3. Monetary Control

Consultants

28 April – 2 May 1980

MCC(80)6 COPY NO

HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

PROFESSOR ROSE'S COMMENTS

Note by the Secretaries

The attached note by Mr Grice, commenting on Professor Rose's Paper (TR(Mon)1) is circulated for information.

M L WILLIAMS
M D K W FOOT

H M TREASURY
28 April 1980

Mr Bridgeman

cc Mr Britton
Mr Riley
Mr Williams
Mr Shields

GREEN PAPER ON MONETARY CONTROL: PROFESSOR ROSE'S COMMENTS

You asked me to comment on Professor Rose's discussion of the Green Paper sent under cover of his letter to Mr Middleton of 2 April.

2. The first half of Rose's note is a précis of the Green Paper: the second half is an appraisal. I must say it represents the most perceptive and balanced discussion of the issues that I have yet seen from outside. Many of the criticisms that he makes coincide with my own reservations about the Green Paper.

3. The Précis. In general, Rose gives an accurate account of the substance of what we said. He has added, however, a number of footnotes and three of these caused me to raise my eyebrows:

a. He draws attention to the printers' error in para 3.9 which unfortunately claims that we are both going to retain and end the RAR. It should be clear both from the context and from the erratum slips issued with some copies that it is in fact proposed to end it. Nevertheless, Rose suggests that it may reflect official indecision with the proof-readers failing to exorcise the unfavoured option before the final printing. It is unfortunate we have given this impression since there was in fact no disagreement on this point. We ought to ensure this misapprehension is corrected;

b. Rose suggests the Green Paper has been rather silly in claiming that notes and coin held by the public could be part of base money. I certainly agree that any scheme which allowed such holdings as part of the base would be peculiar. But schemes of this kind have been suggested. Many of Tim Congdon's adverse comments on monetary base control are implicitly directed against such a scheme;

c. He claims that the difference between base control and base indicator systems is that the former would make interest

rates more dependent on the market. I am not sure if this is in fact true. Under either scheme the market would be integral in determining interest rates and while the market mechanism would be somewhat different in the two cases, I am not clear in which it would be the more important.

4. The Appraisal. Rose makes a large number of points. By no means all of these are criticisms of the Green Paper. Many are complementary or just observations. The main points of concern to us, however, are as follows:

a. He is under the impression that the base indicator option is the officially favoured proposal. In fact, there seems to be very little enthusiasm for such a scheme. The Bank of England are certainly not wedded to it and I could detect very little enthusiasm for it here. In a sense, it was included in the Paper to fill the need to say something positive given that we have found it difficult to find anything to recommend base control. But we would presumably not want to be manoeuvred in the coming debate into a position of defending, or seeming to defend, a system which in fact no one loves;

b. Rose continually writes as if the Paper had only been written by the Bank. While I have to confess to a slight personal pique on this score, given the long difficulties we had with the Bank in the production of this Paper, the issue is more substantial than this. As I understand it, Mr Middleton has agreed with the Bank that the Treasury will take the lead in the debate on monetary base control and the Bank on the remaining issues raised by the Paper. If this is the case, it will not be easy for us to conduct a credible part in the debate if it is believed the Paper was largely written elsewhere. Gordon Pepper was under this same misapprehension and Charles Goodhart has written to him to correct this;

c. The appraisal has considerable discussion of whether short term monetary control is necessary or, indeed, desirable. Our own view is that short term monetary control is not fundamental to the management of the economy except insofar as it increases confidence in the Government's resolve to

control monetary growth tightly in the medium term. This is a difficult message to convey because at first sight it may seem paradoxical. Rose in fact accepts this view explicitly in point 3.iv of the Appraisal but makes other statements about the absurdity and undesirability of short term control which are at variance with it. Indeed, in his conclusion, he wonders whether short term control of the money supply is necessary at all - that is, over any period shorter than could be achieved by fiscal policy alone. This is a fair question but presumably we would want to assert that shorter term control is necessary for the reasons given earlier;

