19. Monetary Control Consultations

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continued

THE FUNCTION OF THE DISCOUNT MARKET

(A paper by the Union Discount Company of London Limited)

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"That essential link and cog in the financial machine which we call the Discount Market invented and brought to perfection a side of business peculiar to the City of London, and unknown practically in other places ...... without which the City would never have reached the position of international eminence which it undoubtedly has reached."

Mr. Montagu Norman,
Governor of the Bank of England - 1935.

The keystone of the credit structure is the general public's belief that its bank deposits can be converted into cash. If this belief is undermined and there is a run on the banks, the economic repercussions can be disastrous. The experience of the U.S.A. in the early 1930's, when thousands of banks had to close their doors, industrial output collapsed by 47% and unemployment reached 15 million, is a graphic demonstration of the dangers.

In Britain a number of arrangements evolved, mainly in the nineteenth century, to ensure that a serious crisis of financial confidence could not occur. They have survived until the present day. Their essence is that the banking system has ready access to cash. (Cash is defined as notes and coin, and bankers' balances at the Bank of England. Notes and coin are legal tender, while bankers' balances are a liability of the Bank of England and therefore totally free from default risk.)

This access to cash takes two main forms - routine assistance to the banking system by the rediscounting of paper (such as Treasury bills and eligible commercial bills); and lending to the Discount Houses. The facilities are usually designated as "lender of last resort" since the Bank is the ultimate source of cash. However, this is a misnomer if it carries the implication that access to cash is exceptional and always at a penal rate. The routine assistance is generally at market rates and may be provided to the banks ("indirect help") as well as via the Discount Houses. The unique privilege of the houses is that only they are entitled to borrow from the Bank of England at Minimum Lending Rate. Its power to lend at MLR enables the Bank to determine interest rates. The hope is that by variations in MLR it is possible to influence the "credit counterparts" (bank lending to the private sector; and the difference between the Public Sector Borrowing Requirement and public sector debt sales to non-banks) to bank deposits and, hence, the money supply.

Advocates of monetary base control consider this system unwieldy and imprecise. They think that bank liabilities bear a stable relationship to the cash held by banks and that control over the quantity of cash also exerts control over the level of bank deposits, which are the principal constituent of the money supply. They therefore favour limiting the banks' access to cash, except in abnormal crisis circumstances. But they have not specified what such circumstances are. As open market operations would still be required to keep the monetary base on target, some of the existing institutions would presumably need to be retained. Again, however, monetary base advocates have been vague as to with whom and by what means the operations should be conducted.

It should be emphasised at this stage that most cash is at present held not by the banks, but by the general public. The banks have only one-sixth of the monetary base and the public has the remainder. The banks' knowledge that cash is readily available from the Bank of England has enabled them to economise to a remarkable degree on the amount of cash in their balance sheets. The motive for this economisation is to maximise profits since no interest is earned on cash and it is sensible to keep holdings as low as possible. The disproportion between the banks' and the general public's cash holdings is important to the subsequent discussion.

Two issues emerge from these introductory remarks. Should the banking system's access to cash be withdrawn? And what functions do the Discount Houses serve? The questions are related. If the answer to the first question is "yes", the Discount Houses' role would be quite different from now and probably very limited. If the answer is "no", some more interesting problems need to be discussed.

The banks' access to cash

A number of major structural adjustments to the financial system would occur if the banks' access to cash was restricted or taken away entirely. At present the banks know that certain assets, termed "primary liquidity", can be exchanged for cash at the Bank more or less whenever they wish. Their portfolio management therefore focusses on maintaining a safe ratio of primary liquidity to deposit liabilities. To a lesser extent, they are also concerned that "secondary liquidity" (assets which can be easily converted into primary liquidity) is at a sufficiently high level. Cash is not held as a prudential reserve, but as a stock-in-trade.

Under Monetary Base Control, the banks could not be certain that the Bank would convert the assets now regarded as primary liquidity into cash. Such assets would therefore lose many of their liquidity attributes. Because of the decline of the Treasury bill issue, the most important form of primary liquidity is currently the eligible commercial bill. Any reduction in the liquidity of this instrument should be a source of disquiet to the institutions which issue them and particularly to members of the Accepting Houses Committee. The competitiveness of the Accepting Houses relative to other banking concerns would be damaged.

More fundamentally, the focus of banks' portfolio management would shift away from the primary liquidity/deposits ratio to the cash/deposits ratio. Because it would be imprudent to economise on cash balances and some would have to be held as a prudential reserve, the banks would have to maintain a higher cash/deposits ratio. The Clearing Banks, which have to keep vault cash to meet deposit withdrawals and Bank of England balances for cheque-clearing purposes, would be most obviously affected. The size of the desired increase in banks' cash holdings would depend on the rigour of the Monetary Base Control arrangements and also on whether there was any change in the public's confidence in its deposits. If confidence weakened, the maximum expected rate of deposit withdrawal could be much higher than today and the banks would need a substantially increased cash/deposits ratio. In consequence, the banks would have a much higher proportion of the cash in the economy than the present one-sixth. Some idea of the possible upheaval is given by U.S. data in the Great Crash. In October 1929 the ratio of deposits to the public's currency holdings was 11.57; in March 1933 it was 4.44.

