


3. Monetary Base Control III

7/11/1980

Sir Douglas Weiss

cc Mr Burns
Mr Rylie
Mr Britton
Mr Monck
Mr Unwin
Mrs Lomax



MONETARY CONTROL

I attach a note by Mr Britton which sets out what are our conclusions on the monetary control consultations. I have sent a copy to Mr Fforde. I have no great hopes of receiving a piece from him though I have asked for it.

2. The note is not intended to be a presentation which one would make to the public but to be a list of points round which that presentation would be constructed.

3. The Bank papers represent a minor change to the status quo. It is difficult to see how they could be presented as other than a justification of the Green Paper diagnosis. They basically represent the status quo without the reserve asset ratio and with more flexible central bank operations. It is not even clear that there would be more flexibility in short term interest rate movements. Certainly the gilts paper indicates there would be no change in debt marketing techniques - with the exception of the restricted indexed gilt which on the Bank's analysis we cannot announce for fear of damaging the existing gilt market, and nationalised industry borrowing which we are not yet in a position to say anything about. No-one will regard this as a fundamental change in the system of monetary control designed to bring about more attention to quantity rather than price. The Bank's proposals on the cash ratio, still based on eligible liabilities, are in fact a proposal to defer any move to monetary base control outside the period of this Parliament.

4. Reflecting on yesterday's discussion there is one point which I particularly want to make. We have prepared in the Treasury a serious piece of work setting out the issues involved in moving to a fundamentally different system of monetary control. Mrs Lomax'

further minute on steps towards monetary base control which you had earlier this week takes the practical steps one stage further. I am not prepared to have this work, which after all has gone to the Prime Minister, ignored by the Bank on the grounds that it has been done by the Treasury rather than a central bank. The issues which we have set out must be argued through - preferably at your meeting. Mr Britton's note provides a peg for this.

5. It is not true to suggest that we have not thought about the denominator of the mandatory base system which we have suggested. It has been discussed with the Bank and Mr Fforde should have been aware of this. You will see from Mrs Lomax's minute of 5 November that a good deal of work has been done on an M2 series. We are in no worse a position on this than the Bank were when they cooked up eligible liabilities as the basis for the corset. And as we are proposing a further stage of consultation in the cash ratio document I do not see that there is any reason why we should allow the arguments for an M2 denominator to be brushed on one side.

6. I am becoming as a result worried about how all this will be presented at the end of November. So far the list looks something like this:

- a. we announce a virtual suspension of the target
- b. some toughish measures amounting to a small increase in public expenditure
- c. the Industry Act forecast with, by implication, a large borrowing requirement for next year
- d. very little on the tax side except possibly NIC, and some small amount from the North Sea
- e. the possibility of some reduction in interest rates.

7. Given this unpromising outlook I think it is quite important to make a fairly forthcoming announcement about our intentions on monetary control even if we cannot move at all quickly.



P E MIDDLETON
7 November 1980

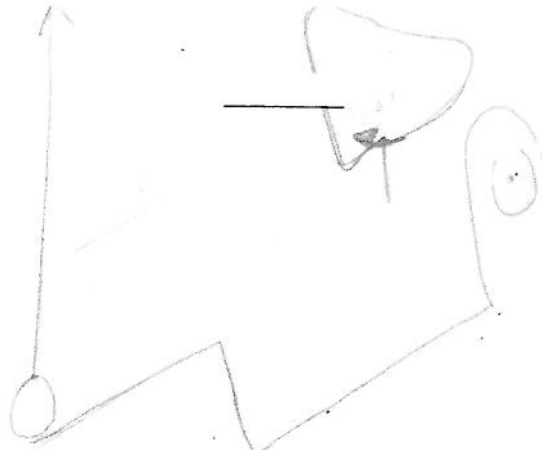
It is also clear that the following are the issues on the Green Paper page:

- (1) We are impressed by the argument that monetary control could be improved by switching the emphasis of short-term monetary management away from control of interest rates and towards control of the cash base. Movement in this direction must be by evolution, not revolution. Some changes can be made now, but in other respects we see a need to keep the options open and review them later in the light of further experience.
- (2) One option would be to target the base itself (non-mandatory monetary base control): another would be to use control of the base as a means of influencing one of the narrower monetary aggregates (mandatory monetary base control). The steps to be taken now should be compatible with evolution towards either system.
- (3) It would not be possible to exercise effective control of a broad aggregate such as £M3 on a month-to-month basis by means of a system controlling the monetary base. A system with a mandatory requirement related to a total including wholesale deposits would result in disintermediation of the kind associated with the SSD scheme. A system with no mandatory requirement could not be used to control any of the wider monetary aggregates except, perhaps, in the long run.
- (4) The indicator system outlined in the Green Paper depends on the existence of a relationship between the target aggregate and the level of interest rates which is stable and well-understood. For the wider aggregates, at least, this condition is not fulfilled. They appear to respond as much to relative interest rates, and expected yields, as to the overall level of the interest rate structure.
- (5) Control of £M3 must, therefore, depend mainly on fiscal policy and debt sales. Month-by-month control by these means is not possible - but neither is it necessary. The commitment to the medium-term strategy set out in the Budget Statement stands.