iv. He raises the question as to how the interest rate changes generated by base control would in fact affect the money supply and its counterparts. He believes that, given that bank advances are not likely to respond quickly to changes in interest rates short run changes in the money supply would have to come about through changes in public sector debt sales. He believes it is unlikely that the movements in very short term rates such as would arise from base control would be sufficient to induce sales of long term government debt. We do, of course, influence expectations about future long term rates under the present system by administered changes to short term rates. But this mechanism would be unlikely to carry through with a regime change to monetary base control where short run rates were no longer administered and would be expected to fluctuate sharply from day to day. This constitutes support for the views which Messrs Fforde and Goodhart have put forward on this matter;

v. Far from accepting this, however, as support for the line taken by the Paper, Rose believes that the Paper has misinterpreted the role of monetary base control. He claims that it is traditionally regarded not as a means of generating the appropriate short term interest rates for monetary control but of controlling the money supply through a stable base asset/deposit ratio. Summing up, it it is regarded as "regrettable" that the Green Paper does not discuss monetary

base control in this light. In this, I believe that Professor Rose is wrong. To be effective monetary control must reduce the demand for money by acting on one or more of its determinants as well as the supply. In the very short run this determinant is likely to be interest rates. A control which does not reduce the demand for money but which merely reduced the amount of deposits which the banks could accept without incurring penalties, would be largely cosmetic. Not only would control be illusory but it would also leave open the possibility of disintermediation. Control by a prescribed base/deposit ratio alone therefore with no effect on interest rates is, as an earlier draft of the Green Paper said, a chimaera. On the other hand, I have sympathy with Rose to the extent that the Green Paper does not contain a proper account of how monetary base control is supposed to work. I was always myself in favour of including a muchmore specific account of its supposed workings and bringing out its relationship to (short term) interest rates. To the extent that we did not do so we may have unwittingly led to the kind of misunderstanding here;

vi. Professor Rose effectively says that he does not believe our story as to why we can now dispense with the Reserve Asset Ratio Recuirement. This disbelief takes two forms. First, what event is it which means that we can now control interest rates without the RAR whereas it was before necessary? Secondly, if, as the Green Paper claims, the RAR was always intended as an aid to interest rate policy and not as a direct reserve/deposit fulcrum why was it ever necessary to have Special Deposits? If the RAR was intended only as a fulcrum against which to generate interest rate changes why was it ever necessary to mop up surplus reserve assets when precisely the same effect could be obtained merely by selling Treasury bills and forcing the market into the Bank of England as under the proposed new system. More to the point, why are Special Deposits still needed under the new system? These are pertinent points and I would not myself know how to answer them. They are certainly questions which are likely to come up again and again in the debate.

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HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

GREENWELL'S COMMENTS

Note by the Secretaries

The attached note by Mr Grice, commenting on the views expressed by Mr Gordon Pepper (at a seminar organised by Fulton Packshaw and in Greenwell's Bulletin of 21 April 1980: TR(Mon)5) is circulated for information.

M L WILLIAMS
M D K W FOOT

H M TREASURY
28 April 1980

MR MIDDLETON

MR PEPPER ON MONETARY BASE CONTROL

Mr Williams and I attended the seminar on Monetary Control organised by Fulton Packshaw Limited on Tuesday.

2. Fulton Packshaw are money brokers and, of the 300 people attending, a high proportion were market operators rather than analysts. There were two main speakers: Gordon Pepper on the Green Paper and Peter Wood, the Treasurer of Barclays Merchant Bank, on the Consultative Document on the Measurement of Liquidity. Not surprisingly in view of the attendance, most interest was on the second of these two papers. A number of points were made in this respect and Mr Williams is separately sending you a detailed note of these.

3. Apart from Pepper's speech, however, there was very little discussion of monetary control. Certainly, there were no comments worth reporting from the floor. We did, however, receive the final copy of the Greenwells Bulletin on the Green Paper on which Pepper intends to base his formal submission to us.