Of course, it must be hoped that nothing of this kind could ever happen in the United Kingdom. But the banks would unquestionably want to hold more cash if a meaningful monetary base system were to be introduced. Unless their other assets were to contract, the extra cash would have to be matched by extra deposits and there would have to be a once-for-all money supply increase. Naturally, the Bank would have difficulty in superintending the transitional period in which this took place.

Moreover, the banks' subsequent operational room for manoeuvre would be impaired. As they could not be certain of acquiring the extra cash base which must for prudential reasons accompany the expansion of their balance sheets, they would have to end overdraft facilities. Such facilities allow their customers, rather than the banks themselves, to decide when their balance sheets grow. The cessation of overdraft facilities would reduce the non-bank private sector's financial flexibility. To compensate for this loss of flexibility, companies and individuals would probably wish to maintain a higher ratio of bank deposits to income than at present. If this additional demand for money was not accommodated by additional supply, the move to Monetary Base Control would be deflationary; if it was accommodated, there would have to be another once-for-all money supply increase.

This discussion of the institutional turmoil which might be caused by monetary base control is not exhaustive. Other points, including several made in the Monetary Control Green Paper, are also relevant. There is nevertheless a clear warning that the Government would find it almost impossible to interpret the money supply statistics if new arrangements were implemented. In particular, changes in both the banks' and non-banks financial behavious might require increases in the money supply unless unintended deflationary repercussions were to eventuate. Such increases could not be reconciled with the medium-term financial strategy and would raise further doubts in the public mind about the validity of the Government's overall economic strategy.

Any interference with the banks' access to cash from the Bank of England carries great dangers to financial confidence. Even in the most benign circumstances, where the structural changes described here - and others about which we cannot now conjecture - happened smoothly, appropriate changes in both the amount of cash in the banking system and the money supply as a whole would be difficult to predict. The Government's emphasis on monetary policy as an efficient anti-inflation weapon might well be discredited.

The Discount Houses in a system with no access to cash

At present most of the Bank's cash injections are channelled via the Discount Houses even though the banks are the ultimate beneficiaries. If Monetary Base Control was introduced and the system's access to cash came to an end, the Houses would suffer more than the banks. Indeed, their rationale would seem to have been removed.

However, the banks might still need them. As we have seen, the banking system's demand for cash would be much higher under Monetary Base Control. The banks themselves may consider that they are less efficient at managing their cash than the Discount Houses and consequently they would like to leave money-at-call as at present. It would be essential that the houses then kept a significant part of their assets in the form of balances at the Bank of England so that they could meet calls with cash as and when they occurred. Whether the houses remained viable in such circumstances, in which they would be earning no interest on much of their portfolio, is doubtful. The houses would have to reconsider their activities as principals.

As monetary base advocates recognise, open market operations would still be necessary under their system because action would have to be taken to keep the base on target. If the houses no longer remained as principals, these operations would have to be direct with the banks. The manpower and other resources devoted to market intervention would not be reduced, but only take a different form. Society would gain nothing, while the institutions affected would be confronted with arbitrary and very heavy costs of change for which they are in no way to blame.

The Discount Houses in a system where access to cash is retained

The argument so far has been that removal of the banking system's access to cash is highly undesirable and, for this reason, that Monetary Base Control should not be introduced. However, we have still to consider whether the Discount Houses merit the lender of last resort privilege in a framework of the present kind where access to cash is a central feature.

The houses' utility is mainly to the banks. When a bank has deposits which it cannot use profitably elsewhere it can leave money-at-call with the houses where a rate of return competitive with money market instruments may be earned. If the bank subsequently experiences an unexpected demand for loans it can run down money-at-call and satisfy its customers. The ability to place money-at-call therefore increases the flexibility of banks' loan arrangements. Indeed, the development of overdrafts may be connected historically with the existence of the Discount Houses. Overdrafts are available on a limited scale in foreign countries in which the money markets are less developed than in Britain where the houses play such a pivotal role. (It should be emphasised that this description of the Discount Houses' position is of their natural business role and not of the false position they enjoy under the reserve asset ratio regime. In fact, the designation of money-at-call as a reserve asset considerably abridges their traditional function. However, it is assumed here and elsewhere in the discussion that the reserve asset ratio is soon to be abolished.)

The houses must be able to respond quickly to changes in the amounts banks place with them. Suppose that banks are calling money back. The houses can sell assets, but if they do so on a large scale the price of such assets fall, causing an increase in short-term interest rates. The ability to borrow from the Bank of England is a way of offsetting withdrawals of money-at-call without the need for asset sales. It is doubtful whether the houses could accept money-at-call if they did not possess the lender-of-last-resort privilege. It follows that the existence of a lender of last resort is a prerequisite for the versatile bank borrowing facilities enjoyed by companies and individuals in Britain.

