MONETARY BASE CONTROL

PART 3

13 May 1981 – 12 May 1981

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P E Middleton
Deputy ~~XXX~~ Secretary

13 May 1981

J Fforde Esq
Bank of England
Threadneedle Street
LONDON EC2

Dear John,

Monetary Control

The Chancellor has asked that we should look ahead and let him have advice about how we see the monetary control system developing over the year ahead. He has also asked that Alan Walters should be associated with the discussions. I wonder therefore whether we could assemble the team which met briefly to go over these matters just before the Budget.

We might start by having a general discussion of the attached paper. We also have in hand a separate paper on the key question, set out in para 4, of the determination of short term interest rates. I hope to table this very shortly.

Yours ever,
Peter

P E MIDDLETON

Enc

[redacted] 45

CH/EXCHEQUER
REC. - 4 JUN 1981
ACTION Mr Middleton
COPIES TO CST
EST
MST C
MST L
Sir D Wass
Mr Burns
Sir K Couzens
Mr Ryrie

Mr Lankester suggested that we need not send a substantive reply to this.
JW 5/6

10 DOWNING STREET

Mr Hancock
Mr Monck
Mr Kemp
Mr Lomax
Mr Turnbull
Mr Ridley

THE PRIME MINISTER

Personal Minute
No. M 8/81

CHANCELLOR OF THE EXCHEQUER

MONETARY CONTROL

It is now more than six months since the new measures for monetary control were announced in the November 1980 statement. The last progress report was in January. I understand that, since then, considerable progress has been made; but my impression is that it has not been quite as rapid as you had originally envisaged.

For example, in the first place, it seems that the Reserve Asset Requirement still remains in place. It was envisaged in the progress report that it would be abolished by the Budget.

Secondly, I understand that the Bank still have not been able to abolish the 1½ per cent cash ratio and introduce the new ½ per cent reserve requirement which was announced at the time of the Budget.

Thirdly, it was envisaged in the progress report that the various changes in money market management and in the Bank's role as lender of last resort (including, I thought, the abolition of MLR) could be implemented at Budget time. I understand that progress has been made in that the Bank has

14/6

substantially

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substantially reduced its discount window lending and is now operating primarily through open market operations; but the interest rate band apparently still remains to be put into effect, and MLR is still with us.

Fourthly, possible new funding techniques were being studied by a Treasury/Bank committee. I am not clear what has emerged from this work.

I am told that you now envisage making the new measures fully operational by August. I understand that we would then be in a position to move to Monetary Base Control if we so wished. I can only say that I very much hope that the programme does not slip any further. Although I know you have misgivings about a ful move to MBC, I am more than ever convinced - especially after my conversations with Dr. Zijlstra - that we must change over to some such system of quantitative control and sooner rather than later. I believe MBC could be introduced and implemented provided it includes a suitable discretionary element.

I would like to hold a stock-taking seminar before the Recess, and my office will be in touch with yours to arrange this.

I am sending a copy of this minute to the Governor.

Margaret Thatcher

4 June, 1981

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cc Financial Secretary
Sir D Wass
Mr Burns
Sir K Couzens
Mr Ryrie
Mr Hancock
Mr Monck
Mr Kemp
Mrs Lomax
Mr Turnbull
Mr Ridley

MR MIDDLETON

MONETARY CONTROL

The Chancellor has seen the Prime Minister's personal minute of 4 June, and has commented that <u>his</u> conversation with Doctor Zijlstra certainly did not serve to fortify any intention to move to monetary base control.

2. Mr Lankester has suggested to me that the stock-taking Seminar should be arranged for the first week in August. I take it that this should present no difficulty?.

JW

A J WIGGINS
8 June 1981

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The attachment is same as sent to Mr Ffrench on 13/5 but p1-2 are revised from version sent to A Walters 11/5. Sent revised version to A Walters 15/7 (minus A Walters min (S87(1)))

Chancellor of the Exchequer

cc Financial Secretary
Sir Douglas Wass
Mr Ryrie
Mr Burns
Mr Monck
Mr Britton
Mrs Lomax
Mr Turnbull
Mr Pirie
Mr H Davies

MONETARY CONTROL: NEXT STEPS

1. Following our meeting on 28 April with Alan Walters, we have produced the attached note which has been sent to the Bank as the basis for discussion. Mr Walters has seen the note. While he cannot be said to be happy with the place it attributes to M_0, he is content to join in the discussions using the note as an agenda.

