16. Monetary Control Consultations

15 November 1980
continued

CLIVE DISCOUNT CO. LTD.

COMMENTS ON THE SYSTEM FOR CONTROLLING THE MONEY SUPPLY AND LIQUIDITY IN THE BANKING SYSTEM IN LONDON

1. Competition and Credit Control incorporating the Supplementary Special Deposits scheme and the 12½% Reserve Assets Ratio has proved a difficult system to operate. In any case, it was never designed as the sole method of controlling the money supply.

   In the case of the corset, the degree of avoidance did not become apparent until an embarrassingly late stage in the target period; the corset has now been scrapped and tighter control of the Reserve Asset Ratio maintenance has been instituted as a stop-gap. This is very welcome.

2. The central issue is not that the distorted M3 figures did not show up sooner but the fact that there was deliberate and large-scale avoidance of controls by the banks. The same situation is likely to arise under any system, so an alternative method of control which might appear to be, intellectually, more effective, could fail for the same reason.

3. The very large P.S.B.R. has been another factor inflating M3 and plenty of commentators have made the point about the private sector suffering because of overspending by the Government.

4. Great strain has been put on the system due to the free exchange rate acting in conjunction with fixed and non-market-related (i.e. administered) interest rates. This has contributed to the large injections of temporary assistance into the system. The total of private sector borrowing has not been much decreased by the level of rates. The reasons for borrowing have changed to being mainly defensive. The even higher rates implied under a Monetary Base system would have damaged the private sector even more severely unless they had been at very high levels for an extremely short period.

5. The American experience, although set against a completely diffe ent economic background, has not proved at all satisfactory so far and the swing in rates this year 10-20-8-14 (28 points!) must be extremely unsettling for all sectors. Added to which, the 15-20 year market in U.S. government paper has become very sensitive to fluctuations in weekly money supply figures. This cannot be desirable and was never previously the case. Apart from government funding, this volatility also affects the stability of corporate funding in this area.

6. Rather than change the system, why not reinforce the controls already in existence and concentrate on reducing the P.S.B.R. and the developing of new funding methods to

7. To switch to a base control system which would bring large and frequent fluctuations in rates would be very damaging - why not project the level to which rates would have risen at crisis points during the past twelve months under a base control system? This should illustrate the dangers well enough.

8. An efficient system of Money Supply Control or any rational control of the economy requires an effective method of controlling interest rates. Not merely the official rate but also those rates such as the Treasury Bill Rate which put pressure in either direction, on the official rate.

We submit that the present mechanism where the Bank carries out a large part of its open market operations through the discount houses works extremely efficiently and that open market operations carried out purely through the Interbank Market would be a very inadequate substitute. The reasons for this are as follows:-

(a) In a centre with some four hundred banks the market place for liquidity provided by the houses has proved an efficient method of monitoring flows.

(b) Open market operations have been carried out very smoothly and successfully through the houses for a great number of years. Frequently under great pressures in terms of time and volume, the results have been uniformly successful.

(c) The regular interchange of information between the various levels of contacts between Bank and Discount Market provide a unique and readily accessible source of information for the Bank and a very convenient method of initiating changes of expectation very quickly and rationally into the system.

(d) The degree of co-operation which the Bank has always received from the Discount Market in assisting them to carry out their interest rate policy would not easily be found elsewhere. An instinctive loyalty to the Bank's requirements has frequently overridden pure commercial judgement - viz the Treasury Bill situation in 1976 and recent outright purchases of Commercial Bills. This attitude stems from a sense of responsibility to contribute towards an orderly system - would that instinct be found elsewhere?

9. As mentioned in the Wilson Committee evidence the discount houses have, through their inventiveness and flexibility, made a most positive contribution to the City as a financial centre; as secondary market makers in high-quality short-term paper, by broadening the markets for Government paper through commercial and banking contacts in the United Kingdom and abroad, by guaranteeing the Government short-term funding requirement in all conditions and by providing short-term finance for industry.

10. Great pressures are being brought to bear on bankers, politicians and central bankers. The main objective of Government policy, control of inflation through control of the money supply, although behind schedule, appears to be working. Hopefully there will be no drastic changes in methods or in the operations of the market place before the existing system has had a chance to prove itself.

N.H. CHAMBERLEN
29.10.80.

October 30, 1980

Monetary Base Control

A Note By

Gerrard & National Discount Company Limited

Many of the benefits claimed by advocates of monetary base control could be achieved without adoption of a strict base or a move to some form of halfway house. The purpose of this short note is to suggest that some modifications to the present system could achieve most of the benefits of a monetary base without incurring the institutional costs which we believe would be considerable.

Controlling the money supply through strict operation of the monetary base without last resort facilities appears to us, although possibly logical, impractical. It would not only produce a once and for all rise in interest rates but would cause fluctuating rates at the same time as destroying the market's ability to cope with them.

A move towards some form of halfway house as indicated in the agenda for the Treasury/Bank of England Seminar in September seems to us to be an academic compromise rather than a practical solution. Our own preference is for a more vigorous operation of the present system.

Although the money supply has grown outside the authority's target range we feel this is not due to the system itself but to its operation. So we do not agree with those who advocate that it should be replaced by monetary base control.

It is arguable whether during recent months monetary growth within the targets could have been achieved by any system within politically acceptable limits. The lifting of exchange controls, the knowledge of the imminent abolition of the corset, the involuntary demand for funds from industry, and the excessively high and irregular PSBR have all created strains and distortions.

One of the major roles of the Discount Market is to take the strain between the market place and the authorities. Collectively the Houses can be used both to dampen excessive short-term movements in the interest rates generated by the market place, and also to emphasise the authorities' wishes throughout the banking system. The Houses have provided an efficient channel through which the Bank of England can operate. This channel could be replaced but we question whether the alternative would be as convenient.

One of the claims for a move to monetary base is that interest rates would become more sensitive to the demand and supply of money. This could still be achieved by official intervention and much could be gained by smoothing the flow of revenue payments and disbursements.

The problem over the last few years has been that the heavy Government borrowing requirement and the increasing irregularity of its funding has made it difficult to determine the level of interest rates required to achieve given targets - whether they be expressed in sterling M3 or in base money. Recently, over 1/6th of the annual PSBR was funded in one week.

The money markets in London are sophisticated and successful, and whilst they are exceedingly complex and made up of many institutions with differing roles, they are highly flexible.

The Discount Market has prided itself on its adaptability and although not always welcoming change, has always been able to cope with it. There is no doubt that it would adapt to any new system. However, radical changes, at a time when there is considerable doubt as to the cause of the recent increase in money supply, would impair the efficient buffer system provided by the markets and would be accompanied by institutional upheaval.

It is not only financial institutions who would be affected, for industry also needs a reasonably stable source of short-term finance and we note the Governor of the Bank of England's concern over the effect that violent reactions to a temporary surge in monetary growth might have on the real economy.

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 (Cmnd. 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

22

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 whith 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 £M3 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