prospective rate. Such action would in itself cause rates to rise, giving rate differentials until the administered rate were also changed. One possible advantage is that rate trends might be less difficult to forecast provided that the Authority over-ride is not used too often.

It is generally agreed that whichever of these courses is followed interest rates would be more volatile. This could require more frequent base rate changes which might be administratively difficult and/or expensive.

With regard to the future of the overdraft system and in problems of cash flow forecasting we see particular difficulties which are exacerbated by our own development and expansion at the present time. We would prefer to be free to use our own managerial judgement over as many areas of our operations as possible whilst acknowledging the requirement for prudential ratios. At the present stage of our development we would not be in favour of measures that had a quantitative control on our operations (as some systems of monetary base control would) for the purposes of monetary control requirements for the banking system as a whole. The indicator System would not affect us in the same way as the possible monetary base control systems and could be supported perhaps on the basis that if we have to have something then that would be the better prospect involving less radical change from the present. Although a mandatory base requirement could be part of such a system, if spread throughout all banks this may be less restrictive than the present requirements for Clearing Banks. In this respect we would have preferred to have seen the detailed discussion paper referred to in paragraph 6,3(iv) before making more detailed comments.

We conclude that both of the new proposed monetary control systems in the Green Paper are somewhat flawed, and in our view a further fruitful area of enquiry is the present system of funding government borrowing through sales of gilt edged securities.

There has been an increasing dissatisfaction with the present system of issuing gilt edged securities, which, it is claimed, results in exaggerated movements in interest rates, increased interest payments on the national debt and an uneven growth of money supply, with control impaired.

The underlying cause of the failure of the present system to our mind has been a mismatch between policy goals pursued by the Government and the authorities; that is that fiscal and monetary policy have not been sufficiently harmonised. However, specific reforms of the market can, we believe, go a long way to allaying the symptoms, if not the cause of the problem. Whilst some changes in the techniques of selling gilt edged stocks have been implemented during the last few years, notably the introduction of the partial tender system, we would nevertheless support the conclusion of the Committee to review the functioning of Financial Institutions,* that these innovations have not gone

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* Final Report Cmnd 7937 paragraph 636

far enough. The Committee recommended that, in consultation with the institutions, the authorities should give consideration to devising means of funding part of the PSBR by issuing long dated stocks through an underwritten tender. We believe this is a constructive and, on the surface at least, appealing proposal, which merits the full attention of the financial community and the authorities.

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13 August 1980

HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

COMMENTS BY THE ACCEPTING HOUSES COMMITTEE

Note by the Secretaries

The attached comments by the AHC are circulated
for information.

M D K W FOOT

M L WILLIAMS

H M Treasury

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14 August 1980

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MONETARY CONTROL CONSULTATIONS

LIST OF CIRCULATED PAPERS
Note by the Secretaries

Recipients might find it helpful to have the attached list of papers circulated to date.

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M L WILLIAMS

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MONETARY CONTROL CONSULTATIONS: CIRCULATED PAPERS

TR(MON)

- 1 Comments ("First Thoughts") by Professor Harold Rose
- 2 Comments by Richard Coghlan
- 3 Comments by Professor Andrew Bain
- 4 Comments by Professor Richard Sargent
- 5 Comments by Greenwells (ie Gordon Pepper)
- 13 (Further) Comments by Professor Harold Rose

MCC(80)

- 1 Arrangements for circulation
- 2 Comments by Grenfell & Colegrave, Investment Research
- 3 Comments by Sheppards & Chase
- 4 Draft paper by David Lomax "Consultative Documents on Monetary Control and the Measurement of Liquidity"
- 5 Comments by Phillips & Drew in "Gilt Edged Research"
- 6 Note by Mr Grice commenting on Professor Rose's paper TR(MON)1
- 7 Note by Mr Grice commenting on Gordon Pepper's views in TR(MON)5
- 8 Note by Mr Williams recording the discussion at a seminar organised by Fulton Packshaw
- 9 Note by Mr Foot commenting on Gordon Pepper's comments in TR(MON)5
- 10 Article by Karakitsos and others "The Indicator System and UK Monetary Policy"
- 11 Comments by Grieveson, Grant & Co
- 12 Comments by Andrew Smithers of Warburgs
- 13 Paper by Mervyn Lewis "Banks, non-bank intermediaries and monetary reform"
- 14 Paper by Dr Hugh Wills "The Economics of Bank Regulation"

MCC(80)

- 15 Paper by the Local Authority side of the Treasury Committee on Local Authority Borrowing commenting on the Green Paper and the Bank's liquidity paper
- 16 Note by Dr Mervyn Lewis on comments by Pepper and Foot - TR(MON)5 and MCC(80)9 respectively
- 17 Comments by Samuel Montagu & Co Limited
- 18 Article by Richard Coghlan "Abandoning Monetarism for Monetary Control"
- 19 Comments by Ian Morrison and Paul Tillett
- 20 Note by Mr Grice recording the Money Study Group's discussion on 16 May
- 21 Note by Mr Pickford, recording the City University Conference on 20 May
- 22 Comments (in addition to those in MCC(80)5) by Phillips & Drew
- 23 Paper by David Howard (of the Fed) "The British Banking System's Demand for Cash Reserves"
- 24 Comments by the CBI
- 25 Comments by the CLCB
- 26 Comments by the Association of Consortium Banks
- 27 Comments by the Committee of Scottish Clearing Bankers
- 28 Comments by Japanese banks
- 29 Comments by the TUC
- 30 Comments by Dr Max Hall
- 31 Comments by the LDMA
- 32 Paper by Dr Mervyn Lewis "Is Monetary Base Control just Interest Rate Control in disguise?"
- 33 Article by Tim Congdon "The Monetary Base Debate: another instalment in the currency school versus bank school controversy?"
- 34 Comments by the Building Societies Association
- 35 Comments by the Co-op Bank
- 36 Comments by the Accepting Houses Committee