4. Very little in the Bulletin is likely to cause us surprise. There are three main points:

a) Pepper believes that the money stock can best be controlled from the supply side. He castigates the Green Paper for advocating control by changing the determinants of demand;

b) he suggests that the problems of controlling the base - given the need to provide residual finance of the Exchequer from day to day - are not as great as the Green Paper makes out;

c) he claims that the Green Paper has misunderstood what proponents of monetary base control are advocating. The Green Paper aims at showing the defects of monetary base control as a <u>precise</u> instrument of short run monetary control. Pepper is proposing a <u>reliable</u> method of control over periods of six months or more.

5. It may be easiest to deal with these points in reverse order since the first is the most substantial.

6. We made it clear in the Green Paper, both in the Introduction and in the part written by officials, that we were discussing techniques of improving short run control. We did this because we believe that we already have the ability to exercise medium term control through fiscal policy and interest rates. Pepper's arguments here, as elsewhere, imply that this is not so. There is no analytical issue here: it is simply a question of fact. It seems to me perfectly clear that in the medium term we can and have exercised good monetary control. Our track record with respect to monetary targets is good and even now, when it is necessary for monetary policy to bear quite exceptional weight, monetary expansion is broadly on target. It may be time to challenge Pepper to state more explicitly why he believes this view of events is incorrect.

7. I have much more sympathy with Pepper's second criticism. In my view, Chapter 4 of the Green Paper where mandatory monetary base control is discussed - though not Annex B - devoted excessive discussion to the short-run operational problems of controlling the base to the exclusion of considering more substantial objections. There are methods of obviating or reducing these problems, averaging, for example, which do not receive fair discussion. Even if it is the case that these problems are insurmountable, the stress they have received is presentationally unfortunate since it looks as if we are placing the Bank of England's operational convenience before tight monetary control. Pepper, and others in the City

less committed to base control, have not been slow to spot this and we may be unwise to press these objections too strongly in the coming debate.

8. The more substantial issue which receives no discussion in Chapter 4 is whether monetary base schemes would yield genuine or illusory monetary control. This is a point on which Pepper will have to be confronted because it is bound up with his (mis)conception of supply and demand side controls.

9. There are two separate aspects:-

a) it is not in fact the case under the present system that we control the money stock from the demand side. Both supply and demand are involved. We control the supply of money because we want to change the determinants of the demand for money, be they directly fundamental macroeconomic variables such as the price level or variables such as interest rates which indirectly influence the fundamental economic conditions. It is precisely these routes which constitute the transmission mechanism, and provide the rationale for controlling the money supply in the first place. By contrast any scheme which controlled the recorded money stock but had no effect on the demand for money would be futile. We might meet the monetary targets in a statistical sense but there would be no effect on the economy;

b) Pepper insists in calling monetary base control supply side control of the money stock or even "controlling the money supply at the source". It is no such thing. It is a direct control which limits the amount of deposits banks can accept without incurring penalty. If the authorities create only £m 4000 base and the prescribed base asset/deposit ratio is 1:10 then the banks can accept £m 40,000 deposits and no more. Let us suppose, however, that with no change in the demand for money the private sector want to hold £m 45,000 bank deposits. Both

sides will have an incentive to overcome the barrier imposed by the base control. The banks will wish to hold the extra deposits because it is in the nature of their business to attract deposits and lend them at profit. The private sector wishes to hold these deposits by supposition so that both sides have an incentive to make the transaction in a very similar form but just outside the scope of the formal control.

10. There is a paradox here because it is these types of circumstance which give rise to disintermediation while Pepper has always criticized policies which do this. The paradox can be put another way in that while Pepper has many times stressed that domestic banks must not be placed at a competitive disadvantage by controls, against other financial institutions, the requirements of monetary base control apply only to banks. Pepper himself never appears to have recognised this paradox let alone resolved it. There is a resolution, however, which shows both the strength and weakness of base control.

