10. A Monetary Control

Consultants

16 June 1980

MCC(80)20   COPY NO.

16 June 1980

HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

MONEY STUDY GROUP

Note by the Secretaries

The attached note by Mr Grice, recording the Money Study Group's discussion on 16 May, is circulated for information.

M D K W FOOT
M L WILLIAMS

H M Treasury

NOTE FOR THE RECORD

MONEY STUDY GROUP MEETING ON MONETARY CONTROL: 16 MAY 1980

The Money Study Group held an all-day meeting on monetary control - specifically, on the issues raised by the Green Paper "Monetary Control" and on the Bank of England's Consultative Paper "The Measurement of Liquidity". The programme of sessions is attached.

2. It was a well attended meeting. About 40 people were present for the two papers in the morning and about 80 for the panel discussion in the afternoon. Mr Britton, Mr Williams and myself attended from the Treasury and Messrs Goodhart and Foot from the Bank. The composition seemed nicely balanced with, I would estimate, half the audience from the City and half from academic life.

3. <u>The Morning Sessions</u> Overall, these were disappointing. Two papers were presented in a short time and there was very little time for discussion.

<u>A:H. Wills (LSE) "The Economics of Bank Regulation"</u> This was an old paper which we have seen before. It uses a very simple model of bank deposit supply and loans demand to draw conclusions about the effects of various types of monetary control schemes, including monetary base control. Unfortunately, this model is very much too simple to analyse a financial system such as ours. In particular, it allows movements only in "the interest rate": there is no distinction made between movements in short or long rates or, more importantly between the rate of interest on money and that on competing assets. Since such relative movements are vital to the workings of monetary control, some of Wills' conclusions need qualification while others are just plain wrong.

4. Professor Harold Rose (Barclays Bank) made two interesting points in discussion, prompted by, though not directly relevant to Wills' paper:

(i) if monetary base control were operated in a way which taxed the domestic banking system then there would be a move towards offshore banking outside the scope of the controls. But if monetary base asset pressure had caused a tax of a particular level, this could explain only a once-and-for-all increase in offshore banking not a trend growth. In general, one would expect fluctuating base asset pressure not a trend increase and indeed under normal circumstances, Will's paper seemed to show that the variation in tax would not be very great. Thus monetary base control might lead to large offshore disintemediation but of itself cause trend growth in this activity.

(ii) the operation of the Reserve Asset Ratio has probably not had much impact on banks' lending rates but may have had substantial impact on their profitability. Its abolition is therefore likely to be welcomed by the banking community.

5. B: M K Lewis (University of Adelaide (Bank of England)

The main point of Lewis' analysis was that different kinds of banks operate in different ways and justify different control techniques; also a number of monetary aggregates may be relevant to the authorities in exercising monetary control and £M3 may be only one amongst several indicators which deserve attention. From the point of view of control the Green Paper recognises this and notes that the authorities have regard to a range of aggregates in assessing monetary conditions. But at the same time it states that "policies directed to controlling any one of the aggregates by adjusting the PSBR and interest rates will tend to control the others over a period though not necessarily to the same numerical rate of growth". This may not be satisfactory insofar as PSBR and interest rate policies that will produce an optimal growth of £M3 may produce suboptimal rates of growth in other important aggregates even in the long run. This could not be ameliorated by choosing a different target aggregate since the fundamental inconsistency would remain. In these circumstances, it would be better to retain both quantity controls such as by the monetary base, and interest rates, since they might be expected to have differential effects on the aggregates.

6. These are interesting ideas though it is not very clear from the paper how quantity and interest rate controls could be operated independently. Unfortunately, the discussion did not help. Lewis' presentation was not very close to the paper and the time available was limited.

7. The Afternoon Session There were three stages of the proceedings: first, the six panel members were allowed 10 minutes each to summarise their views on the monetary control debate; second, there was a period of about half an hour devoted to discussions by the panel; finally, the discussion was opened to the floor.

