11. Monetary Base IV
Part C

Comments on Green Paper

29/10/1980 – 30/10/1980

CONFIDENTIAL

Alexanders
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Comments on the need for change in the existing system of monetary control

1. We are in sympathy with the Government's policy of seeking to reduce inflation by reducing the rate of growth in the money supply. It is relevant to start by pointing out some factors which may have contributed to the recent difficulties in achieving this.

   1) the government has been a substantial and unexpectedly large net borrower.

   2) the political reluctance to allow interest rates to rise has prevented the increasing cost of money from playing its proper part in curtailing the money supply. This has led to frequent and various manoeuvres to alleviate shortages in the hope they may turn out to be temporary.

   3) the non-bank, non financial private sector has been under severe strain and consequently private sector lending has grown through the overdraft system.

   4) the abolition of exchange controls has facilitated operations through the Euro sterling and foreign exchange markets and complicated the problems of monitoring and control.

   5) the extent of the bill leakage under the corset system was and is unknown to the authorities.

   6) the system of reporting to the Bank of England has obscured whether all banks have been maintaining 12½% Reserve Assets on a daily basis.

2. It is easy to use hindsight in criticising recent monetary policy. Our motive is not to make cheap points, but to suggest that an important criterion in judging whether the present rules should be changed is what contribution such changes will make to dealing with the difficulties which have been listed. We believe that the present system may have defects but that wholesale

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reform might be counterproductive and runs the risk of using institutions and rules as a scapegoat when the real problems may lie with economic policy and the detailed operation of the present system.

3. We wish to discuss in detail two features of the present system which have recently been questioned, in our view wrongly.

4. First there is the question of last-resort lending. We assume that this will continue whether or not it is as excessive as in the past. It is an essential part of the system if London is to maintain its importance as an international financial centre, since the very size of daily cash flows between the Central Bank and the banking community cannot be easily accommodated without it.

5. There is no doubt a theoretical argument that the right to such borrowing should be extended to any substantial financial institution e.g. the clearing banks. It is to some extent a historical accident that the discount houses have the sole right here; whereas in e.g. Germany it is the banks. But the present system is tried and tested and the skill and expertise needed for such operations is at present lodged in the discount market.

6. The discount house system represents a competitive market. The discount market deals even-handedly with the whole financial system; any shortage which an individual bank or industrial company or building society may have day to day is cleared by the calling of loans or sale of paper at market rates. When customers find themselves resorting to their clearing banks for accommodation, such accommodation takes place at terms dictated by the clearer, not at rates determined freely in a competitive market.

7. More generally, the function and duty of the discount market is to operate an impersonal and independent market in liquidity, in full competition with each other. Quite properly the clearers operate differently. They are reluctant for practical reasons and reasons of customer relations to vary Base Rate. They wish to maintain their share of the market in money so will only reluctantly reduce assets by selling gilts or call in loans to restore their liquidity ratios. They have different motives and commercial philosophies in handling their business - which are appropriate

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to their functions but harmful to the free and fluid operation in the market for short term liquidity.

8. The clearing banks which are for good reasons less agile and monolithic in their operations than the discount houses, cannot perform the function of managing liquidity so efficiently; though they could no doubt do so after a fashion.

9. We note the conclusion of the Green Paper that the reserve asset ratio makes no useful contribution to monetary control. We believe however that it, or something like it, is very important for the efficient management of the liquidity of the banking system as a whole. Whatever prudential ratios are to be observed it will be necessary for financial institutions to hold their liquidity somewhere; and for this purpose the discount market has, from the point of view of the authorities, great virtues. First, a high proportion of the net liquidity of the system as a whole is concentrated in the balance sheets of a few readily accessible houses. This makes it far easier for the Bank to monitor and control the system than if liquidity were maintained through the balance sheets of many hundreds of financial institutions. Second, the discount houses do not (on any scale) lend to other institutions from whence they get their deposits. There is therefore less danger than in the case of the present interbank or Euromarkets of double-counting of liquidity or lack of underlying assets to back deposits.

