

## 6. Monetary Base Control

Congdon on Central Banking

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Financial Secretary

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MR MIDDLETON  
✓

cc Sir D Wass  
Mr Burns  
Mr Ryrie  
Mr Britton  
Mr Monck  
Mrs Gilmore  
Mr Pirie  
Mr Turnbull  
Mr Grice  
Mr Spencer  
Mr Ridley  
Mr Cardona

#### CONGDON ON CENTRAL BANKING

The Financial Secretary wanted a note on Tim Congdon's forthcoming Banker article (April) in time for his lunch with Messel's on 27 April. The attached comment by Mr Grice meets the remit.

2. Reading Congdon's article I was struck by how much the internal debate has moved on even since the September seminar. Discussions with Professors Brunner and Meltzer, and still more with Professor Walters, have focused on the merits of targeting the base over periods of about six months or even longer. The earlier debate - and the Green Paper - presented MBC as a way of improving monetary control over very short periods - certainly less than six months. Congdon is thinking in Green Paper terms - which is why he shakes some of the skeletons first unveiled in the original BEQB article. But once one starts to contemplate substantial month to month deviations from the base target, as in Switzerland, his fears about abridging the Bank's lender of last resort role begin to look absurd. None of the serious proponents of MBC have suggested that "Bagehote's rule" should be abandoned - indeed Professor Walters has always been emphatic that the Bank should create cash without limit in times of crisis. As Mr Grice points out, the situation with

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an individual bank is different in principle: in practice, however, even if the Bank bailed out every bank in trouble, which it probably would do (since allowing banks to collapse is not a very good advertisement for its own prudential supervision) the implications for the base, over the relevant time period, would be pretty minimal.

3. I feel myself that the case for MBC has got a little lost in the latest thinking. Professor Walters' most recent letter to you seemed to demolish it entirely, by pointing to recent research by Yoshino which suggests that the choice of policy instrument is not, after all, critical. The only real issue seems to be the choice of target aggregate. Perhaps the pendulum has swung too far in the opposite direction. Even so there is clearly less difference at the operational level between MBC and the present system than we originally thought (and Congdon now thinks) providing we are talking about achieving control over broadly the same time period. Mr George's annex to our paper on the Walters scheme (4 February) puts it all very calmly:

"However the objective is defined (ie whether in terms of wide monetary base or narrow monetary base - bankers' balances with the Bank of England - or indeed of M1 or £M3) the mechanism through which the Bank has to operate is essentially the same: in one form or another the Bank either provides cash to or withdraws cash from the banking system through open market transactions, with a safety valve (which may be used to a greater or lesser extent) in the form of discount window lending. The choice of objective determines the basis on which such open market operations are conducted, ie. the extent to which the Bank provides cash to or withdraws cash from the banking system. Thus in the case of a wide monetary base objective, if the wide monetary base were overshooting, the Bank would seek over an appropriate time scale to withdraw cash from the system which would in turn put upward pressure on interest rates.

If the objective were a different aggregate then it would be that aggregate in relation to its desired path, that would determine the Bank's stance in the conduct of its open market operations."

4. Over a period of time, it will clearly make quite a bit of difference whether the Bank are conducting open market operations to validate a particular interest rate, or to achieve a quantitative target for bankers' balances or the wide base. This would be so, even if Congdon is right that, on a day to day basis, the Bank must be the effective arbiter of short rates. Whether this latter proposition is itself correct is dubious. The Bank have at times come close to asserting this. But their argument is not, as Congdon says, because MLR is inevitably an anchor; for most of the time, the Bank can operate without recourse to discount window lending. Their fear is that, in a system where the authorities deal directly with the "giant" clearers, the concept of a "market determined rate" is distinctly tenuous. We have been sceptical of these fears: but they may be right.

