

## 6. Monetary Control Consultations

22 – 29 September 1980

*Hu: Mcc*

M (80) 40  
22 September 1980

COPY NO.

HER MAJESTY'S TREASURY  
MONETARY CONTROL CONSULTATIONS

COMMENTS BY BRITISH OVERSEAS AND  
COMMONWEALTH BANKS

Note by the Secretaries

The attached comments on the Green Paper from the British Overseas and Commonwealth Banks Association are circulated for information.

M D K W FOOT  
M L WILLIAMS

H M Treasury



## MONETARY CONTROL

The Government has resolved to reduce the growth in money supply in order to achieve a permanent reduction in inflation in the United Kingdom. In order to do so, it has considered ways in which it could acquire control over the money supply in the medium term, whilst at the same time minimising short term fluctuations in money growth within the overall trend. The money aggregate  $\text{£M3}$  has been chosen as the appropriate measurement of growth.

The Green Paper, which is a joint consultation paper by H. M. Treasury and the Bank of England, considers the following alternatives:-

- a) Monetary Base Control
- b) Indicator Systems

### A. MONETARY BASE CONTROL

A known proportion of a banks' deposits to be kept in base money whether voluntarily or mandatory. In this case, the Authorities have the option to control the base and thereby bank balance sheets, as growth is restricted to a multiplier of the base, or use movements in the base to trigger changes in interest rates. Whether there is a mandatory requirement for base assets or not, this scheme would require a fundamental change in the fabric of the London financial markets. To be effective, the Bank of England would have to cease open market operations as they are known today to become truly a lender of last resort in times of crisis rather than a lender of first resort, as it has sometimes been described. The Authorities seem to have stepped back from making such changes and the status quo has been preserved. With such a constraint, the efficient application of Monetary Base Control would be limited. Certainly its adoption would require bankers with vast experience and expertise within the existing market framework to acquire new skills and there would undoubtedly be a difficult transitional period during implementation.

The Paper clearly rejects Monetary Base Controls for the following reasons:-

- a) "Significant institutional effects resulting in a less flexible



money market."

b) Lead time measuring success and therefore uncertainty of benefit.

c) "Known costs and uncertain benefits."

d) Interest rate changes generated might not produce a smooth short term monetary growth.

The "pros and cons" of Monetary Base Control do not seem to have been fully discussed in the Paper and perhaps a closer look at attempts in other countries might be appropriate, e.g. Switzerland and the USA. However, without a willingness to change the present market structure, such discussion is somewhat academic.

## B. THE INDICATOR SYSTEMS

This scheme seems more attractive to the Authorities and avoids the need to control the base. The Authorities would simply react to movements in the base against the desired level of growth, which would trigger changes in short term interest rates. It is suggested that changes in interest rates could alternatively be linked to changes in £M3 as indicated from weekly returns to the Bank of England by banks.

The trigger mechanism would be automatic, except that the Authorities would maintain the discretion to override the trigger points.

Weekly figures would undoubtedly place a greater burden on banks than the existing monthly returns. A pilot study has already been collected from a sample of banks, but unfortunately this was not particularly satisfactory, as it did not show the same trend as the monthly figures for the market as a whole. Possibly this was due to reintermediation between the "Corset" make up days.

The advantage of this scheme as seen by the Bank of England is that the market structure need not be altered in any way and so radical change is unnecessary. Although the Paper suggests that the Authorities would have to justify discretionary changes in interest rates, the fact they they are able to means that they will remain under political pressure when appropriate action seems politically unpalatable.

/...

When looking at Monetary Base Control or the Indicator System, there appears to be a concentration on short term interest rates as a treatment to the symptoms of an excessive supply of money. Arguments that the Authorities should concentrate more on the actual supply of money rather than attempt to treat the effect are not answered in the Paper and greater discussion on this point seems necessary.