28/11

No more details:

- A. Control of M3 will be improved by the following measures:
- (i) /any fiscal elements in the package/;
 - (ii) /flouting about National Savings/; and
 - (iii) /any changes in marketable debt, including reference to development of broader market in central government short-term debt/.
- B. We wish to see the market playing a more significant role in the determination of short-term interest rates. We intend, therefore, to change, slowly and cautiously, the nature of official intervention in the money markets. The development will be away from targeting interest rates and towards targeting the monetary base. As a first step, the Bank will be operating with a view to limiting recourse to the discount window (or "lender of last resort") facilities - see separate statement by Bank.
- C. The existing cash ratio is itself an incentive to disintermediation and could become a more serious one when the market plays a more active part in the determination of short-term rates. To minimise this problem, we propose that the cash requirement against wholesale deposits will be eliminated. The Bank will be issuing a consultation document in which the considerations governing the definition of retail deposits, the size of ratio required and the interest (if any) to be paid on bankers' balances are set out in full. The existence of a cash ratio in this form would make it possible for the authorities at a later stage to influence the growth of retail deposits by controlling the rate of growth of the monetary base. If a non-mandatory system of monetary base control was preferred, the cash ratio would be abolished.
- D. The reserve assets ratio will be abolished/modified with effect from [] []. It is hoped that the consultations on liquidity norms will soon be brought to a conclusion.



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7 November 1980

2/6/03 G

Sir Douglas Wass GCB
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Dear Douglas,

The proposal put forward by Middleton as the point d'arriv  e yesterday was the following:

- (a) that   M3 should remain as the (primary) monetary target;
- (b) that short-term interest rates would be produced by an MBC system which operated through a mandatory cash ratio of 5-10% (on which a market rate of interest would be paid) of retail deposits; and
- (c) that any divergence between the   M3 that resulted from the PSBR and short-term interest rates determined as under (b) and the target for   M3 should be offset by debt sales.

This proposal has been developed by Treasury economists under Britton - with technical assistance, on a personal basis, from some junior Bank economists. There has been no official consultation with the Bank.

In the Bank's judgment the proposal is simply not practicable as it stands because there is no known or realistically imaginable technique for debt sales that could be relied upon to reconcile any given PSBR and whatever level of short-term interest rates happened to emerge under (b) with the targeted   M3 (ie, (c) above is pure fantasy). Whatever else emerged from the MBC debate the one thing that was clear was that MBC was not compatible with a   M3 target.



A more reasonable proposal would be to abandon £M3 as the target variable and move to a new retail deposit (M2) target, ie, to adopt (b) above in isolation. The main objections to this more comprehensible proposal are:

(a) Conceptual

- ££'s* *imagine*
- (i) We know nothing about the proposed aggregate: we have no previous figures for it; have no idea how it responds to interest rates; or how it relates to nominal income. It would be years before we could assess whether or not it had in practice any significance as a control variable - whatever the theoretical case may be. If we were to decide to move to a narrower target aggregate there would be much to be said for M1, of which we do at least have some data and experience
- But you can do £M3*
- (ii) Like M1, it suffers from not being capable of analysis in terms of its credit counterparts. There are different views about the importance of this. A subtle temptation is the thought that by concentrating on a narrow aggregate we could escape the problems of the PSBR or debt management or bank lending, etc. In fact this would not be so: policy failures in these areas would simply be reflected in pressure on short-term interest rates and to contain such pressures we would be driven back to acting on the credit counterparts.

(b) Practical

- We cannot*
- (i) We do not know whether M2 is feasible either as a statistical concept or as an operational quantity. The purely arbitrary suggestion is that it should include balances of less than £50,000. We would need to establish whether there were collection problems for the banks. Problems of multiple accounts or of fluctuating balances immediately spring to mind; and one wonders how the figure would be adjusted over time, eg, to take account of inflation, etc. Nor is it difficult to devise possible forms of evasion, eg, by compensating loans. It is for the statistics side of the Bank to advise on the feasibility in this area - there has been no official consultation: the statisticians' preliminary reservations, which are set out in the attached note and which have been expressed informally to Treasury officials, are simply brushed aside.
- What about £50*
£M2
- (ii) A 5-10% cash ratio - even if interest-bearing - would be a serious distortion of the banks' preferred asset structures. It would involve a substantial earnings penalty unless the interest paid was equal to the return which banks could otherwise earn, ie, LIBOR plus. The earnings penalty would have a number of implications:

- Interest
control*
- (a) It would be an incentive to the banks to reduce their direct reliance on M2 deposits leaving these to be collected by building societies and money market funds, etc. to be amalgamated and redeposited outside the M2 definition;
 - (b) It would be an incentive to offshore banking with the likelihood that branch bid deposits and other large retail deposits would be booked overseas;
 - (c) It would give a positive incentive to liability management through the wholesale market, so that the impact of any increase in credit demand would be reflected in short-term interest rates very directly with serious implications for the stability of the system.
- Sowbel*
- (iii) A 5-10% cash ratio would also mean that banks would wish to hold minimal other liquid assets. This would have severe consequences for the flexibility of the domestic money market and would limit the Bank's capacity to deal in such other liquid assets. (It would not be possible for the Bank to deal directly itself in the interbank market for the reasons discussed in the Bank's paper for yesterday's meeting with the Chancellor.) *for*
 - (iv) As with a non-mandatory system we should have no knowledge for years about the banks' demand for reserves (in this case for excess reserves) and so would have no basis on which to conduct our monetary base operations without inducing entirely random interest rate fluctuations.