2. I hope that we will now be able to make progress along the road mapped out at the meeting we had on 28 April. There are two key areas:

a. Funding. It would be very helpful if you could arrange to discuss with us the paper produced by the Wass group last February. This will provide a steer for further work on funding including the important question raised in para 19 (c) of the attached note - the structure of the securities market. This is separate from the question of tactics in the gilt-edged market over the next few weeks which we hope to discuss with the Financial Secretary.

b. The Determination of Short Term Interest Rates. You will see that para 4 promises further work on this, which is well advanced. It is here that we shall have great difficulty in sorting out how in practice the different elements which we identified in the Budget should influence interest rates. The short note, also attached, which Alan Walters has contributed shows that he would give primacy to the wide base targetted over a longish time horizon of six months to a year. We shall rather start from the presumption that £M3 is still the key variable, modified by the information we derive from the other sources, including the narrow aggregates. Our objective will be to formalise things sufficiently to provide a clear presumption about when rates should change on the assumption that more movement will be possible when we get the bands in place.

3. I should perhaps add that the Bank are just about on the last stage of their consultations with the banking system. They have to see the clearers again today - the point at issue is whether the discount houses are being put in too favourable a position in certain circumstances. But we should be able to make a substantive move to get the key elements of the new system in place by June or July. So it is quite important to make progress on the other issues set out in our note at the same time.

PEM

P E MIDDLETON
14 May 1981

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MONETARY CONTROL - THE NEXT STEPS

Introduction

.. Following the public discussion of the Green Paper on Monetary Control, Ministers decided against a move directly to a system of monetary base control. Instead they have initiated a number of changes to improve control which, while falling short of monetary base control, do not close off the option. And the Chancellor has recently confirmed that the first priority should be to complete successfully the implementation of the changes set in train.

2. This note therefore looks at the characteristics of the system of monetary control as it is emerging following the decisions taken last November and in the Budget. It considers what steps are necessary to complete the system, what arrangements need to be established to operate it and monitor its effects, and what improvements can be made.

Characteristics

3. By the time the present discussions are completed, a new system will be in place for the Bank's operations in the money markets. It will have the following characteristics:

a. There will be no Reserve Asset Ratio for the purposes of monetary control but banks have agreed not to make major changes in their holdings of liquid assets pending completion of talks on prudential liquidity. These interim arrangements will be replaced in due course by individual norms around which there will be some flexibility.

b. Access to the discount window will be much less freely available and then only at a rate to be varied from day to day which would be penal in relation to those established in the market. MLR will be abolished or suspended, soon after the new system has been brought into being. There is a question of how the size of the penalty element in discount window lending should be determined.

(1)

c. The Bank's operations will be conducted mainly in bills through the discount houses. The criteria for the eligibility

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of bills will be widened and arrangements will be established to ensure adequate supply of ~~bills~~ cash to the discount market. Call money will continue to be an important feature of the system.

d. The Bank will operate so as to keep very short term interest rates - up to 7 days - within an unpublished band. Where the authorities felt prevailing interest rates were satisfactory, the Bank will buy sufficient paper at prevailing rates to achieve the level of bankers' cash consistent with those rates. This would be done by inviting offers of paper at existing market rates and accepting what was offered. Where an upward movement in rates was required, the market would be left with less cash than it wanted. Banks which were unsuccessful in obtaining cash by selling paper would have to resort to the discount window, ie borrow at penal rates. If rates reached the unpublished ceiling rate, the discount window would be operated freely or open market operations would be undertaken freely.

e. All banks will have to keep a minimum (non-interest bearing, non-operational) cash ratio of half a per cent of eligible liabilities. In addition the clearers will hold operation balances with the Bank, again non-interest bearing.

4. The target aggregate will continue to be £M3 on the grounds that its closer links with fiscal policy make it a more suitable target for a medium term strategy. However, interest rates will not be set solely by reference to deviations of £M3 from the target. The behaviour of the monetary base and over 6 monthly periods other aggregates, and a number of other factors including inflation, the level of real interest rates and the exchange rate will also be taken into account. No systematic way of taking account of these other factors has yet been constructed, though a separate paper is in hand to elaborate these criteria.

5. The new system will mean operating on fundamentals - fiscal policy, funding instruments, and short term interest rates through the bill market. There are no direct controls, no exchange controls, and there will be no MLR.

Operation of the New System

6. There are a number of questions raised by the new system:

a. What are the advantages of the changes and to what extent will they materialise?

b. What degree of control can it be expected to deliver?

c. What further developments can be made?

a. Advantages of the New System

7. One of the advantages claimed for the new system is that it will allow market forces to play a greater role in the determination of the structure of short term interest rates. Nevertheless, the new system is clearly one in which the authorities retain discretionary control over the general level of interest rates. While it is true that in its money market operations the Bank has arranged matters so that it responds to bids, the setting of the band will still be the prerogative of the authorities exercised on a discretionary basis in much the same way as if an MLR system were being operated. The behaviour of the target aggregate, whatever it is, will continue to be an important determinant, though it will not be the only one, in setting the band and hence in decisions to provide or withdraw cash from the system. One point which needs to be clarified is whether the system can mop up liquidity as effectively as provide it.