8. The Panel Statements Andrew Britton opened the discussion. He stressed that the Green Paper was limited in scope. It was concerned primarily with control of the money supply using techniques at the short end of the market: it did not deal in depth with fiscal policy, exchange rate policy or with techniques of selling public sector debt. He believed that, in the public debate so far, the question as to whether existing techniques were supply or demand side controls had not been a useful one. The real question at issue was whether control should be by the authorities' influencing prices (interest rates) or quantities (eg. the monetary base or the quantity of gilts sales). Which of these were appropriate would depend on why we were controlling the money stock in the first place. In this connection, it was worth noting that monetary control was not aimed entirely at short run control of £M3. While there were good reasons, set out in the Green Paper, why monetary targets should be expressed in terms of that single aggregate, in the medium term the authorities have to be able to control all the monetary aggregates. It was therefore important not to choose a control technique which controlled £M3 but could not influence these other aggregates. For these

reasons, Mr Britton believed that the debate needed to concentrate on three points:

a) would a move to control by quantities mean that control of £M3 would be more <u>precise</u>;

b) would it constitute a more <u>stable</u> system to the extent that interest rate movements would be less volatile;

c) would quantitative control be more <u>reliable</u> in the medium term than control by prices?

9. <u>Professor Griffiths (City University)</u> felt that monetary control over the last decade had been inadequate. The variance in the growth of the money supply had been enormous but nevertheless accompanied by quite unnecessary large swings in interest rates. The solution, in Andrew Britton's terminology, is for the authorities to control quantities - in particular, the monetary base - rather than attempt to control interest rates. The Green Paper raised five main objections to non-mandatory monetary base control:

a) MBC would imply substantial changes in the operation of the destruction of short term money markets;

b) the demand for monetary base may not be stable;

c) there would be operational difficulties in controlling the base;

d) liability side management by the banks would make the interest rate responses to base control exceedingly volatile and potentially unstable;

e) there would be a long transitional period when we did not know whether non-mandatory MBC was yielding adequate monetary control or not.

10. Griffiths was not convinced. On (a), certainly some short term money market practices would have to change. In particular it was vital, if monetary control was to be effective, that the Bank should cease to act as automatic lender of last resort. On (b), the demand for base assets had not been unstable in Switzerland when MBC had been applied nor did UK banks' demand for other assets appear to be unstable. With respect to (c), the essential simplicity of MBC meant that it had great operational ease so that it was difficult to see what operational difficulties the Green Paper had in mind. Dealing with liability side management Griffiths stated that he did not know what this was but suspected it was a shorthand criticism the Bank of England applied to schemes of effective monetary control. He was concerned, however, about objection (e) which he did believe to be substantial.

11. The monetary base indicator system, Griffiths believed would be initially no different from the present situation and he was therefore opposed to it.

12. Christopher Johnson (Lloyds Bank) Mr Johnson noted that the natural interests of the Clearing Banks were different from those of the authorities. The Clearing Banks' main wish was freedom to lend on sound commercial demand without restriction: the authorities' business was to exercise effective monetary control, which may be very different. In this sense, issuing the Green Paper at all was somewhat odd. It was as if the authorities were asking an innocent prisoner (the Clearing Banks) how he ought to be punished.

13. While stressing that there was not a monolithic Clearing Bank view, Johnson nevertheless noted that MBC was alien to most bankers and they would tend to oppose it strongly. A major problem with any scheme which relied too heavily on movements in interest rates regulating monetary growth was that the short run response of bank lending to changes in rates seemed to be perverse. Moreover, the large interest-bearing component of £M3 meant that

an increase in short rates, thus flattening the normally positively sloped yield curve, could increase demand for £M3 at the expense of gilts. For this and other reasons, he opposed MBC. He congratualted the authorities on marshalling the arguments against it better than he would have been able to do himself.

14. Johnson raised two other points:

a) a decision to join the EMS, to which the Green Paper referred only vaguely, would have profound implications for monetary control. In these circumstances, it was not clear how MBC would operate. DCE would then become the primary indicator of monetary policy. The authorities should in any case reconsider the merit of using DCE as an indicator;

b) although MBC in the full sense would not be welcome to the Clearing Banks, they might be prepared to work with the monetary base indicator system, if the authorities were to favour that scheme.

15. Gordon Pepper (Greenwells) Mr Pepper had not changed his view since the Special Greenwells Bulletin on the Green Paper. He therefore reaffirmed these views without explicitly repeating them. Why were the Treasury and the Bank so hostile to MBC? Pepper believed that there were 3 main reasons:

a) the authorities were naturally conservative in attitude;

b) given their political sensitivity, the authorities were reluctant to lose control of interest rates, even if this implied ineffective monetary control;

c) there was the emotive issues of the lender of last resort facility. The Bank of England was naturally anxious not to abridge its responsibilities of guaranteeing the overall stability of the financial markets. Unfortunately, the authorities had not differentiated between the Bank's acting in general as the occasional guarantor of stability and its day-to-day technical actvity in the money market as lender of last resort. MBC would entail curtailment of this second function but would in no way affect the former.

