

# 12. Monetary Base IV Part C

Comments on Green Paper

29/10/09

## Monetary Base Control

### Observations by Gillett Brothers Discount Co. Ltd.

The theoretical pros and cons of a monetary base system (M.B.C.) have been extensively canvassed throughout 1980 and need no further elaboration. The Green Paper on Monetary Control (Cmd. 7858) put its faith on interest rate policy and dwelt at length on the difficulties involved in applying any form of M.B.C. Subsequently the Treasury and Civil Service Committee concluded that "the Committee considers it unlikely that an automatic application of a single technique of control will be either appropriate or acceptable to Parliament".

However the disappointment over the failure of the present system to produce favourable statistics has engendered fresh speculation whether M.B.C. would not do the job better, but in the heat of controversy, in our submission, practical considerations are not being given their proper weight and as practitioners in the money market we conceive it our duty to sound the following note of warning:

1. No monetary system ever devised can undo the damage occasioned by a lax fiscal policy. The M.B.C. controversy, with all due respect, is like an argument about the techniques of fire-fighting while the arsonist is still at large. To initiate an expansion of credit and then as it were penitently seek to deny the means of payment is on the most charitable view an exercise in futility.
2. Granted that some form of monetary control is necessary to supplement a responsible fiscal policy, the problem is not one of finding new machinery in the hope that it will produce painless solutions to difficult problems, so much as of finding the political will to make the existing machinery work effectively.
3. Control over interest rates has been at the root of monetary policy in the United Kingdom ever since the latter consciously

pursued such a policy. It is the proposed abandonment of this control which is the most disturbing feature of M.B.C. For the adoption of M.B.C. implies a willingness to let interest rates move as high or as low as pressure on the monetary base takes them, without regard to the nature or likely duration of these pressures and conceivably in conflict with other policy objectives, e.g. exchange rate policy. Political analysis lies beyond our brief but in passing we cannot help expressing wonder at the belief evidently entertained in some quarters that a high "administered" level of interest rates will involve the government of the day in public obloquy while a similar or higher level of "consequential" rates will not.

4. It is sometimes argued that extreme volatility of short-term interest rates does not necessarily affect the yields of long-term government debt or mortgage rates. Practitioners will find this hard to accept. The markets interlock. A more likely outcome would be loss of confidence by institutional investors in the long market, making the government's debt funding even harder than it is now. This view is reinforced by recent events in the U.S.A., where violent fluctuations in short rates have produced bank failures, acute problems in the real estate market, huge swings in long and medium term bond yields, many Wall Street failures and serious tension between the Federal Reserve and the U.S. government - all this in a country where inflation is modest by our standards. The week by week comments of Dr. Henry Kaufman of Salomon Brothers throw an interesting light on the destabilising effects engendered by a hankering to accommodate some elements of M.B.C. within an existing monetary system.

The experience of Switzerland, which has a tiny public debt, low inflation, an as yet uninternationalised currency and a tightly organised and homogeneous banking system is in our submission irrelevant to countries like the United Kingdom and the U.S.A.

5. The recent disillusionment with the present system is almost entirely due to the effects on the statistics of reintermediation.

It is a paradox that this should lead to renewed clamour for the introduction of a system which, it was suggested in the Green Paper, runs an even higher risk of encouraging disintermediation. Moreover it seems perverse to turn the monetary system upside down because £M3 has proved an inadequate measure of the public's liquidity. The sensible course would be to seek a more reliable measure.

6. A M.B.C. system is a new system. It would inevitably take the authorities by a process of trial and error some time to learn how to operate it. The results are unpredictable and the consequences could be as disconcerting as those experienced over the removal of the "corset". It is significant that M.B.C. finds its supporters largely in the academic community, i.e. those whose intellectual curiosity can only be assuaged by experiment. Practitioners and administrators are on the whole hostile or agnostic. We do not believe that this is due to the self-interest of the one or the timid conservatism of the other. It is because they both in their own ways understand that market psychology is more subtle than the outsider supposes. What is perverse to the academic is often obvious to the trader.