10. In conclusion, we believe that whilst it is essential to preserve some form of liquidity requirement, any radical change to the existing system should not be made without confidence that it represents an improvement; for which the onus of proof is on the critics of the present system.

D.W. Grant
29th October 1980.

COMMENTS BY ALLEN HARVEY & ROSS ON THE RESERVE ASSET SYSTEM

Q.1 What is the basic structure of the UK monetary system?

Answer 1. The central bank (The Bank of England) operates primarily through specialist institutions (the discount houses); these institutions are independent of the commercial banks, being separately capitalised as public companies; these institutions undertake various responsibilities as principals, e.g. the weekly underwriting of the Treasury Bill issue and the making of two-way prices in short-term banking assets, in return for which they are given lender of last resort facilities by the Central bank. The discount houses act as a buffer between the Bank of England and the clearing banks.

Q.2 What are the main advantages of this buffer system to the Central bank?

Answer 2. (a) Efficiency

The Bank of England receives the figure of net surplus or deficit in the money market with a minimum of effort and in time for remedial action to be planned and carried out.

(b) Reliability

The money markets continued to function in the 1973 - 1975 banking crisis when other parts of the banking system failed.

(c) Cheapness

The Bank of England can operate with a minimum of their own staff by using, indirectly, the staff of the discount houses to discover the net surplus or deficit in the market at any one time and to ensure that remedial action reaches the banks which require it.

(d) Control

The Bank can, and does, maintain control of both the size and the quality of the discount houses' portfolios, which in turn ensures that the best traditions of portfolio control and credit judgement are maintained - to the benefit of all who do business in the City's financial markets.

(e) Communication

The Bank can make its wishes known easily and promptly by communicating through the comparatively small number of discount houses. The Bank can easily - and anonymously - check on the market's assessment of commercial banks and on new trends in market practice.

Q.3 What are the main advantages of this buffer system to the commercial banks?

Answer 3. (a) Independence

Individual banks can deal anonymously through the network of specialist middle-men, without having to refer their market judgements to the Central bank. The original support in the C19 for a buffer system between the commercial banks and the Central bank came from the commercial banks, to give them freedom for manoeuvre in their money markey tactics. When the Bank of England was nationalised, the commercial banks again found it convenient, for their own independence, to have a buffer system.

(b) Efficiency

The system basically works well.

(c) Security

The clearing banks can put their liquid balances to work without risking non-repayment because they receive collateral for their loans and know that the lender of last resort facility is available to all the discount houses.

(d) Predictability

Interest rates fluctuate within tolerably predictable limits. Advocates of alternative systems admit that interest rate fluctuations might be more violent than under the existing buffer system. As the business of the main London banks becomes increasingly complex, and as their customers become increasingly sophisticated, the banks have a vested interest in a system which avoids extreme penalties.

Q.4 What are the disadvantages of a buffer system to the Bank of England?

Answer 4. Remoteness

The Bank does not deal directly in the main money markets, which may lead to a lack of expertise in market management.

Q.5. What are the disadvantages of a buffer system to the commercial banks?

Answer 5. None, so long as the buffer system can keep pace with the growth in the banks' businesses. If the capital capacity of the buffer system is static at a time when the volume of bank business is growing, the banks will have to find alternative means of satisfying liquidity requirements.

Q.6. Why is the reserve asset system unpopular at the moment?

Answer 6. (a) Because £M3 has not behaved as the Government hoped it would.