16. Pepper believed that a communications breakdown had characterised the debate so far. Most important in generating this had been a failure to discriminate between factors affecting the supply of money and those affecting the demand. One reason why this was important was that Keynesians (who, Mr Pepper implied, were seriously misguided, if well-meaning) could not work the supply of money into their analysis whereas they could incorporate the demand for money with little modification. In general, there was no reason to suppose that the supply of and demand for money would coincide. As we have seen, indeed, in the UK over the last decade this is the rule rather than the exception, a feature built into the small model of the UK economy developed by Richard Coghlan et al at the Bank of England. Because supply and demand can differ, it is clearly better to control monetary fluctuations at source ie. to control supply. This is what MBC would do: precise control - one of Andrew Britton's targets - was not necessary. Ending, Pepper noted that considerable confusion still surrounded the relationship between money supply and demand and suggested a first rate piece of academic analysis was needed to clear it up.

17. <u>Roger Alford (LSE)</u> The organisers had asked Mr Alford to discuss the Bank's Liquidity Paper to which he confined himself at this stage. He believed that the paper made a very clear distinction between monetary control and banking supervision and in general we helcomed this. The Bank of England were evidently concerned that:-

(i) excessive maturity transformation could be dangerous;

(ii) The banking system as a whole should have sufficient liquidity for soundness as well as each individual bank.

For these reasons, they had proposed an integrated liquidity test which could be applied to each bank in order to derive a total and a primary "need for liquidity" for that bank. Primary liquid assets differ from other liquid assets in that they constitute liquidity for the banking system as a whole as well as for individual banks. While the primary liquidity need is then mandatory the secondary liquidity need is negotiable with the formula acting only as the basis for discussion.

18. In general terms, Alford believed this to be a sensible procedure but he had a major reservation about the relative treatment of retail and wholesale deposits. The Bank suggests a total liquid assets cover of 25% for retail deposits, a higher figure not being necessary if banking practices are fundamentally sound. But for wholesale deposits up to 3-6 months maturity much higher covers are proposed on the grounds that an individual bank may not be able to replace wholesale deposits as they mature. Alford believes that this is incorrect; provided the bank's practices are sound and the banking system as a whole has sufficient liquidity, the individual bank will always be able to replace its wholesale deposits, if necessary. The differential treatment of wholesale and retail deposits is therefore unwarranted and unfair.

19. Dr. Goodhart (Bank of England) Undaunted by Messrs Pepper and Griffiths' less than complimentary account of the Green Paper, Dr. Goodhart summarised the main points which had come out of the public debate so far. He also noted some which had not, but ought to have, arisen from the debate:-

a) the purpose of the exercise: the Green Paper had stated unequivocally that the strategy should be the medium term control of money with monetary targets expressed only in terms of £M3. The authorities had been surprised, not unpleasantly, how widely £M3 had been accepted as the right aggregate;

b) there also appeared to be growing recognition that it was the medium term trend growth in money which was important, not erratic short run movements;

c) not much attention had been paid, however, to the issue of rules v. discretion. This was quite separate from the issues of control by quantities v. prices or supply v. demand. It was nevertheless an important issue since a key feature of any monetary control system was the degree of freedom allowed to the authorities to intervene;

d) another topic which had been neglected was the proposed monetary base indicator system. Most protagonists in the debate so far had merely restated their position from before the Green Paper. Such a system would be distinctive since it would give prior and clear revelation of the authorities' reaction function. This could have definite advantages in that it would increase the information available to the markets. On the other hand, it could prove a destabilising system if base rates continued to be sticky;

e) there had been no discussion of the detailed operation of a monetary base system. There had been some tendency to quote Swiss evidence in favour of a non-mandatory MBC. It was worth noting, however that the variability of monetary growth in the UK was not greater than in most other European countries and was actually lower than in the case of Switzerland.

f) there did seem to be a common feeling among outside commentators that lenders of last resort facilities had been too generous in the past. One approach might therefore be to restrict this facility gradually. It was all the more unfortunate for this reason that there had been little discussion of detailed operational matters which might give the authorities some basis for such a gradualist approach.

20. Further Panel Discussion

Responding to Dr Goodhart, Professor Griffiths agreed that it was a weakness of the case for MBC that no one had yet written a detailed paper on how it would be operated. There was, however, in existence a comprehensive Federal Reserve paper on lender of last resort facilities which would give useful material in designing a scheme to restrict their use over time. With respect to interest rate volatility following the introduction of MBC, he believed that rates would be more volatile day-to-day but fluctuations would be less over periods of a month or longer.