Since we have devoted some space to pointing out the shortcomings of M.B.C. it is right that we should make clear what system we would prefer. The answer is set out in paragraph 6.1 of the Green Paper - fiscal policy and interest rates - but there is an important proviso. Interest rate policy means moving interest rates to the level considered by the authorities appropriate to achieve their objective regardless of what is "politically acceptable". If past experience tells them that in practice their hands will be fettered because of, for example, the special claims of mortgagors or exporters, then a claim that interest rate policy is in itself enough would be both frivolous and misleading. If it is argued that in the real world special interest groups have to be conciliated, we can see nothing for it but a return to quantitative controls in order to supplement

the interest rate weapon. The disadvantages of such a course are set out in paragraphs 1.12 to 1.17 of the Green Paper and we would merely comment that (a) every solution carries its own problems, (b) such measures accompanied every tightening of credit in the post-war period up till 1971 and were not unsuccessful, (c) it is conceivable that the authorities are being over-fastidious in the weapons they select for the all-important fight against inflation, and (d) it would be better for them to use such instruments than to go through life proclaiming that interest-rate policy is sufficient while knowing in practice that they will never be allowed to use it effectively.

In such a system we believe the discount houses have an important role to play for the following reasons:-

1. One of the unforeseen and undesirable consequences of the arrangements which have been in force since 1971 has been the proportionate fall in the volume of gilt-edged stocks held by the commercial banks. The result of this has been twofold -
  - (a) A drop in the banks' liquidity so that in times of difficulty the Bank of England has had to have recourse to the cumbersome device of purchase and resale, and
  - (b) An inability to use the open market operations of earlier days whereby the Bank could ensure by their interest rate policy that a build-up of loans by the banks at the expense of their gilt holdings would be accompanied by discouraging losses.

We were therefore disposed to welcome the proposal in the Liquidity Paper which afforded 1-5 year gilts the status of secondary liquidity as a move in the direction of the pre-1971 system. Under these arrangements, it will be recalled, the clearing banks had substantial gilt holdings and the discount houses made the market at the short end. In these conditions it was possible for the Bank to influence gilt yields throughout the whole range of maturities through its open market operations, which were conducted not only in the gilt

market but in the bill market. The fulcrum whereby this was achieved was the discount houses. The reason for this was that bills and bonds were their trading stock, whereas similar instruments in the hands of the banks were merely reserve liquidity, being held as often as not to maturity.

2. It is suggested sometimes that under modern conditions the discount market has no useful part to play. After all, the argument runs, the Bank this year has had to make repurchase arrangements direct with the commercial banks. Interest rate pressures first manifest themselves in the inter-bank market. How much simpler it would be if the clearing banks became the main instrument for the Bank of England's open market operations. We think this view is mistaken:-

- (a) Conditions in 1980 have been abnormal. Exchange Control has been lifted, the supplementary special deposits scheme is ended. The schemes outlined in the Green Paper and in the Liquidity Paper have not yet been activated. Against this slightly anarchic institutional background the Bank is simultaneously trying to (i) reduce the acceleration of  $\text{M}_3$  and (ii) prevent interest rates rising above an "acceptable" level. It would be quite misleading to suppose that the tactics employed by the Bank to meet the exigencies of the present emergency would be suitable as a permanent feature of their future operations.
- (b) The discount houses have been peculiarly suited to their role of official intermediaries precisely because they are not commercial banks. It is interesting to note that historically the preference of the authorities for operating through neutral intermediaries rather than through one favoured group of banks probably had much to do with the development of London as an international financial centre - overseas banks could set up in business without being frozen out by an established oligopoly of local banks; there was an open market for

their bills. We think that it is desirable that discount houses should continue to fulfill their present function because

1. it is desirable that, as far as possible, all commercial banks should enjoy even-handed treatment,
2. the discount market has shown itself a peculiarly amenable instrument in carrying out the Bank's wishes and there is every reason to suppose that it will do so in future.

3. In order to allow the discount houses to play their part properly we submit that two further steps are necessary.

- (a) With a few exceptions the houses have been permitted to expand their resources only out of retained profits. Over a prolonged period of high inflation and a tax system under which no inflation relief is given to institutions holding net monetary assets, their resources have been diminishing in real terms. Commercial banks beset by similar problems have been encouraged to replenish their resources by coming to the market for fresh capital. If the discount market are in the future to play a helpful and significant role they should surely have the same freedom.
- (b) More diffidently we question why a discount house is permitted to hold a total case of thirty times its resources, while its permissible total undefined assets may only amount to twenty times, admittedly on a different base. The underlying reason for the distinction presumably lies in the wish of the authorities to limit the power of the houses to extend credit to the private sector. We realise that the autumn of 1980 is not an auspicious moment to make such an adjustment, but in the long term there is conceptually no more difficulty in accommodating a potential private sector expansion of thirty times the houses' resources than in making provision for a maximum of twenty times. This is merely a matter of arithmetic. On the other hand

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if the reason is a "prudential" one we believe it is ill-founded and the consequences sometimes perverse. Under modern conditions the main risk run by a discount house is an interest-rate rather than a credit risk.