In addition to the above schemes for monetary control, the paper announces the intention of imposing a cash requirement on all Recognised Banks and Licensed Deposit Takers, in addition to the London Clearing Banks. This is not covered in great depth by the Paper, because it is meant to be covered by a follow up paper, which is now well overdue, possibly being held back whilst market conditions are so illiquid. Whilst it may seem more equitable to spread the responsibility for providing cash to the Bank of England, to support its open market operations, it is likely to be more costly to non-Clearers and therefore more onerous. One cannot comment more fully on this aspect until the details of the cash requirement have been published for discussion.

## MONETARY CONTROL

The opportunity to comment on the joint Treasury-Bank of England Green Paper on monetary control is welcome, both because of its importance for economic policy and because, combined with the Bank of England's proposed liquidity requirements, it is likely to be a major determinant of the shape of the financial system over the next decade.

### Two General Points

Two general points can be made. The Green Paper concentrates on problems of short-term monetary control. Short-term fluctuations in money supply growth do not in themselves pose a threat to anti-inflationary policy, and there is a danger that efforts to control monetary growth - and particularly the growth of the wider monetary aggregates which react more slowly to policy changes - on too short a time-scale would be counter-productive. In particular, the proposal to alter interest rates in line with weekly movements in sterling M3 appears inappropriate.

Secondly, it is clear from the Green Paper that the authorities wish to retain a large measure of control over interest rates, either by discretion or according to a predetermined rule. Effective short term control of the money supply probably requires a greater willingness to allow the level of interest rates to be decided by the markets.

### Proposals for monetary base control

The practical objections raised to a system of monetary base with a mandatory relationship between base and deposits (Sections 4.10-4.16 and Appendix B) are convincing. The use of a more informal system of monetary base control, combined with targets for sterling M3, should not, however, be ruled out.

The advantages of monetary base control are that the monetary base is under the direct and immediate control of the authorities and that it is less open to distortions than are wider monetary aggregates. Control of the



monetary base (provided that there is not a mandatory ratio between base and deposits) would permit short term fluctuations in the wider monetary aggregates while providing some assurance that they are only temporary.

Monetary base control would require a willingness by the authorities to accept short term fluctuations in interest rates, and the Bank of England's lender of the last resort facility would have to be available only in the last resort. It is reasonable to expect that interest rate fluctuations would be reduced as the market becomes used to the new system and operators learn to iron out fluctuations which they perceive to be temporary. Any change to a system of monetary base control would involve a difficult transitional period requiring continued support from the authorities.

#### Indicator systems

The intention of an indicator system, whether related to the base or to Sterling M3, is presumably to depoliticise interest rates changes. We suspect that the frequent opportunities for the use of the official override that could be expected with a system based on weekly figures would make interest-rates charges more, rather than less, sensitive politically. As the Green Paper notes, the scale of response to deviations from the monetary target would be arbitrary; there is thus little reason to believe that the system would be an effective means of short-term monetary control.



h u m c c

MCC(80)42

29 September 1980

COPY NO 7

HER MAJESTY'S TREASURY  
MONETARY CONTROL CONSULTATIONS

COMMENTS BY THE INSURANCE COMPANY ASSOCIATIONS

Note by the Secretaries

The attached, somewhat inconclusive, comments by the Insurance Company Associations is circulated for information.

M L K W ROOP

M L WILLIAMS

H M Treasury

INSURANCE COMPANY ASSOCIATIONS

RESPONSE TO THE CONSULTATION PAPER ON MONETARY CONTROL (CMND.7838)

The Insurance Company Associations appreciate the invitation to respond to the Consultation Paper on Monetary Control, published by HM Treasury and the Bank of England in March (Cmnd.7838). We are fully aware that the success or otherwise of official actions in the area of monetary policy is of major importance to our members, both as investing institutions and as business organisations sensitive to the pressure of costs. We therefore strongly support efforts to improve the mechanisms for monetary control. However, bearing in mind that many issues of monetary theory and policy are unresolved, we are not close enough to a conclusion to express firm opinions on the direction of possible changes in the control mechanisms. When consultations on the Paper have progressed further, we should be happy to discuss any implications which may arise for the longer-term capital markets, particularly as regards the management of the gilt-edged market.