Reasons:

i. Failure by the Government to keep the PSBR on target.

ii. Failure by the Bank to monitor the system accurately.

iii. Failure by the Bank to use effective control methods over banks which did not maintain reserve asset requirements at all times.

iv. Political decisions by the Government, e.g.,

A. removal of £ exchange controls.

B. refusal to allow interest rates to rise above 17% in the short-term, although the medium-term strategy had created the pressure for a short-term squeeze

C. lack of co-ordination between fiscal policy and monetary policy.

v. Structural features of the traditional UK banking system, e.g.,

A. large unused overdraft facilities making precise predictions and control difficult

B. endowment profits from lending at high interest rates against relatively cheap current and deposit accounts

C. allowance of bank interest charges in tax omputations.

(b) Because banks have not maintained a balance of liquidity in excess of their minimum reserve asset requirements - and are sometimes below their reserve asset requirement.

Q.7 Could the reserve asset system be improved upon, to bring the monetary statistics under tighter control?

Answer 7. Yes, if:

(a) Interest rates are not pegged by political intervention when market forces are pushing towards higher levels.

(b) The Bank controls the system more effectively.

(c) The Bank becomes more involved in the quoting of two-way prices in the market.

(d) The capacity of the discount market grows at the same pace as growth in the banking system.

AJB
28.10.80

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29th October, 1980

A. L. Coleby Esq.,
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Dear Tony,

I enclose herewith a few notes which I hope you may find of some interest.

We have not attempted to go into any detail about how a revised system might work on a day to day basis, there has not been time. We have, therefore, stuck to broad principles.

Yours sincerely,

Edward Ryder

E. D. D. Ryder

Enc.

INTRODUCTION

The present system of monetary control has been in existence since Competition and Credit Control was introduced in 1972 and before that a similar and arguably better system existed. There is no doubt that in recent months the present system has proved itself incapable of controlling the growth in money supply but this is probably no fault of the system itself but rather the seemingly impossible feats asked of it.

Revolving as it does around the money supply targets, one would expect interest rates to rise as growth exceeds the target. However, with the PSBR undeniably out of control and with the unwillingness of the Authorities to allow rates to rise, and so bring the bank lending side of the equation back into line, one must not be surprised at its failure. This situation has also been aggravated by the disbandment of the corset and the resulting reintermediation which proved to be a very much larger factor than was anticipated.

Given that the greater part of the funding for the year has already bee achieved, and that reintermediation has for the most part taken place, there would seem to be no reason why the present system, with a few alterations, should not continue for many more years. It is, after all, highly flexible and allows a great degree of fine-tuning. Could it be that the fine-tuning has been wrong, thus leading to the recent anomalies, and not the basic mechanism?

MONETARY BASE CONTROL

The arguments against a full monetary base system have been aired at length in numerous learned papers and it is not proposed to repeat them all again. It is perhaps relevant that many of the criticisms have not been answered and so far as is known, no day to day plan of the mechanism's operation has yet been produced. There are one or two general points tha seem to be worth stressing:-

1. A great strength of London as a financial centre is its stability and flexibility. A system which provides for no control over the interest rate cannot be described as either. The best call-money market in the world could not survive under these conditions.

2. As a consequence, it is likely that other markets, such as the commodity, shipping, and even insurance markets will drift to more stable environments.

3. International businesses could also be expected to move abroad. Restrictions applied to London banks would result in higher margins and London's profitable position as a leading centre for international markets would disappear.

4. Much of the City's success has been due to the tradition of enterprise, linked with sound credit-worthiness. Short-term quantitative control would threaten the confidence in the survival of individual institutions and the survival of particular sectors.

5. Any direct attempt to restrict one aspect of money supply, such as bank deposits, will only result in the extra growth of other types of credit such as leasing, commercial bills and euro-sterling. It is the total expansion of credit that fuels inflation, not one particular element.

6. The Discount Market's role in the present system of taking short-term funds from banks and other institutions and converting them into useful longer assets, relies on the lender-of-last-resort facility. If this were withdrawn, the effectiveness of the short-term London Money Market would be grossly impaired.