21. Mr Johnson believed that one could not separate the issues of control and supervision. How, for example, would banks obtain the primary liquidity prescribed by "The Measurement of Liquidity" when, according to the Medium Term Financial Strategy, the government was planning to create less of it. He also pointed out that banks do not have automatic lender of last resort access, as had been suggested, because of the intermediation of the discount houses. In fact, the Clearing Banks would prefer to deal direct with the Bank of England. Finally, although he favoured a piecemeal approach to reform of the financial system, he did not believe that the discussion could be on a piecemeal basis. The authorities would be unlikely to get a reaction from the Clearing Banks on either the Green Paper or the liquidity paper until the additional note on cash ratios had been published.

22. Mr Alford pointed out that there could be scope to create additional liquidity through the issue of commercial bills. So far as monetary control was concerned neither the existing system nor the proposed indicator were necessarily those which would be prescribed by optimal control techniques. In fact, it was not even clear if the systems were stable or viable.

23. Mr Britton pointed out that the monetary base indicator system of the Green Paper had only been put forward to stimulate discussion. It was not in any sense the officially preferred outcome. His own problem with a mandatory MBC was that it looked too much like the Supplementary Special Deposits system and could share the known defects of that scheme. Mr Pepper regarded this as a misunderstanding. Under MBC the suspension of lender of last resort facilities destroys the present ability of the banking system to create primary liquidity at will. This is the essential difference which enables MBC to yield effective monetary control. Like Mr Johnson he regarded the issues of control and supervision as closely linked.

24. Charles Goodhart recorded his belief that movements in interest rates do affect monetary growth but that the effects could take time to emerge. It was, for example, the heavily negative real interest rate in 1977 which probably led to the excessive monetary growth of 1978. One factor making for attenuation of interest rate effects could be the feature of the tax system whereby most interest on bank advances qualified for tax relief. Turning to MBC itself, he was not clear whether its proponents claimed it just to be a more effective and reliable way of generating the interest rate changes necessary to monetary control of whether it had further effects. If so, what were they desirable? Unfortunately, tea was taken at this point so that we never found out.

25. <u>Discussion from the Floor</u> Opening Maurice Perlan (LSE) asked why the authorities believed the OSBR to be important if they were comtemplating moving to a system where money was controlled by acting on some arbitary quantity such as the monetary base. Andrew Britton said the authorities believed that there was a strong link between financial wealth and the money stock. Clearly the PSBR was a major influence on the level of financial wealth. Richard Jackman (LSE) disputed this, however, on the grounds that movements in financial wealth were only tenuously related to the PSBR. Moreover, if physical wealth should also prove relevant to the demand for money then the links with the PSBR would be even less clear.

26. Anthony Harris (Financial Times) claimed that the authorities needed the PSBR to be central to monetary control not so much to control the private sector but to control the spending and taxation behaviour of the politicians. He had two other points: first, the main effect of the high PSBR's had been to crowd the private sector out of the long term borrowing market. It had thus been forced to borrow short by way of bank lending. This inelastic demand for bank lending had weakened the effect of interest rates on monetary control. This situation might be helped if the government were to widen the range of its debt instruments so that it was not entirely reliant on borrowing from an area where companies used to raise their finance. Secondly, he believed that the authorities would always need to retain some discretionary powers. Structural change in the economy as, for example, in the public/private sector split or the advent of North Sea oil itself changes the meaning of the money stock statistics. These changes require discretionary interpretation.

27. Brian Griffiths felt that the authorities were presently not pursuing a monetary policy but a credit policy. Since monetary growth was near the bottom of the target range, interest rates should have been allowed to fall. They would have done so if the authorities had not been obsessed with restraining credit.

Dr Goodhart denied this move to credit pòlicy had occurred. Over the last few weeks a number of special factors had depressed monetary growth. These were predictable and, indeed, had been predicted. Given the expected ending of these factors, it was indeed necessary to restrain bank lending but only in order to meet the announced monetary targets. The authorities had no separate credit target they were trying to meet. But the whole episode of the last few weeks did illustrate the value of leavi some discretion to the authorities. An automatic system would have brought down interest rates at a time when such a movement would have been inappropriate. Gordon Pepper retorted that in order to use their discretion, the authorities needed to forecast when special factors were going to occur. In general, they were not very good at forecasting. Returning to Anthony Harris' points, he noted that the PSBR was closely related to the monetary base as well as to £M3. MBC would therefore also act as a restraint on the politicians spending. He also wanted to clarify his position in embracing mandatory MBC. This he was not as a permanent arrangement but the first step in a move towards a non-mandatory series style system.