11. Suppose that the banks as a whole are short of base assets given the deposits they could attract. Individual banks may obtain extra base assets by selling public sector debt to the non-banks in return for Bankers balances and will seek to do so. Of course, if the authorities do not expand the base, the banking system as a whole cannot obtain extra base assets but in the process interest rates on public sector debt will rise as the banks seek to unload debt onto the non-banks. As interest rates rise, the demand for money (and bank deposits) will fall until eventually it is reduced to the amount banks are allowed to hold given the available base. This is the favourable outcome for control in that there is a very precise route from controlling the base to controlling the money stock. But note that even here the demand for money is integrally involved. Control has been successful because it has affected the determinants of the demand for money and hence the real economy.

12. But there are at least three reasons why this favourable outcome may not come about:

a) faced with a shortage of base assets, the banks may react not by bidding for more base assets but by transforming their deposits into similar forms just outside the scope of controls. This is the dis-intermediation case and the reduction in recorded monetary growth would be illusory;

b) the banks may try to obtain extra base assets by selling very short-dated public sector stock to the non-banks, Treasury Bills for example. Indeed given that most public sector debt held by banks is of this form, this is the most likely outcome. In that case all that would be happening is that the private sector would be reducing its bank deposits somewhat but holding more Treasury Bills. Since a CD, for example, is not appreciably more money-like than a Treasury Bill, control would again be largely illusory;

c) banks may try to obtain extra base assets not by selling public sector debt to the non-banks but by bidding for extra deposits in order to acquire more base assets. In this situation the banking system as a whole cannot hope to ease base asset pressure, but each individual bank can. What would happen in response to base asset pressure is not only that public sector interest rates would rise - thus reducing the demand for money - but the own-rate of interest on bank deposits would also increase. It seems possible that this liability side management by the banks could render monetary base control unstable. Moreover, experience of liability side management over the last decade makes this instability a very real threat.

13. Perhaps unlike most people in the Treasury, I do not myself think that it has yet been demonstrated which of these outcomes, favourable or otherwise, would be most likely if base control were introduced. But it remains incorrect even in the favourable case to describe it as a supply side control. This is more than sementics. To the extent that it did influence only the allowed amount of bank deposits and did not affect the demand for money, the control would be useless.

14. Finally, I would make two minor observations on the Bulletin:

a) in Appendix 3, Pepper states that he has in mind a lagged or current accounting requirement. This is important because it is the first time we have had a specific statement from him on this;

b) the counterparts of the monetary base given in p4 are incorrect. Changes in the base arise from the CGBR and other factors not the PSBR and other factors, as stated. There is an issue of substance here in that the change weakens the role of the monetary base as a self-imposed discipline on the authorities. At times when, because of large borrowing requirements, the base was proving difficult to control the authorities could do so by reducing on-lending to the public sector and hence the CGBR but not the PSBR. There are thus a range of issues for local authority and public corporation finance which monetary base control opens up and which neither we nor Pepper have yet begun to investigate.

J. W. Grice

J W GRICE
25 April 1980

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HER MAJESTY'S TREASURY
MONETARY CONTROL CONSULTATIONS

FULTON PACKSHAW

Note by the Secretaries

The attached note by Mr Williams recording the discussion on the Green Paper at a seminar organised by Fulton Packshaw is circulated for information.

M L WILLIAMS
M D K W FOOT

H M Treasury
28 April 1980

FULTON PACKSHAW LIMITED: SEMINAR ON SYSTEMS OF MONETARY CONTROL: 22 APRIL 1980

I attended this seminar with Mr Grice (and Mr Trundle and Mrs Drummond from the Bank). Gordon Pepper spoke on the Green Paper (GP) and Peter Wood on the liquidity paper. Most of the discussion was about the liquidity proposals; this note records only comments on the GP.

