

1. Monetary Control Consultations

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HER MAJESTY'S TREASURY
MONETARY CONTROL CONSULTATIONS

COMMENTS BY THE LOMA

Note by the Secretaries

The attached comments on the Green Paper by the London Discount Market Association are circulated for information.

M D K W FOOT
M L WILLIAMS

H M Treasury

Paragraph 6.4 of the Green Paper on Monetary Control invites comments on three particular problems discussed in the Green Paper, viz:-

1. Whether the difficulties with monetary base control could be surmounted;
2. If so, whether there would, on balance, be an advantage in a change to such a system;
3. Whether a system of automatic adjustment to the Bank's lending rate would, on balance, be advantageous.

We have concentrated in particular on the practical aspects of the problems raised, believing that the theoretical aspects will be dealt with more competently in other quarters. Being ourselves part of the monetary system, we know we shall have to live with the consequences of any changes in the method of monetary control. We have, therefore, an interest in ensuring that a reformed monetary system is at least as efficient as the present system.

Markets function most efficiently against a background of stability and confidence. Although instability became a feature of the UK money market in the 1960's and 1970's as the rate of inflation increased, confidence in the money market was maintained because:-

1. Users of the market were aware of the close relationship between the Bank of England and the members of the LDMA, through 'lender of last resort' facilities and the exercise of control by the Bank on the quality of paper dealt in by the market and on the size of portfolios.
2. Lenders to members of the LDMA received physical collateral and margin for their loans.

It is assumed in the Green Paper that instability will continue to be a characteristic of the money market in the future, as interest rates are moved swiftly and sharply to correct deviations in the money supply. If so, confidence in the continued and efficient functioning of money market institutions, whatever the degree of instability, will be a necessary condition for a successful monetary policy. We believe, therefore, that the close relationship with the Bank of England will be as important for the LDMA in the future as it has been in the past.

The LDMA accepts the Green Paper's reservations concerning the difficulties of monetary base control and does not feel competent to judge whether such difficulties could - or should - be surmounted.

contd.....

The LDMA does not believe that there will be an advantage in a change to a system of monetary base control. We would not argue that the present system should remain forever unchanged, but we would note that the present system has a track record of efficient survival in difficult economic circumstances and should be readily adaptable to future monetary conditions. When, for example, tax revenues from North Sea oil are available to the British Government in large amounts, the need for the Government to borrow may be greatly reduced. Economic recession may be a feature of the next few years, relieving the monetary system of the pressure from inflated financing requirements. The present system should adapt easily to such conditions. The system does not of itself create inflation or depend upon inflation for its continued existence. There is no reason to suppose, therefore, that there will be any disadvantage in maintaining the system.

The LDMA does not favour a system of automatic adjustment to the Bank's lending rate because we would not be confident that an automatic system would always be adhered to. Indeed, in Chapter 5.10, it is stated that "it would seem desirable that there should be a power for the authorities to override automatic interest rate changes". The market would always fear that the "override" would be used at a moment of crisis, to interfere with market forces, to the market's possible disadvantage. Mechanistic systems cannot replace the value of market judgements. Initially, a mechanistic system is inflexible; ultimately it cannot be entirely relied upon. Another reason for doubting the effectiveness of an automatic trigger system is the unreliability of the statistics used for the "trigger". Chapter 5.3 points out that "the system would be as fallible as the data on which it was based". Weekly figures are no more likely to be accurate than monthly figures - whilst requiring additional unproductive paper work. There would also be a problem in preventing leaks of price-sensitive information to the stock market if, for example, banking deposits constituted part of the "trigger" calculation, as the major banks would be producing weekly figures which would be known internally before being available to the market generally.

Although the LDMA can adjust to unstable markets, we do not accept the arguments of those who advocate a "bias towards change" in making Bank Rate decisions. A "bias towards delay" is preferable to a "bias towards change" in a system which would link interest rate changes to statistical data of uncertain reliability. The cost of borrowing in a market biased towards change would be certain to be higher than in a market biased towards stability, because dealers would be anxious to protect themselves from loss and would seek higher margins to compensate for the higher risks to which they would be exposed. If the Government continued to be the main borrower in the market, it would have to bear the cost of the "bias towards change".

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HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

PAPER BY MERVYN LEWIS

Note by the Secretaries

The attached paper by Mervyn Lewis (additional to those already circulated in this series) is circulated for information.

M D K W FOOT

M L WILLIAMS

H M Treasury

IS MONETARY BASE CONTROL JUST INTEREST RATE CONTROL IN DISGUISE?

Is monetary base control merely "a means for the markets to generate the interest rates necessary to bring the rate of growth of the money supply back towards the desired path" (Green Paper - our emphasis), or is it something more? If the former, most of the participants to the flagging monetary control debate could eventually reach some form of accommodation, in which interest rates are left more to market forces. Many of the critics of present monetary policies really wanted no more than this in the first place. For their part, HM Treasury and the Bank of England would like to see interest rates at some remove from direct political interference.