8. Another possible advantage of the new system is that it reduces the so called "bias for delay". There may be some element of this since the position of the band will be considered at regular monthly meetings but regular consideration of the level of interest rates could equally well be achieved using MLR. Implied in this is a willingness to let rates rise promptly as well as fall. It is also claimed that the new system may "depoliticise" interest rates since there would no longer be the drama of infrequent administered MLR changes. It is sometimes claimed that the system in the US, where the FOMC gives instructions on the interest rate bands to the manager, has succeeded in reducing the political sensitivity of interest rates. However, it is not clear that this would be achieved here where Ministers are more

directly responsible for monetary policy. If Ministers are to succeed in distancing themselves from rising interest rates, they will be able to take less credit for reductions.

9. There are two properties of the new system which are claimed to have advantages. First, there will be more uncertainty about the terms on which banks can obtain cash and secondly, the cash ratio will take the form of a minimum, with the balances formally required to be held at the Bank of England being non-operational. As a result of these changes the banks, particularly the clearers, are likely to hold "excess" reserves for the first time. Under the old, averaging, system holdings of cash above the required level were tolerated as they in effect "bought" the right to go below the required level at a later date. Under the new system, any "excess" holdings will have an opportunity cost and the banks will therefore have a strong incentive to keep such holdings to a minimum.

10. It is claimed that this will force banks to pay more attention to asset management eg to shift from base related to market related pricing of overdrafts. If this occurred, it would be advantageous in reducing round-tripping. Whether it would restrain the trend of bank lending must be doubtful.

11. A further advantage claimed for the new system is that it will be possible to learn something about the properties of a monetary base system from the banks' cash holdings above the minimum. While it is true that some element of voluntary or excess balances will appear for the first time, this argument cannot be pushed too far. Money at call with the discount houses, ie an asset only slightly inferior to cash, will still be a feature of the new system and the banks will operate in the knowledge that at the upper limit of the range they can get unlimited credit.

12. The new system can reasonably be said to be an improvement over the present system even if it does not achieve all the advantages claimed for it. First, it should permit short term interest rates to be adjusted more requently and promptly even if it does not fully remove the bias for delay or completely depoliticise interest rate movements. Secondly, by imposing a

cost on banks' holdings of cash above the minimum, it should encourage helpful changes in banks' behaviour. Finally, there is now a more realistic view of the time horizon within which it is appropriate to control monetary growth. It is unlikely, though that the new system will provide complete information on how a monetary base system might work; this will always remain to some extent a leap in the dark.

b. Degree of Control

13. It is necessary to establish how close a degree of monetary control it makes sense to aim for. As a minimum, the Government is likely to want some assurance that it can come within, or at least not miss by much, the target ranges for £M3 set year by year. There is also merit in trying to ensure a reasonably smooth path for £M3 during the course of the year in order to prevent destablisation of market expectations. But there would be little point in achieving a smooth path for the monetary aggregates month by month if this were at the cost of injecting instability at some other point in financial markets. Removal of potential distortions such as round-tripping would, however, be advantageous. A further factor pointing to a longish time horizon for achieving the £M3 targets is the relative importance as an instrument of control of fiscal policy, whose effects work rather slowly.

14. With various instruments of direct control having been removed, a key instrument available to the authorities within the target period, will be movements in short term interest rates. The experience of 1980 indicates the limits of this in controlling £M3, particularly if other forces are working against it eg the position of the company sector, or if other factors eg the strength of the exchange rate, inhibit its use. Our view on the sensitivity of £M3 to interest rate changes is in a state of flux, more recent work indicating rather stronger effects than previously estimated.

15. However, much depends on the relativity of long and short rates for the wider aggregates. A rise in short rates with long rates fixed would have only small or even perverse effects on monetary growth but a rise in long rates with short rates

fixed or a rise in both together would have a strong effect. But the scope for manipulating the yield curve is very much an open question. Is it possible through the introduction of new funding techniques to determine long rates independently or would a policy of aggressive funding at the long-end, through its impact on money markets, drag short rates up with it?