2. In his opening statement, Pepper repeated his view that the first three chapters of the GP were a good critical analysis. But it was not clear, given the authorities' apparent views on MBC, why a cash ratio was to be required for all banks. Was it because the authorities were not confident that interest rates would prove a sufficient means of controlling money supply growth? (Pepper compared this with the "long stop" of the RAR adopted as part of the CCC arrangements. In the event, the RAR was used to do more than vary interest rates: and then by squeezing the supply of reserve assets, we were led into the problems of liability management, etc.) The implication is that we see the cash ratio as a long stop if interest rates fail to work. Pepper thought that, although MBC was unlikely to be introduced in the next 12 months or so, it would remain a live issue, and some shift to it was expected in the next 4-5 years (lagging the similar change of emphasis in the States).

3. Pepper then took the seminar through his latest bulletin. I will not summarise it again here, but he put considerable emphasis on the value of smooth monetary base growth as removing one source of fluctuation in the money supply figures. He concluded by saying that there were very few arguments of substance in the GP against MBC.

4. In a subsequent "dialogue" between Wood and Pepper, Pepper made clear that he envisaged a much wider range of short term debt instruments being available. Interest rates would be much less volatile under MBC and adjustments would be quicker (since there would be a wider short term debt market, and only small adjustments would be needed to ensure that the non-banks changed their holdings of short term debt in such a way as to keep sterling M3 on a smooth path; Pepper did not mention the discussion of this

in Annex B). Pepper was, in response to questions, less definite about the effects on interest rate levels of MBC. He argued that the indicator system would be the worst of all worlds, since it would mean both disruptive and volatile interest rate changes (because we would be reacting, often unnecessarily, to fluctuations in the "supply" of money). When pressed, Pepper agreed that the underlying determinants of monetary demand were, in the medium term, more important than short run control techniques.

5. There were three discussants. Brian Williamson (Gerrard and National) spoke largely about the impact of the liquidity proposals on the discount market, and Noel Hepworth spoke of some of the possible problems of the liquidity proposals for local authorities. Richard Green (Hill Samuel Investment Management) felt that Pepper was too relaxed about meeting targets optically, and also about the general risk that more direct control techniques would cause disintermediation. But he argued that MBC had the advantage over present policies of making it "less easy" for fiscal and monetary policy to be out of line. (The argument, I think, is that if we are explicitly controlling the base, there would be no disguising - since it would immediately show up as a divergence - our unwillingness to increase interest rates in response to monetary growth off target; a sterling M3 target, however, allows prevarication as we wait - vainly - for special factors to reverse themselves. This argument seems to rest on some view about the short term stability in the relationship between monetary base and sterling M3, or perhaps it is about lags in obtaining figures.)

6. There was some discussion of the role of excess reserves (with Pepper saying that the brevity of the passage in Annex B was "scandalous"). Pepper emphasised that reserves would be a usefull buffer, and fluctuations in their level acceptable since short term fluctuations in monetary growth have no implications for medium term control. I asked him over lunch how he squared this with his desire to secure smooth money supply in the short run by fluctuations, which were purely cosmetic, in non-banks' holdings of short term debt. He did not give a straight answer, but I think that his argument would be in terms of the presentational value of smoother short run control, that non-bank holdings of a much wider range of debt were not entirely cosmetic and there were no damaging implications from such disintermediation.

M L WILLIAMS
28 April 1980

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2 May 1980

HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

GREENWELL'S COMMENTS

Note by the Secretaries

The attached note by Mr Foot commenting on Greenwell's Bulletin of 21 April is circulated for information.

M D K W FOOT
M L WILLIAMS

H M Treasury

PEPPER ON MONETARY BASE CONTROL

1 Pepper has now commented in a Greenwell's Bulletin on the sections of the Green Paper dealing with Monetary Base Control (MBC). He is delaying comment on the indicator system until he has clarified his ideas about the most desirable form of MBC "in order to have the best yardstick against which to compare" the two. This paper comments briefly on Pepper's views; inevitably there is some overlap with Mr Grice's paper (circulated as MCC(80)7) but the subjects are of sufficient interest to justify a return visit.

A summary of Pepper's view

2 Pepper considers that there has been a major failure of communication so far in the 'great debate'. The authorities regard the stock of money as primarily demand determined, he thinks of it as supply determined.