### Conclusions

1. We can see no case for introducing M.B.C. The benefits are illusory; the potentiality for harm incalculable.
2. We support the proposals outlined in the Green Paper and Liquidity Paper, though we suspect in practice they would have to be fortified by some of the quantitative controls that the Green Paper rather cavalierly rejects.
3. We see the discount market as peculiarly equipped to play a central role in the new arrangements.
4. To assist in this role we have made suggestions for ameliorating two of the disabilities under which the discount houses at present labour.

29th October, 1980.



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29th October 1980

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*Dear Mr Coleby,*

As it has proved so difficult to reach any really useful consensus of opinion as a market on the difficult question of monetary control, it has been suggested that individual houses submit their own ideas through the chairman of the L.D.M.A.

We start by analysing some of the reasons for the supposed failure of the present system of control, because it may well be that if these factors are still present then any system may fail through being subjected to intolerable pressure.

Due to the very large P.S.B.R., the bulk of the funds available for investment have been sucked into the gilt-edged market at a high yield with the result that the capital market has been closed to industry and companies have been forced to borrow directly from the banks. At the same time, due to the recession, the private sector has been forced to borrow in order to carry their unsaleable stocks and to meet the high interest rate charges. On top of this the ending of exchange controls enabled the banks to evade the restrictions placed on them through the corset by an even wider process of disintermediation. In view of all this, it is little wonder that the monetary targets were exceeded.

Moreover, we now have a position where, although the level of monetary growth is nominally well outside the target, one has a feeling that in the real world the squeeze is very tight indeed and it is hard to see much evidence of the excessive money about, especially in our market, though of course it is evident in the high levels of personal savings. It must surely be possible to

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make out a good case for saying that the monetary policy is in fact working, albeit by a rather more circuitous route than was originally planned under a rigid M3 target.

In view of this, one is bound to ask if it is wise at this juncture to experiment with a new system which might well have a very adverse effect on the workings of the money and security markets.

Most experts in the field of monetary base control stress that the two main consequences to flow from a change towards monetary base would be very volatile interest rates, dictated by market forces rather than by the decision of the authorities to fit in with their economic policy, and the removal of the existing system of lender of last resort.

It has admittedly been a criticism of the present policy that interest rates were never allowed to rise to a point where the demand for money would be choked off, though this point might well in fact be much higher than many people imagine, as there always appear to be some people who have to borrow whatever the cost. But widely fluctuating rates are another story and would hardly lead to the orderly secondary market in liquid assets which would appear essential for any banking system which places importance on liquidity. One wonders also what the effect would be on industry already suffering severely from the effects of the recession and high interest charges, and on the gilt-edged market where confidence is so easily shaken by the prospect of interest rate uncertainty.

Tied in with this is the question of lender of last resort and, although there would still presumably have to be facilities for evening out the daily ebb and flow of money between the government and the banking system and within the banking system itself either through open market operations or lending, there would come a time when the authorities felt it right to halt an increase in the banks' base money. At this stage rates could rise very sharply as people scrambled for liquidity and sold paper. Those involved in the secondary market would perhaps feel in these circumstances that there were considerable dangers in relying too heavily on the overnight market for their funds and would generally be forced to seek longer deposits from the banks and other institutions with some overall loss of liquidity to the market.

In this connection, we welcome the greatly increased flexibility shown recently by the Bank in their open market operations and it surely says something for the efficiency of the discount market that such a major change in operation could be undertaken with the minimum of disturbance.

As you know well, we have for some time suggested that the reserve asset system was in need of a policeman and we welcome his arrival. It is perhaps unfortunate that those outside our market seem unaware that he will also be keeping an eye on us through strict observance of the undefined assets multiple. The banks all too readily believe that our market escapes such restrictions.