THE RESERVE ASSET SYSTEM

The present system has evolved, with a few alterations along the way, over the last 50 years or so and this in itself is one of its greatest strengths. London has built itself a reputation as the finest and most flexible short-term money market in the world and the fact that there are more foreign banks in the City of London than in any other financial centre, is not unconnected. Is it right for a Government to jeopardise the reputation of London as a monetary centre and the presence of numerous foreign banks and the extent of valuable invisible exports that the City produces, just to test a new mechanism that is of doubtful worth and which has been tried and found wanting in the USA? We suggest that it is not, and that the present system can be adjusted to advantage without the institutional upheaval that Monetary Base implies.

Apart from the most common argument against Monetary Base Control, namely that of unalleviated money shortages coinciding with large-scale cash withdrawals, thus causing a banking crisis, there are several other objections to the present system which perhaps stand out more to operators in the market than to theoreticians and politicians outside it. One of the major problems is that of the concept of a bank's liquidity being represented to the extent of $12\frac{1}{2}\%$ of the eligible liabilities in reserve assets. This has become out of date and impracticable. To the simple-minded, liquid assets should be available for use in a situation where funds are needed at short notice. The present system does not allow this. A bank not only has to go into the market to borrow the funds that it has on-lent, but also an extra $12\frac{1}{2}\%$ to buy the reserve assets to maintain the ratio. Thus a marked difference between the two markets (inter-bank and reserve asset) emerges. Lately this has been exacerbated on make-up days by window-dressing for monthly returns.

A version of prudential liquidity ratios, as discussed in the White Paper (March 1980) would help to solve this dilemma. It would allow banks to hold a wider portfolio of liquid paper and thus encourage them to stay within the limits for more than one day in every month.

The second adjustment that should be made is to the cost and availability of official help. Whilst, for a Discount House it is obvious that so long as the intervention is done through the LDMA, then the cheaper the better, it is not necessarily to the good of the market as a whole.

The Discount Market has been the major vehicle for official help for upwards of 100 years and as a result some might argue that it is time for a change. However, we defend our role in this with the utmost vigour. The only other sector that could act as agent between the authorities and the market on a day to day basis are the Clearing Banks and they would be wholly unsuitable for the following reasons:-

1. They have not been trained in this aspect of market operations and thus could not be relied upon to be better than the Discount Market.
2. Clearing Banks are in a highly commercial and competitive area and they could not therefore be impartial. Discount Houses have nothing to gain but much to lose if they are not seen to be impartial.
3. Foreign Banks would be most unwilling to have to deal with the Clearers who are, after all, direct competitors. The foreign banks, therefore, would be unwilling to disclose their positions to the Clearing Banks. By dealing with the authorities through the Discount Market they retain anonymity.
4. The Clearing Banks have shown themselves to be unable or unwilling to restrict round-tripping.
5. The Clearing Banks are already the most powerful group within the money market. They would, therefore, be likely to wield this power, which may not be in the interest of the market. The Discount Market, on the other hand, are used to doing what is wanted of them.

6. To centralise open market operations on the Clearing Banks may seem a very neat and tidy idea, but would it not be playing into the hands of any future Government who might wish to nationalise the Clearing Bank system.

Going back to the cost and availability of the day to day intervention, a fundamental problem seems to be that it is difficult and sometimes impossible for the Bank to inject cash into the inter-bank market, thus causing these rates to rocket while reserve assets ratesfall. As a result, round-tripping starts and the bank's' lending figures become distorted. With the growth in the commercial banks' balance sheets and with the Discount Houses often 'full' on their 20 times multiplier, it becomes difficult for the Houses to pass on the official help. If loans to the inter-bank sector were to qualify under the 30 time section of their books, the situation would be made easier. In order to discourage both sectors of the market from relying too much on the official help always being available, its cost and nature should be varied from time to time so that on occasions it would be penal.

CONCLUSION

In our opinion the present system is the most satisfactory in the overall interest of the Authorities and the City of London and it can be made to work provided that:-

1. Window-dressing is stopped.
2. Round-tripping is stopped.
3. The Bank of England is treated as the lender of last resort.

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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 different 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 help reduce M3 and pressure on interest rates.

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.