#### Other Issues

5. The Financial Secretary may like to be aware of two other issues raised by Tim Congdon on which we have recently commented. The first is money market assistance. In a recent review article (which he sent to Mr Burns) Congdon argued that over-funding the PSBR inevitably forces the authorities into intervening in the foreign exchange market (via forward swaps) in order to relieve money market pressure. This overlooks the possibility that the Bank may buy commercial bills (as well as Treasury bills), as a way of relieving cash shortages in the domestic money markets. In point of fact, this route has been used more often than forward swaps.

6. The second issue is the seasonal fluctuation in the exchange rate. Recent work by Adam Bennett tested the proposition that sterling is always seasonally strong between

November and February and weak between March and June/July. He concluded that there was no evidence of general seasonality but that isolated months (notably January) did seem to be affected by seasonal factors.

7. I attach a note by Peter Spencer which discusses this earlier Congdon article in more detail.

RL.

RACHEL LOMAX  
23 March 1981

## CONGDON ON 'THE FIRST PRINCIPLES OF CENTRAL BANKING'

Tim Congdon's article of the above title is due to be published in the "Banker" in April. It is well written but I think it is fair to say that it has little logical structure. It is, rather, a collection of observations on monetary theory and policy linked only by the common feature that they argue against adoption of monetary base control.

2. There are perhaps three major and contentious points in the article:

- (i) that adoption of monetary base control would lead to abridgement of the lender of last resort role of the Bank of England, one which was established painfully and haltingly from the experience of <sup>the</sup> nineteenth century;
- (ii) that monetary base control would destroy the overdraft facility which is so important in the quality of service which the city provides to industry and to its overseas customers;
- (iii) that monetary base control would not allow markets to determine interest rates freely but that they would have to remain fixed by the authorities.

I do not feel that any of these points argue against base control with any strength for the reasons set out below.

3. It is probably true in retrospect that issues of banking supervision and monetary control are more closely linked than we allowed at the time of the Green Paper. The subsequent problems we had in drafting acceptable new proposals for banking supervision bear witness to this. Congdon pointed this out early on and must take credit for this. Nevertheless, his discussion in the present paper is confused. First, it is important to distinguish - as Congdon does not - between a run on an individual bank and on the banking system as a whole. Second, it is necessary to distinguish between primary liquidity (those assets which the banks as a whole may regard as liquid) and secondary liquidity (liquid assets for an individual bank which may include claims on another part of the banking system). The important point about either form of base control is that only the monetary base, essentially cash, can comprise primary liquidity. Since the essence of monetary

base control is that the authorities do not create cash freely, the only assets which banks as a whole can be sure of having as cash are their direct holdings of cash. They cannot guarantee to be able to convert other assets as desired.

4. Consider, *first*, a mandatory base system in which  $n\%$  of banks liabilities have to be held as base assets. There can be no other prudential requirement in terms of primary liquidity since this would overdetermine the system. There might, however, be secondary liquidity requirements since these have no bearing on the base. Under these circumstances, a run on the banks as a whole is not very likely since each banker must be holding primary backing for its assets at a level which experience has found to be adequate. If in spite of this there is a run on the banks, perhaps because of a fundamental failure of confidence in <sup>the</sup> economy rather than specifically in the banks, then the authorities should indeed follow "Bagehot's rule" and create cash without limit until the crisis is averted. This temporary suspension of base control will have no effect on monetary control since the wider aggregates will have been falling as the withdrawal of deposits proceeds. But there is all the difference in the world between acting as lender of last resort in these exceptional circumstances as Bagehot intended and incorporating free creation of cash into a day-by-day technical monetary control as we do at present. There have been no occasions in the twentieth century in the UK when such action would have been necessary and only one in the US. Provided it is made clear that there is no intention of abandoning this genuine lender of last resort role, there is no reason why the facility should ever be needed.