Furthermore this explains why lender-of-last-resort privileges should not be available to all banks but rather should be confined to the Discount Houses. Any bank with the ability to borrow from the Bank of England would have a competitive advantage over other banks. Because it could be certain of obtaining cash when required, whereas banks without the privilege could not, it would be able to offer more flexible and attractive loan terms. The Discount Houses, by contrast, do not compete with the banks in lending to companies and individuals. They do not initiate loan undertakings in any material sense but only discount bills which have been issued by the banks. By directing lender-of-last-resort assistance through the Discount Houses, the Bank of England can both preserve the efficient lending facilities now granted by the British banking system and ensure that no one group of banks obtains an unfair lead over another. In this way, the activities of the Discount Houses are pro-competitive.

The strength of the argument is most obvious in the case of the Clearing Banks. They are the natural candidates for lender-of-last-resort privileges since cash flows into and out of the economy pass through them. However, if they could borrow from the Bank of England and non-clearers could not, they would be able to offer much better lending terms to their customers than the non-clearers. This would be an artificial and improper advantage. Moreover, they would have great power in the inter-bank market. Whereas other banks would have to pay market rates, which might be above MLR, the clearing banks could in principle borrow at MLR whenever they wished. (In practice the Bank would no doubt have to deny them help at some point, since otherwise it would merely be handing profits over to these banks).

The solution might seem to have two parts - the Bank should extend the lender-of-last-resort facilities to all banks; and it should consider intervention in the inter-bank market other than the Discount Market. These two suggestions may be discussed in turn.

The objection to the Bank granting the lender-of-last-resort facility indiscriminately is that its knowledge of the banks involved might not be sufficient to ensure the money was correctly used. As the Bank knows the Discount Houses well, transactions between it and the houses are conducted smoothly and with little fuss. If the Bank had to have transactions with several hundred banks, its administrative costs would be much higher and it would need to check that no particular bank was exploiting its borrowing opportunities too much. In West Germany each bank is allocated a rediscount quota based on its capital reserves. The need to obtain such a quota represents a barrier to entry for a new or foreign banks. Although perhaps a minor irritation this limits competition in the banking industry. In Britain, by contrast, any bank (or Company, for that matter) can leave money-at-call with the houses and thereby benefit indirectly from the Bank of England's lender-of-last-resort arrangements. Foreign banks' ease of entry into the City and the intensified competition which follows it, may in this way owe much to the existence of the Discount Houses.

Intervention in the inter-bank market was mentioned favourably by the Clearing Banks in their evidence to the Wilson Committee. It would immediately raise the problem, analysed in the last paragraph, of which particular banks should benefit from assistance. There is, however, another objection. Lending in the inter-bank is not secured, whereas any loans the Bank makes to the Discount Houses have to be secured against instruments which are created by a desire to borrow outside the banking system. Treasury bills, eligible commercial paper and local authority bills are all claims on non-bank entities. Frequent and systematic official intervention in the inter-bank market would encourage the belief that it is unnecessary to hold liquid assets which arise from the credit requirements of government or companies. It would be thought instead that short-term claims on other banks, generated by inter-bank transactions, are genuine liquidity. But this impression is illusory since in a crisis of confidence there may be doubts about the ability of banks to meet their obligations. (The blockages in the C.D. market after problems at the Scottish Co-operative Wholesale Bank in 1974 illustrate the point). Of course, banks might be willing to borrow from the Bank of England on a secured basis. But this would require that they hold sufficient quantities of negotiable instruments. At present the ratio of negotiable instruments to total assets is very low for most banks, particularly those, which have specialised in wholesale business. On the other hand virtually all the Discount Houses' assets are negotiable and are therefore appropriate as security for loans from the Bank of England.

Our arguments suggest therefore that the extension of lender-of-last-resort facilities to all banks has drawbacks in terms of both the reduced simplicity of open market operations and the imposition of a new barrier of entry to banking. Assistance routed through the inter-bank market would undermined the secured basis of present Bank of England lending to the Discount Market.

SUMMARY

The Bank of England's willingness to provide the financial system with cash improved the flexibility and efficiency of the lending facilities the banks offer to British industry. The intermediation of the Discount Houses ensures that no particular bank or group of banks is able to exploit this advantage at the expense of the others. Expressed in economic terms, the benefits from lender-of-last-resort are a "public good" and the existence of the Discount Houses prevents this "public good" being appropriated by any particular private institution. In this way the houses strengthen competition between banks, as well as playing an essential and recognised part in maximising the efficiency of banks' cash management.

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A move to monetary base control could have potentially grave and damaging macro-economic repercussions. The withdrawal of the lender-of-last-resort privilege from the Discount Houses would reduce the micro-economic efficiency of the financial system. In our view the Government should consider very carefully indeed whether either measure is desirable since their identifiable costs are large and certain, whereas the benefits are impossible to quantify and highly debatable.

30th October, 1980.