16. It will however be necessary to decide when to move the interest rate bands and whether, eventually, to widen them. A particular question is the role which past movements in the narrow aggregates - M1, non-interest bearing M1 and the monetary base - should have in determining movements of the bands. It is possible that movements in these aggregates over a shorter period (eg 6 months) than would be appropriate for £M3 could play an increasingly important role in the determination of short term interest rates.

c. Next Steps

17. A number of loose ends need to be tied in order to put the new system fully into place:

a. Completion of the negotiations with the banks, the discount market and other financial institutions and issue of a document setting out the agreed arrangements.

b. Decisions are needed on when to launch the interest rate band, and on its width.

c. The Bank have suggested that even with an interest band there might still be some residual role for an MLR. They have been asked to set out their thinking on this - Mr Monck's letter of 10 April to Mr George.

d. A timetable needs to be set for the removal of the reserve asset ratio first as a minimum requirement and secondly in its transitional role as prudential norm. This is linked with the pace of discussions on prudential norms for individual banks or classes of banks. Can we be sure that prudential guidelines on liquidity will not create awkward problems for monetary control of the kind created by the RAR?

Items (a) and (b) should be completed by June.

d. Operating and Monitoring the New System

18. In order to operate the new system and to monitor its effectiveness further work is needed in a number of areas:

a. We need to complete work in hand on clarifying the criteria for settling interest rates and the weights to be attached to different indicators and aggregates, including the monetary base, in different circumstances. Is the width of the band solely to accommodate noise or does it make sense to try and aim at a particular area of the band?

b. In order to come to a view about the effectiveness of the new system it is necessary to set out in advance the changes it is supposed to bring about. What changes might one expect to observe in the structure of interest rates, how might the market respond to the knowledge that we are prepared to see short rates move within a band albeit a narrow one, what changes in bank cash holdings and in overdraft facilities can be expected? Mr Monck's letter also asked the Bank to prepare a note on this.

e. Further Developments

19. The new system is not intended to be an unchanging one, and further improvements are needed to strengthen the ability of monetary instruments to correct divergences from the target if the fiscal decisions turn out to be misjudged. A series of changes and adaptations are therefore to be expected. The main areas in which further developments need to be investigated are:

a. What would be the consequences of widening the interest rate band? How much interest rate variability could the discount houses tolerate? What would be the consequences of a contraction in their operations?

b. The Bank's preference for operating through the discount houses in the bill market stems from their feeling that operations in the interbank market would degenerate into negotiation with the clearers - the "giant counterpartie This they claim would be inconsistent with allowing a greater role for market forces. We need to examine in greater depth the consequences of operating in the interbank market. Could part of the Bank's operations be conducted there?

c. The work on funding needs to be resumed. The paper produced by Sir Douglas Wass' group last February has not yet been discussed with Treasury Ministers. A number of steps have been taken eg the National Savings initiative, the launch of the indexed gilt (a paper discussing the terms, frequency and method of sale of future issues is being prepared). We need to consider whether there are any further steps which can be taken either by way of new instruments or by new techniques. In particular, a study is needed on the implications of the various structural changes which are already taking place in the securities market.

Conclusion

20. The new system is an improvement but it will need development in order to strengthen the control of monetary aggregates which can be achieved by monetary instruments. We therefore propose to pursue with the Bank the steps needed to install, operate, monitor and develop it as proposed in paras 18-20. We shall report to Ministers on progress and issues for decisions.

NOTES ON MONETARY BASE CONTROL - THE PRESENT SITUATION

1. Since November 1980 there has been no rule for interest rate control and open market operations. The general procedure has been to sell as many gilts as the market will take, but this is at prevailing interest rates. We are not moving interest rates in order to control any monetary magnitude. In short there is no monetary control. We are responding to the demand for money and not determining its supply.

Monetary Base Control

2. There is no reason why we should not attempt to control the monetary base of the system. Since M_3 is influenced, but certainly not determined by, the sales of gilts to the non Bank private sector, there is no reason why this policy should not continue alongside the system of monetary base control. In this control system we are only concerned with the liabilities of the Bank of England in the form of cash held by the public, cash in bank tills and bankers' deposits. There does not seem to be any marked inconsistency between controlling these liabilities to some specified 5% growth rate, on the one hand, and pursuing existing policy of selling gilts in order to influence the path of M_3 on the other. Thus monetary base control is entirely consistent with the present control mechanisms used in medium term financial strategy.

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The Disadvantages

3. It is thought that the main disadvantage would be the fact that interest rates will oscillate more than under present conditions. But this depends very much on the monetary base policy pursuit. If we try to keep a growth path day-in day-out of 5%, there certainly will be marked oscillation, but if instead we are concerned with growth over much longer periods, say six months to one year, then there is no reason why there should be induced liquidity crises of this nature.

/In fact we

In fact we should make it clear that the day-to-day operations of the system are concerned with supplying adequate liquidity to the banking system. The control of growth rate at 5% per annum would be over a period longer than six months and probably about a year in duration.

12 May 1981