The idea that control of the money supply via the monetary base is different from interest rate control was stated forcibly by Milton Friedman to the House of Commons Select Committee (as reported in The Observer, July 6):

"Direct control of the monetary base is an alternative to interest rates as a means of controlling monetary growth. Of course, direct control of the monetary base will affect interest rates, but that is a very different thing from controlling monetary growth through interest rates."

If monetary base control is different, we must ask how it works and provide a frame of reference for evaluating its costs and benefits vis-a-vis interest rate control. Our concern is with the behaviour of the banking system, for this is where the money supply problem currently exists.

Base money (alias high-powered money or simply cash) is important to the banking system because it is the ultimate means of payment. Convertibility into cash is one of the characteristics expected of deposits which are treated as 'money', while transferability in the settlement of debts and to make payments is a distinguishing feature of banking services. In an overdraft system, transfers can also be made from accounts in debit, so that liquidity services are provided on both sides of the balance sheet. Banks can be

visualised as purchasing primary securities, pooling them to eliminate risks and combining them with capital, labour, materials and high-powered money to create 'liquidity'. High-powered money has the role as an input into banks' production function.

How much high-powered money is required by the banks depends on the nature of the production process and on institutional arrangements. Banks providing liquidity services face uncertain demand for cash from deposits and from loans where there are undrawn facilities or open credit lines. They are able to employ the law of large numbers to keep cash at low levels, but cannot eliminate the need for cash completely. As a bank lends or invests, the loss of cash puts it in a position where any subsequent deposit withdrawals or loan demands may necessitate sales of securities at a loss or interbank borrowings at unknown rates. These possible costs must be balanced against the benefits of increased income. In this way, the availability of cash limits banks' acquisition of non-cash assets.

Control of the money supply is exercised by restricting the quantity of the factor of production, base money, to the banking industry. Since the monetary authorities have a monopoly over the production of this factor input, they can make it available in less than perfectly elastic supply: in the limit, the supply could be made perfectly inelastic. Banks are then in the same position as firms in any industry for which the inputs required for production are available only at sharply increasing cost. For an individual bank, the restriction of the supply of base money imposes an external cost as banks in the system expand deposits and bid for reserves. (Each bank's supply response is a mixture of a movement along a short-run cost curve and a shift of that cost curve as rising factor prices impose an external pecuniary diseconomy.) An individual bank can react in a variety of ways: by bidding for inter-bank funds, raising deposit (and loan) rates, improving services, cutting back on new facilities, cancelling or reducing existing facilities, selling CDs, disposing of bills or bonds. The route actually chosen will be the one most profitable to the bank.

O immediate difference from the interest rate mechanism presently operated is the involvement of the banks. Following the removal of the corset, the banks are now almost passive spectators in the process of monetary control. In response to an increase in MLR, their 'job' is to raise base rates in line (which they have done), but that is about all. The Bank of England, as it were, appeals directly over their head to the public's demand for credit. In the meantime, the banks can continue to push out facilities with relative impunity. If borrowers are not daunted by the higher interest rates, the banks could conceive their job to include bidding for deposits and reserves to sustain any expansion of advances. Monetary base control, by contrast, impinges directly upon banks' decision-making and provides a pecuniary incentive for them to participate in the process of adjusting their balance sheets to the dictates of monetary policy.

A second difference concerns the adjustment mechanism, which, under monetary base control, would be chosen by the banks on profit-maximising grounds. At present, the form of the adjustment (eg interest rates operating upon credit demand) is chosen by the authorities. If that fails, the authorities must either raise rates further, or wait for credit demands to subside. Until the latter eventuates, banks are supplied with cash to prevent them running out of reserves. Left to themselves, banks could well choose to respond to a reserve shortage in the same way - by raising deposit and loan rates. Should interest rates fail to restrain the demand for money or credit, this could not be the end of the matter. A reserve deficiency would still exist and banks would be forced to try something else. Some assurance would exist that the adjustments would proceed until monetary growth came into line. The idea that there is some new breed of banker who will always eschew asset management for liability management is patently false. If interbank rates are bid up high enough, it would pay some banks to sell bills and bonds to the private sector in order to obtain funds for lending out in the interbank market. Liability management is allowed to succeed because the Bank provides the reserves needed to validate deposit expansion.

Perhaps the most important difference is in terms of the implications for behaviour next time round. Once banks are forced to make up reserve shortages by borrowing interbank at 'penalty cost' or by

selling securities at a loss, they are likely to exercise much greater care in future when granting facilities and open credit lines. Unused facilities are a valuable source of liquidity to customers, and banks might, in different circumstances, be expected to vary the 'price' for this service. There would also be an incentive for banks to refrain from lending and build up reserves when reserve shortages are anticipated. Accordingly, surges in monetary growth may be less likely to occur.

In this description, monetary base control is qualitatively different from interest rate control. At the aggregate level it operates by imposing a quantitative restriction upon banks' intermediation. This is translated directly into individual banks' profit calculus. Both the initial response and subsequent adjustments are determined by market forces, and the rewards and punishments these forces give to banks would seem very considerable benefits indeed. Unfortunately, it is not as easy to be clear about the possible costs.