28. From the floor, it was asked why the authorities did not pay special attention to overseas sterling balances since these were affected by credit creation. Andrew Britton replied that the short answer was,we were pursuing a monetary policy not a credit policy, though of course the authorities did consider a range of monetary and credit indicators as well as £M3. Harold Rose (Barclays Bank) suggested that both credit and money could be important to economic activity. It seemed undeniable that credit did affect the economy, especially in the short run. Brian Griffiths asked whether the authorities believed the inadequate monetary policy of the last decade was due to inadequate credit policy. Replying, Charles Goodhart declined to tell us whether he had stopped beating his wife or not but claimed not to understand the question. If the accusation was that interest rates had not been raised as early or as much as

was necessary, was MBC seen merely as a way of making interest rates apolitical or did it have greater significance? Gordon Pepper said that MBC would make the banks more cautious about marketing loans. Andrew Smithers (Warburgs) also argued that MBC had a different function. It constituted a self-regulating way for the banking community to exercise monetary restraint. Banks which expanded their books excessively would have to buy base assets at penal rates from banks which had exercised restraint. John Flemming pointed out that, providing there was no shortage in the system as a whole, this was unlikely to prove costly given the opportunity cost of excess reserves to others. A commentator from the floor pointed out that US banks tried to avoid holding excess reserves. A further commentator from the floor, said that he could see no case for mandatory MBC except to give the authorities the power to remove it later. Unfortunately, the rationale for this interesting view never became clear. (But this is obviously the man Mrs Gilmore and I have been looking for to defend Special Deposits.)

29. Brian Griffiths was also opposed to mandatory MBC because it would lead to distortions and disintermediation. Roger Alford accepted this but pointed out that in the UK context, it was not clear if the banks would demand any base assets at all under a voluntary scheme. Christopher Johnson endorsed this; to the extent that the banks demanded base at all, it would be affected primarily by confidence and prudential considerations which had little to do with monetary control.

30. Finally Tim Congdon (Messels) noted an apparent inconsistency between the Green Paper and "The Measurement of Liquidity". In the former, the prospect of disintermediation was greeted with horror but the proposals of the liquidity paper would cause just such an effect. Charles Goodhart replied that the Bank did not believe that the prudential proposals would lead to disintemediation. But these matters were for discussion and if it were shown that any of the prudential proposals would produce disintermediation, then they would be seriously reconsidered.

31. <u>Appraisal</u>

All in all, it was an interesting day. But the panel discussion yielded very little from the outside contributors we did not already have. Pepper and Griffiths merely restated their positions. On the other hand, Johnson's revelation that the Clearing Banks are likely to be vigorously opposed to MBC is of interest.

32. In substance, the floor discussion also gave limited yields. Much of it was well wide of the mark. On the other hand, it did allow some assessment of the support for MBC. My own assessment was that support was limited: very much so in the case of City representatives and probably also in the case of the academics.

J. W. Grice

J W GRICE
12 June 1980

MONEY STUDY GROUP

The Group has organised an all-day meeting on Friday 16th May to discuss monetary control. This is in response to the recent publication of the Green Paper: Monetary Control, and the accompanying discussion document of the Bank of England: The Measurement of Liquidity. The programme is as follows:

11 A.M. Hugh Wills (London School of Economics)

<u>The economics of bank regulation</u>

12 A.M. Mervyn Lewis (Adelaide and Bank of England)

<u>Banks, non-bank financial intermediaries and monetary reform</u>

(Copies of either paper are available on application to the Group Secretary.)

2.15 P.M. A general discussion of the Green Paper and discussion document. The discussion will be opened by each of a panel of invited discussants giving their views. The panel will be as follows:-

Roger Alford (LSE)
Andrew Britton (Treasury)
Charles Goodhart (Bank of England)
Brian Griffiths (City University)
Christopher Johnson (Lloyds Bank)
Gordon Pepper (W. Greenwell and Co.)

The meeting will take place in room S.075 of the London School of Economics.

R. L. HARRINGTON

UNIVERSITY OF MANCHESTER

N.B. The International Economics Study Group are holding a meeting on the 19th May at 2.30 p.m. in the LSE. R. B. Johnston of the Bank of England will present a paper on 'Banks' international lending decisions and the determination of spreads on syndicated medium-term Euro-credits'. Full details from Professor J. Black, University of Exeter.