As far as our role in the system is concerned, one wonders whether the majority of banks in the City would not prefer the present method of operation through the Discount Market rather than putting themselves at the mercy of the increasingly more powerful barons of the Clearing Banks. However, we must be careful not to advance our cause unless it can be shown to be the more efficient of the many alternatives now proposed.

In conclusion we find it hard to believe that at the end of the day economic policy would be any better served by a completely new system. Surely there must be a good case for continuing with the present one now released from the distortions of the corset, with proper enforcement, and hopefully with a more compatible fiscal and economic policy from the Government.

Yours sincerely

Michael Taylor

MRT/eaj

KING & SHAXSON LIMITED

TO BE OR NOT TO BE?

Our approach to the problem of Monetary Control is very much from the standpoint that there should be no change simply for change's sake. It has not been shown to our satisfaction that change is necessary nor that the alternative proposals are preferable or even workable.

Criticism of the present system has become strident since explosive growth in M.3 was revealed by the removal of the corset following abolition of Exchange Control in October 1979. Further fuel has been added by recent gyrations in money market rates and the consequent distortion of the published aggregates. At the same time the Bank of England has been criticized for the extent to which it has been obliged to intervene to relieve shortages - leading to Mrs. Thatcher's "Lender-of-first-resort" jibe. It is worth noting, perhaps, that the assistance has largely been necessitated by her own Government's insatiable appetite for borrowing.

In our view the present system has never been permitted to operate properly without constant interference of one sort or another. It is only now that we are beginning to see a reserve asset squeeze, intentional or otherwise, and it seems reasonable to expect it to have much the same effect as a "Base Money" squeeze. Furthermore, political considerations dictate that interest rates are never allowed to reach a level at which they would choke off borrowing. We are not advocates of excessively high or volatile rates but believe that it is impossible to control the price and supply of money at one and the same time. It seems that the present incumbents of No's 10 and 11 Downing Street insist on having their cake and eating it.

Within the present framework, the Discount Market has fulfilled its role admirably, often in exceptionally difficult circumstances. It has acted responsibly and co-operated with the Bank of England, not always to its commercial benefit. Over many years the Houses have been the prime market-makers in Bills

of Exchange. Not only has this provided a useful and flexible source of finance for industry but also an effective weapon for relieving liquidity shortages. A good example occurred on 24th October when an exceptionally large shortage was bought out by this means. A healthy Acceptance market is in our view essential to the smooth running of the system.

We believe that a system which did not incorporate lender-of-last-resort facilities would prove to be inoperable and that there would be no limit to the level to which short term rates could rise. Such assistance should continue to be confined to the Discount Houses. Secured loans to the Houses merely relieve a shortage of liquidity rather than enable them to expand their books, operating as they do under the constraint of multipliers. Banks on the other hand are not similarly restrained and might well use the facility to on-lend in either the domestic or Eurosterling markets.

In short, we do believe that the present system would work if given a fair chance. We understand the desperation of an impatient Government, under pressure from many quarters, to find an instant panacea but we fear that hasty and ill-considered tinkering with Competition and Credit Control will not provide the answer. The Houses role within the structure should remain unaltered.

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29th October 1980

A variation in the rate of growth in the money supply, now measured as Sterling M.3., is a consequence of change or changes in a number of factors.

- 1) Public Sector Borrowing Requirement (P.S.B.R.)
- 2) The sources from which the P.S.B.R. is funded.
- 3) Foreign Exchange movements.
- 4) Domestic Bank lending.

In turn each of these factors is influenced by official interest rate policy.

1) Public Sector Borrowing Requirement

The level at which the P.S.B.R is set is entirely the sovereignty of the elected Government. We recognise that whilst it may be desirable for the P.S.B.R. to be reduced either absolutely or as a proportion of G.N.P. there are social considerations which prevent reduction beyond a certain point at time of acute recession such as we are now experiencing. It is however essential that there be one constant in the Money Supply equation and we would strongly advocate that once the P.S.B.R. has been announced and spending levels fixed they be strictly adhered to.