3 Because both the demand for and supply of money respond only slowly to changes in interest rates, attempts to control demand through interest rates will lead to eventual control but interest rate fluctuations may be large, especially if the supply alters suddenly because of non-price factors. If the authorities instead controlled the supply of money, fluctuations in price would "in all probability be smaller", because erratic fluctuations in supply would be avoided. He does not, however, want rigid short-run control of the money stock - "monetarists do not argue for very short-run control of £M3".[1]

4 The second leg of Pepper's argument is (a) that control of the base is the best way to control money and (b) that the Bank must be able to control its own liabilities. From (b) follows the conclusion that in normal circumstances (liquidity crises would be exceptions) the Bank should not provide unlimited support to the discount market as a matter of routine. "The central bank can control the supply of reserves if it can control the total of its assets. If its assets are tending to grow too quickly ..../it/ can sell some of its .... Treasury bills. ....the central bank does not need to forecast events; all it

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(1) This will be news to Professor Griffiths, for one.

needs to do is to react to events as they occur." Flexibility in the system - Pepper has always favoured a mandatory cash requirement - would be provided by the fact that the banks would hold excess reserves and that the requirement could be an average over, say, a month.

5 Pepper then returns[(1)] to his long-held view that "residual control of the supply of money should be affected by sales of marketable short-dated central government debt". He accepts that such control would be cosmetic if sales were of debt which constituted primary liquidity and could therefore be encashed at will by banks; but under his limited lender of last resort powers this encashment would not be possible. In response to the Green Paper's questioning of whether relative yields would adjust in such a way as to ensure greater non-bank take up of debt when banks needed to sell assets, he merely reasserts that the requisite "small" change in yields would occur.

A commentary

6 Pepper, like Griffiths, places great weight on the supply side versus demand side issue. The way he puts it, however, does not perhaps do full justice to his case.

7 If the supply schedule of money (base) is set by the authorities and adhered to, it is hard to see how - as Pepper claims - fluctuations in demand will lead "in all probability" to smaller fluctuations in interest rates than in the present system. What is done now (in terms of his analysis) is surely that the authorities operate on the demand for money but with upper and lower bounds at any point for key (three month) interest rates. If the demand for money temporarily surges (the demand curve shifts to the right) driving interest rates up to the upper bound, the authorities intervene, effectively making the supply curve for money perfectly elastic; the money stock rises more than it otherwise would but interest rates rise by less (diagram 1 over page).[(2)] A fixed

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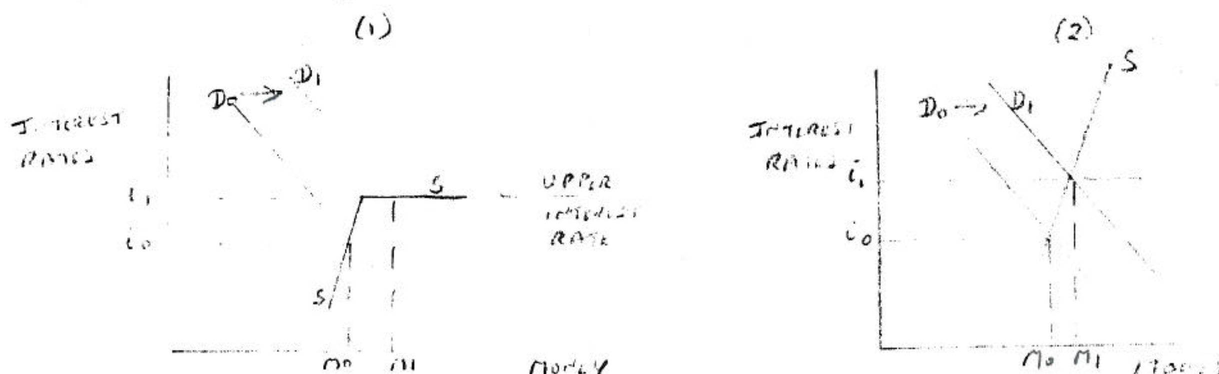
(1) There is first a long digression on the US system since 6 October, with particular emphasis on the Fed's non-price rationing of discount window assistance. It is difficult to see the relevance of this piece, as there is no suggestion that such an approach should be adopted in the UK.