5. The arguments are quite different in the case of a run on an individual bank. If the bank has generally been prudent, obeyed the supervisory instructions, etc. and is fundamentally sound, then the authorities may want to co-ordinate a rescue operation. But it is likely that this would have few implications for the base. Like the "lifeboat", the operation would be primarily in arranging and guaranteeing secondary liquidity for the bank not just advancing cash without limit in the grand Bagehot manner. If, on the other hand, the bank had behaved recklessly and was in a fundamentally untenable position there is a good case for allowing it to fail. It has never been a principle of central banking that any commercial banking, however reckless, must be validated ex post.



6. In the case of a non-mandatory system, there can be no liquidity requirement on the banks in primary terms at all. Since the base forms the only primary liquidity in such a system, any prudential primary requirement would effectively convert it into a mandatory system. To that extent, the risk of a general banking crisis must be that bit greater. In a mandatory scheme the public have the guarantee of the bank having to hold a minimum amount of primary liquidity at all times as well as the general guarantee of the government acting as lender of last resort as necessary. In a non-mandatory situation, they have only the latter since the banks themselves must decide how much primary liquidity they want to hold. That said, the increment in risk must be very small. Prompt action by the authorities should always head off an incipient crisis and experience shows that the need for such action is seldom. For a run on individual bank, the arguments are just as above: the reckless bank should be allowed to fail and the sound bank can be shored up as long as is necessary with no consequences for the base.

7. Turning now to Congdon's discussion of overdrafts, it is certainly true that monetary base control would reduce the role of overdrafts. Even if they did not disappear entirely they would be less easily available and probably much more expensive. Banks would have to take these steps in order to make the management of their base ~~and~~ positions feasible. It is also true that banks' customers may experience a certain amount of inconvenience. But one cannot have strict monetary control and the ability for the public to borrow as much money as they like whenever they like. It is always convenient to be able to borrow money to finance extra expenditure over income, to accommodate inflationary wage awards and so on. But it is precisely this which the government's monetary policy is designed to counter. One cannot, as Congdon does, advocate strict monetary control in general but then reject a specific scheme of control which does so precisely because it does yield strict monetary control.

8. Part of the debate is over the time period that strict control has to operate. No one has ever pretended that monetary growth has to be controlled day-by-day or even, necessarily, quarter-by-quarter. But it does need to be controlled over periods of somewhat less than a year if the authorities' intentions are to be realised. Certainly the scheme of control needs to bite over this longer time period but it should also allow flexibility upto the maximum within this time period. Probably a non-mandatory base control system would have the edge in this respect.



since it is the least rigid variety. On the other hand, the implication for mandatory systems is not that they should not be used but that the requirements themselves should contain a certain amount of flexibility. By means of averaging, for example, this is possible and the desired amount of flexibility and, opposing, precision can be designed into the scheme. By contrast, ~~Congdon's~~ preferred option of using interest rates as the monetary control instrument has certainly yielded an admirable amount of flexibility. Unfortunately it has not proved capable of delivering an acceptable degree of monetary control over any reasonable period.

9. Congdon's third point is a denial of the argument that the markets would determine interest rates under monetary base control. His argument is that because the market is normally short of cash and the Bank is the only outside source of cash, it can thus supply the excess cash requirement at a price of its own choosing, normally MLR though not necessarily so. While this scenario is correct as a description of the present system of control, it is not at all what would happen under base control, as Congdon seems to imagine.

10. The big difference would be that under the present system the market is normally in a small deficit. It is happy with this situation because it can make up the shortage from the Bank of England at non-penal or only marginally penal rates. Under base control, the Bank would not supply cash freely and the market would normally want to be in small surplus. Suppose there were a mandatory requirement that banks held 5% of their qualifying liabilities in base assets. Each bank would want to hold excess reserves to protect itself against a sudden drain of base assets which would involve punitive costs. Thus the market as a whole might want to hold 6% of its liabilities in base asset forms. The authorities' tactics would normally be to supply this amount but then to allow the base only to grow at a target rate - for illustration say 8% pa. If the banks' qualifying liabilities grew faster than this rate then their base asset ratio would fall from 6% towards the minimum 5% and thus below the banks' desired position. As banks competed with each other to obtain their desired base assets, interest rates would rise. This would tend to restrict monetary growth and the base asset ratio would again rise. Alternatively, if monetary growth were less than the growth in the base, the banks' reserve asset ratio would rise above their desired 6%. Interest rates would then fall and monetary growth would be stimulated until the base asset ratio came back

into line. At all points the market would indeed be determining interest rates conditional only upon the authorities' base target growth. The authorities would not be intervening in any other way.