2) The Sources from which the P.S.B.R. is funded

The definition of Sterling M.3. makes it imperative that as high a proportion of the P.S.B.R. as possible is funded from non-banking domestic sources. The Government is thus in competition with the Banking system and other deposit taking institutions and must innovate in the type of debt offered. A modest step has been made in this direction by the extension of the issue of Index-linked National Savings Bonds; which at least carry the implication that inflation will eventually be brought under control as against the issue of high coupon long-dated Gilt-edged stock which indicates the opposite.

Additionally thought must be given as to whether it is desirable to continue to allow foreign investment in Government debt both on the grounds that it contributes nothing to the control of M.3. and that it creates a potential "hot money" problem for the future.

Finally some attempt should be made to "smooth out" funding throughout the fiscal year, a remark which applies equally to tax flows into the Exchequer, to avoid distortions in the plot of Sterling M.3.

3) Foreign Exchange Movement

Despite the suspension of Exchange Control, the combination of high domestic U.K. interest rates and the new status of sterling as a "Petro-currency" has caused a new inflow of foreign funds. To blunt the upward pressure on the exchange rate the authorities have largely accommodated this demand for sterling thereby increasing the money supply. It is therefore strongly suggested that some form of inward Exchange Control, such as the Swiss Government have employed in the past, be now introduced.

Another effect of the lifting of Exchange Control has been the growth of the Euro-Sterling Market. Very little seems to be known about this market and even less as to what impact it has on domestic money supply. A study of this subject is urgently required.

4) Domestic Bank Lending

The whole of the foregoing is intended to demonstrate that any method by which Bank lending is controlled cannot be decided in isolation. Indeed there is a strong argument that effort be directed towards the elimination of external pressures on the system rather than towards the design of a new system to accommodate those pressures.

Judgement appears to have been passed that because distortions have occurred in the growth of Sterling M.3., or rather the manner in which it is recorded, the existing system has failed. This we would refute.

The present system has its origins in "Competition and Credit Control" the basic objectives of which are implicit in the title. If we may quote from the introductory address by the then Governor to the International Banking Conference on 28th May, 1971. "Basically what we have in mind is a system under which the allocation of credit is primarily determined by its cost."

The main mechanisms of control envisaged were:-

- 1) Central Bank control of the Reserve Asset base either by variation of the volume of Treasury Bill issue or Discount House ratios.
- 2) "Qualitative" guidance on Bank lending.
- 3) Alterations to the level of Special Deposits to adjust banking liquidity.
- 4) More frequent changes in Bank Rate. To quote again from the Governor's address "indeed we envisage using Bank Rate more flexibly than in the past."

In practice, however, this system has not been allowed to function properly. On each occasion that interest rates have threatened to rise above a level that the Government of the day has decided as "politically acceptable," there has been direct intervention to hold interest rates down. For example it is arguable that interest rates should have been allowed to rise early this year beyond a level identifiable with an M.L.R. of 17%, as market forces then indicated. Although there would have been a sharp shock to the financial system the resulting fall in the rate of monetary growth might well have enabled interest rates to have been brought down to a lower level than that which now prevails.

Similarly no real attempt has been made to curb the growth of Bank lending through control of the reserve asset base. Instead the "corset" was introduced and the reserve asset base allowed to grow to accommodate official bank lending. There would, of course, have been no objection to this approach had the "Corset" been effective; unfortunately it was not.

To repeat, Competition and Credit Control has not failed; it has just not been properly implemented. Notwithstanding this conclusion we would not resist change, if such change were for the better. Majority opinion amongst advocates of Monetary Base Control appears to favour a system based upon deposits with the Central Bank. The dangers inherent in such a system were pointed to by the Bank of England's Economic Intelligence Department in the Quarterly Bulletin of June 1979. To their conclusions we would add the comment that it seems the height of folly to adopt a system which relies even more heavily on interest rate disciplines when as already demonstrated such disciplines will never be fully implemented. We thus believe that Monetary Base Control would not be an improvement but a retrograde step.

Finally it is our opinion that the plethora of economic theory now available has obscured the main point at issue. If it is deemed advisable to concentrate upon the growth of Bank lending, as the major variable of Sterling M.3., why not apply direct controls? Quantitative restraint, embracing Acceptance Credit, is simple and effective. This approach, perhaps modified to some extent by the proposals contained in the Bank of England's publication "The Measurement of Liquidity" might well prove to be the answer and avoid the radical institutional changes otherwise proposed.

PAGE & GWYHER LIMITED

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