(2) Only if the surge in demand persists do the authorities respond by reviewing their attitude to higher short-term interest rates.

supply curve of any plausible slope would mean that the same surge in demand would lead to a smaller rise in the money stock but a larger increase in interest rates (diagram 2).[1] The only way in which this would seem not to follow is if something in the changed world envisaged by Pepper changed the relative slopes of the demand and supply curves very significantly.



8 The essence of the supply side control case, however, can be put rather differently, ie, that it is by controlling the supply that the authorities will ensure a faster adjustment of market interest rates (to the level necessary to clear the market and to produce a money stock within the authorities' target) than the present discretionary system. In preparing the Green Paper, it was accepted that this was possible but also that there could be problems - particularly with the interest rate initially overshooting the final equilibrium rate, rather as seems to happen now with floating exchange rates.

9 A stronger hypothesis than the above, which Griffiths seemed to be advancing at the Bank's Academic Panel recently, is that supply-side control engenders both a price and a quantity (rationing) response from banks such that the final equilibrium is different from that which would follow if demand-side control were used. This view seems sustainable in the very short-run if banks do indeed ration loans when the authorities tighten monetary policy. But then, the unsatisfied demand will force interest rates up, with just the same results that would have happened had the authorities operated directly on interest

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(1) It is to be emphasised that the diagramatic representation used here sacrifices some reality for convenience. Nothing is implied about the stability of the demand curve nor about the time periods involved. Further one could argue that, as the authorities supply reserves rather than money to keep interest rates down, the analysis could be better conducted in terms of the demand for and supply of reserves.

rates. Indeed, in present UK conditions, two things would be likely to happen in response to such supply-side control. Firstly, the banks would practice liability rather than asset management - ie any short-run rationing would be short indeed. Secondly, there would be an immediate spill-over into non-reserve-requirement forms of business (the bill leak, or the euro-markets). This would result, at least temporarily, in a lower £M3 figure; but given the closeness of substitution of assets in this area, it would be hard to argue that prices and activity in the economy would be any different from those which would result from demand-side control.

10 It is not clear whether Pepper is advancing the weak or the strong version of the supply-side hypothesis. It may be, with his emphasis on "reliable" longer-term control of money, that he has the weak version in mind.

11 The second area where Pepper is awkwardly vague is in the constraints he would impose on lender of last resort facilities (1). Pepper does not accept that the Bank of England must be the buffer against, for example, unforecast daily swings on Government account. Presumably in his scheme, all these would have to be met in the following way:

(a) In the face of an unexpected swing against the market late in the day, the discount houses would be short of funds. If deprived of normal recourse to the Bank, they would have to borrow from banks.

(b) The banks, for their part would have lower aggregate cash balances at the Bank.

Over the period of the requirement, the banks would have to increase their cash balances again, unless they had been holding excess reserves at the outset.

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(1) It seems reasonable to assume that there can be no non-price disincentive against borrowing (of the Fed variety). While it is the bank that is short of reserves that borrows in the USA, the discount house that borrowed in the UK would have been put in that position by the withdrawal of call money by a bank short of balances at the Bank. In other words, the borrower in the UK would not be the one with the "excessive" level of deposits and could hardly therefore be "warned off".

11 This is not the place to explore in detail whether such a system would work and what its implications for the discount market would be. However, it might be worth establishing that this indeed is what Pepper has in mind, against the eventuality of having to reply to it in detail (eg before the Select Committee). In particular, there would presumably be a strong implication that the present liquidity proposals were inappropriate, seeing that the curtailment of lending of last resort facilities must undermine the liquidity of even Treasury bills.

Economics Division
Bank of England

M D K W Foot (601 4315)