11. The same argument applies exactly to a non-mandatory system. For this purpose, such a scheme may be considered just as a mandatory one but with a zero base asset requirement. Thus all base assets held by the banks are then excess reserves but this has no bearing on the application of the previous argument.

12. To sum up, Congdon has identified three arguments which he believes strike a telling 'blow' against adoption of monetary base control. I do not think he has made his case:

- a) adoption of monetary base control would not lead to abridgement of the Bank's historic role in preventing a general collapse of the banking system. No system of base control rules out genuine central bank lending of last resort: only the Bank's free creation of cash day-by-day in times of no crisis is circumscribed;
- b) base control would probably lead to a less flexible financial system than at present and, in particular, the overdraft facility might be curtailed. But it would be the explicit purpose of the control to reduce flexibility with the gain of increased monetary control. The present system delivers flexibility, certainly, but only at the cost of an unacceptably low degree of monetary control over reasonably long periods;
- c) Congdon's assertion that base control would not allow the markets to determine interest rates is plain wrong. This incorrect assertion stems from confusion of how the present system works with what would be the case necessarily on adoption of base control.

13. It should be said against this that there are problems with monetary base control and they are certainly serious ones. But they are not the ones Congdon identifies which, at best, have<sup>only</sup> marginal impact

J. W. GRICE

19 March 1981

"Can the Bank of England pursue a monetary policy independent of external influences?" - Some comments on a note by Tim Congdon.

This note points out some of the interdependencies between the domestic money markets and the foreign exchange markets and looks at recent developments from this point of view. Mr Congdon is particularly worried about the effects of overfunding on the exchange rate and argues that this forces the Bank of England into exchange market intervention. Our own view is that overfunding does affect the exchange rate, but that the evidence is much less conclusive than Mr Congdon suggests. And as a matter of statistical fact the effect on interest rates and the exchange rate has been offset in the domestic money markets and not the exchange market as he asserts.

The basic Congdon thesis can be set out as follows:

- i- bank lending to the private sector is interest inelastic.
- ii- therefore short run control of the money supply must come through the effect of changes in interest rates on gilt sales
- iii- if gilt sales are used to offset the effect of excessive bank lending rather than simply funding the PSBR then this 'overfunding' distorts bank balance sheets: Lending to the private sector rises faster than deposits, so that bank holdings of public sector debt fall.
- iv- In the absence of the corset banks respond to this liquidity squeeze by bidding for deposits. This pushes up short term interest rates and the exchange rate.
- v- The Bank of England offsets the exchange rate pressure by selling sterling.

This story is quite uncontroversial and familiar with the exception of the last step. Mr Congdon seems to be unaware of the fact that exchange market intervention has been minimal over the last two years. What has happened is that the Bank has tended to offset the pressure in the domestic money markets instead. If capital is highly mobile internationally this should not in principle make much difference - when the authorities buy US Treasury bills for the reserves <sup>this</sup> should have a similar effect on bank liquidity as buying UK Treasury or commercial bills.

Congdon seems to be lead into making this mistake by the identity in paragraph 2. This equates the public sector financial deficit (PSFD) with the net acquisition of public sector debt by domestic non bank (NA) bank (BA) and overseas sectors (FA).

This is a rather unorthodox and confusing identity which only holds in the sense that the net acquisitions figures are net of public sector transactions in the liabilities of the other three sectors. Congdon overlooks public sector purchases of domestic bank and non bank liabilities and over emphasises the role of overseas liabilities - intervention - as a consequence.