For restraint upon cash to be an effective control device, it is not enough that its supply be inelastic, as is witnessed by the idea of using negotiable licences to control banks' deposit expansion. As with base money, the supply of negotiable licences would be monopolised by the authorities. As banks expand beyond allowable limits, variations in the market price would raise costs against individual banks. Yet it is generally agreed that such a scheme would encourage banking to be done outside the controlled area - particularly in offshore markets. Would the same consequences follow from monetary base control? If banks' holdings of base money were involuntary, as under a reserve requirement, this might well be the case. But we have argued that banks' demand is a voluntary one based on a production function for liquidity services, not an arbitrary restriction upon an institution designated to be a 'bank'. Institutions in the Eurosterling market (not that such a market can really be said to exist, thanks to the Bank of England) which provided substitute liquidity services, would require inputs of high-powered money, just as is the case in domestic markets. What competitive advantages would they have over domestic banks to be able to attract the deposits and reserves needed for liquidity production? Much the same question must be asked of the idea that non-banking intermediaries in domestic markets would provide substitute liquidity services.

But are liquidity services the distinguishing characteristic of money? If they are, then perhaps one-third of M3 should be excluded from the definition. This is a conservative estimate of the amount that represents wholesale funds of the non-bank private sector, much of which is held in banks which specialise in wholesale banking. This type of banking differs substantially from retail banking, which is the model outlined earlier. Retail banks exist by producing liquidity services; they endow claims with attributes of capital certainty, convertibility and transferability. The economic basis of wholesale banking is to lower transactions costs in markets for corporate borrowing and lending and to intermediate within the term structure of interest rates. In contrast with retail banking, in which virtually all deposits are in sterling and withdrawable on demand (or at very short notice), wholesale deposits are for various maturities and in a variety of currencies. Unlike retail deposits, where each bank may have millions of small accounts, to which the law of large numbers can be applied, each bank in wholesale business may have only a few hundred large accounts and is not large enough, relative to the total market for wholesale funds, to apply the same principles.

Because the economic basis of wholesale banking is different and the balance sheet structure differs, a different 'production process' applies. A substantial degree of matching of currency and maturity is the rule, even when, with non-bank business, substantial maturity transformation occurs. (Maturity transformation in sterling wholesale banking is only slightly less than that which now occurs in Euro-currency business.) A critical role is played by the interbank market in 'reconciling' the public's preferences with those of the banks. Funds are channelled from ultimate lenders to ultimate borrowers through several banks. What begin as short-term deposits finish up as rollover loans of several years' duration. Each bank is mismatched, but not to any great extent, and no one bank is left with a large share of the transformation. This is in marked contrast to retail operations, in which the transformation is undertaken fully by the bank accepting the deposits. It follows that the Bank's proposals about prudential liquidity, with the higher requirements in interbank funds, strikes at the heart of wholesale banking, and indicates a failure to understand this type of intermediation.

Our immediate concern, however, is that, for wholesale banking activities, there is no demand for base money. In this sense, much of the British banking system has already progressed to a cashless society. Even the concept of a reserve ratio has little meaning, for the demand for marketable securities (bills, CDs) to cover an open position depends on the mismatching, maturity by maturity, not upon any scale measure of the total balance sheet.

Restraint upon the supply of base money will curtail retail banking and those substitutes for retail banking which involve the production of liquidity services using inputs of high-powered money (or, in a pyramid of credit, claims against retail banks). If, as we have argued, wholesale banking involves different services and different production processes, it is unlikely to be constrained directly by monetary base control. The vital question, then, is, should it?

Analogies are helpful, but which is the correct one? At one extreme, we could, as Friedman does, liken the production of money to that of motor cars, with high-powered money like steel. Steel is a vital and irreplaceable input to the production of motor cars, at least in the short run. By restricting the supply of steel, control could be exercised over the production of motor cars, even though there are different brands and different models. Alternatively, we could envisage money to be like containers. There are several different types of container (steel cans, glass, aluminium, plastic) and many different production processes involving quite different inputs. Each type of container, and its associated input, has its distinctive merits, but all can be substituted at a price. Is the same true of different forms of banking and finance more generally?

Thus the monetary control debate is really a debate about the first principles of monetary economics. Is the aim of monetary policy to control something special called money, or is it to control all borrowings and lendings and all forms of financing in the economy? In the latter case, the Bank's interest rate policies are clearly appropriate. But if money does have a special place, it is unnecessary and inefficient for the Bank to control all borrowings and lendings

when a more direct means of controlling the relevant money supply is available. Monetary base control will involve interest rate variations as a by-product or as a means to an end, but it may not prove necessary to deflate all borrowings and lendings and alter all credit conditions in the economy on the way. Altering all financing demands in order to change one particular form of financing is a blunt instrument.

There is something to be said for both views. Proponents of monetary base control have, somewhat slavishly, applied a theory developed in the United States, with its preponderance of retail banking, to the quite different environment of the British banking system. On the other hand, it is surely the case that those bank and non-bank claims which are backed (directly or indirectly) by base money are more liquid than much of wholesale money, which differs little in character from commercial paper. By ignoring the importance of base money to liquidity production, the Bank has overemphasised wholesale banking and failed to distinguish money from credit.

24 July 1980
M K Lewis