At the very least these, and no doubt other questions, would need to be thoroughly considered by those that would be responsible for operating the system before the Bank could possibly endorse any kind of commitment to going in this direction. There is no conceivable way in which we can agree to adopt a mandatory M2 system (still less with a £M3 target) in the course of the next week or so if at all.

Yours ever

Keith McMahon

*See D. 1000 office also
received this - you didn't*

MONETARY BASE CONTROL: A 'RETAIL DEPOSITS' DENOMINATOR

- 1 This note addresses itself to the statistical implications of using 'retail deposits', defined as deposits below a certain figure (say £50,000 or £100,000) as the denominator of a scheme of monetary base control. It assumes that all sterling deposits below the cut-off point would be included in the control aggregate but that a rate of interest would be paid on the monetary base held, so as to leave the banks, as far as possible, indifferent as to whether liabilities lay below or above the cut-off point. (1)
- 2 It should be stated at the outset that, although the banks currently break down deposits by sector, by currency, by maturity and by payment of interest, (2) distinguishing deposits by size would be a totally new concept for them. It follows that there are no statistics presently available for the purpose.
- 3 From a statistical point of view, two questions seem to arise. First, would the concept of an aggregate determined by a cut-off point in terms of size be statistically sensible? Secondly, what problems would be involved in obtaining the necessary figures? These are discussed further in the paragraphs that follow.
- 4 The concept of distinguishing deposits by size would seem likely to give rise to erratic movements into and out of the target aggregate, to a greater extent than is the case with £M3. Apart from CDs, bank deposits are not, in general, discrete instruments; rather, they form a continuous range with no natural break-points. It would be impossible to avoid accounts frequently moving from one side of the cut-off point to the other, perhaps a result of quite small transactions. Moreover, since companies' accounts would also be included, there would be frequent large movements at times of tax or wage payments. An account with a deposit of £100,000 one day might go down to £5,000 or be overdrawn the next. It could not necessarily be assumed that on average such swings would cancel out.

(1) Clearly this assumption only holds good up to a point.

(2) Not necessarily all at the same time or on the same form.

Almost certainly they would not, since when a company pays out wages a large balance, excluded from ^{the} aggregate, will be converted into many small (personal) balances which will be included. Also, the fact that companies pay ^{taxes} at the same time would tend to produce erratic fluctuations in the number of accounts covered. To some extent, these distortions could be removed by seasonal adjustment, but we have no experience of the sort of seasonality involved and at least three years of figures would be required for seasonal patterns to be estimated. Moreover, unless the cut-off point were indexed in some way or other, deposits would get drawn into it automatically as a result of inflation (see below). On balance, it is likely that an aggregate of this type would be subject to considerable erratic fluctuations, hard to interpret and could not be seasonally adjusted for at least three years.

5 The matter of data provision also bristles with difficulties. It would be an exceedingly onerous addition to the present statistic requirements ⁽¹⁾ at a time when the banks are also about to be asked for a wide range of additional information, especially for supervisory and international reporting purposes. Not only would it require time and effort on the banks' part to set up the necessary reporting system, but it would also be burdensome to operate, in that the balance on each account on each reporting day would have to be inspected to see whether it came above or below the cut-off point. This would be complicated if the cut-off point were regularly revised on account of indexing. For banks which are fully computerised, this should not be an impossible problem, although it would take time to carry out the necessary programming. ⁽²⁾ For banks without a fully computerised system, of which there are still quite a few, it would be a nightmare.

6 The Bank have no powers to require banks to provide figures for this sort of purpose, and their provision would therefore have to be negotiated. Since the reporting requirements would seem likely to be onerous, the banks are unlikely to be enthusiastic for the introduction of a scheme of this kind, whatever their views about its merits or otherwise in theory. Even if their whole-hearted co-operation could be assured, it seems unlikely that any scheme of this kind could be brought into operation at all quickly. Without discussing it with the banks, we cannot be precise about timing, but experience suggests that it could not become operational in less than

(1) The abolition of the present ELs and reserve ratio system would not be likely to bring much offsetting benefits.

(2) The amount of work involved here is difficult to estimate, and would depend on the degree of flexibility in existing computer systems.

a year from its promulgation.

7 It is concluded that, from a statistical point of view, a scheme of this kind looks exceedingly unattractive. It would seem likely to produce an aggregate which would probably be highly volatile and consequently difficult to interpret. An additional point here is that, unlike M3, this aggregate would not be related to the counterparts on the assets side of the banks' balance sheets. A scheme of this kind would also impose a very considerable reporting burden on the banks, and could not possibly be introduced at all quickly.