This oversight is also clear from differences between the identity of the text and table 2. For the purpose of the table Congdon defines overfunding as the difference between the PSBR and gilt sales to the non banks. In contrast, when talking in terms of the identity he defines over funding as a situation in which NA exceeds PSFD. These definitions are only equivalent when public sector purchases of bank deposits and non bank liabilities (such as commercial bills) are zero.

Using the identity he argues that when NA exceeds PSFD, the expansion of bank lending also forces BA to be positive so that NA plus BA exceeds PSFD. FA is therefore negative. This can be brought about either by overseas sales of public sector debt - unlikely when the other sectors are buying - or official exchange market intervention. This leads him to state that intervention is the 'inescapable consequence' of overfunding.

Of course when gilt sales exceed the PSBR there is a clear tendency for exchange rate pressure to occur. But the Bank relieves the pressure by purchasing commercial (or Treasury) bills in the domestic money markets. This reduces NA given that it must be defined net of such purchases for the identity to make sense. The authorities may alternatively engage in gilt swap transactions with the banks or lower the special deposit call or reserve ratio. This allows BA to be negative.

The authorities have also, from time to time, engaged in forward currency swaps with the banks. Spot sterling is made available to them in return for overseas currencies, this being offset by a forward transaction. The overall effect is to switch banks into sterling giving them public sector liabilities instead of overseas ones. In Congdon terms this raises BA and reduces FA and squares with his intervention story quite well. However such swaps have been very limited both in their duration and as a fraction of the overall amount of money market assistance.

Congdon goes on to develop his thesis in several different ways. The first is to note the seasonal link between the PSBR and the exchange rate. This relationship is interesting and one which we have been aware of for some time. Mr Bennett has recently reviewed the evidence for this. However Congdon argues that the mechanism is one in which tax payments force up interest rates and thus the exchange rate. I have my doubts about this since it would mean that overseas investors would benefit both from higher UK rates and from an appreciating exchange rate over the tax season. The Congdon mechanism can only work if the rise in UK interest rates is unanticipated - which I doubt - or if capital is not very mobile internationally. A more plausible story is perhaps that multinationals pull money in from abroad to pay their taxes independently of rate of return considerations. This will then depress UK interest rates and push up the exchange rate, keeping speculative and arbitrage incentives broadly unchanged. I will have a look at the data to see which of these views is correct.

The second piece of evidence, the connection between the PSBR, gilt sales and the exchange markets (shown on a quarterly basis in Table 2) is much less convincing. Admittedly large sales of gilts will help the exchange rate but so does a rise in the exchange rate help the gilts market. And an improvement in confidence in the government's financial policy will directly affect both markets. The correlation which Congdon notes has been remarked upon before, and has been extensively researched. A Bank of England study\* using daily data recently concluded that there was a high degree of simultaneity with weak causality effects running in both directions.

The paper ends on a fairly optimistic note. Congdon observes that a rise in UK interest rates may help the banks by causing overseas inflows into bank deposits. This therefore helps at stage (i) of the analysis since it allows banks to finance private lending without expanding the money supply. Again this point is fairly obvious and has been the object of much comment.

Congdon believes that this effect occurs because the overseas demand for sterling deposits is an investment demand (and thus sensitive to interest rate differentials) whereas the domestic demand is a transactions demand (and thus insensitive to these differentials). There may be something in this.

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\* B C, Hilliard. "Exchange flows and the gilt edged Security market: A causality study" Bank of England discussion paper No 2.

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However, one alternative explanation is that in the past, resident substitution between sterling and foreign currency deposits has been limited by exchange controls. Now that they have been relaxed residents have been quite willing to swap their sterling bank deposits with the overseas sector for overseas assets, despite the adverse rate of return. This is the short run effect of exchange control abolition. The long run effect is to allow residents to trade on a par with non residents. There is therefore no reason to think that this effect will help us out in future, since both types of deposit will be influenced by international interest rate differentials.