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PART 5

15/4/1981 – 30/6/1981

Pages 75-94

NOTES ON MONETARY BASE CONTROL - THE PRESENT SITUATION

1. Since November 1980 there has been no rule for interest rate control and open market operations. The general procedure has been to sell as many gilts as the market will take, but this is at prevailing interest rates. We are not moving interest rates in order to control any monetary magnitude. In short there is no monetary control. We are responding to the demand for money and not determining its supply.

Monetary Base Control

2. There is no reason why we should not attempt to control the monetary base of the system. Since M_3 is influenced, but certainly not determined by, the sales of gilts to the non Bank private sector, there is no reason why this policy should not continue alongside the system of monetary base control. In this control system we are only concerned with the liabilities of the Bank of England in the form of cash held by the public, cash in bank tills and bankers' deposits. There does not seem to be any marked inconsistency between controlling these liabilities to some specified 5% growth rate, on the one hand, and pursuing existing policy of selling gilts in order to influence the path of M_3 on the other. Thus monetary base control is entirely consistent with the present control mechanisms used in medium term financial strategy.

cp: that the recent monthly figure is well above this. So at least S.A.
[illegible]

The Disadvantages

3. It is thought that the main disadvantage would be the fact that interest rates will oscillate more than under present conditions. But this depends very much on the monetary base policy pursuit. If we try to keep a growth path day-in day-out of 5%, there certainly will be marked oscillation, but if instead we are concerned with growth over much longer periods, say six months to one year, then there is no reason why there should be induced liquidity crises of this nature.

/In fact we

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In fact we should make it clear that the day-to-day operations of the system are concerned with supplying adequate liquidity to the banking system. The control of growth rate at 5% per annum would be over a period longer than six months and probably about a year in duration.

12 May 1981

MR MIDDLETON

cc Mr Britton
Mrs Lomax
Mr Turnbull

MONETARY BASE CONTROL: WHERE NOW?

I hope that we can send Mrs Lomax's paper with this title to the Bank, even if you do not want to show it to Professor Walters at this moment. It strikes me as an excellent paper and it would be a pity to waste it. It would be interesting to discuss it with the Bank, perhaps during the follow-up to the meeting you have arranged for next Tuesday. If, as seems likely, they agree with it, it would come in useful in relations with No 10 at a later stage.

NM

N MONCK
15 May 1981

Mr Monck,

I did not mention this at the meeting but I agree that you should take it as part of your discussions with Mr George.

PEM 19/5

cc Financial Secretary
Sir Douglas Wass
Mr Ryrie
Mr Burns
Mr Mountfield
Mrs Lomax
Mr Turnbull
Mr Pirie
Mr H Davies
Mr Ridley

MR MIDDLETON

MONETARY CONTROL: NEXT STEPS

The Chancellor was grateful for your minute of 14 May, and the paper prepared by HF3 which was attached to it. He welcomes the progress made so far, and suggests that we should aim to have a further round-up on where we are and where we should go before the summer Recess. If the Bank show any signs of dragging their feet in the meanwhile, he will be ready to take the matter up with the Governor. He wishes to be in a position to make a report on all this to the Prime Minister before the summer holiday .

JOHN WIGGINS
18 May 1981

929/6

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

18 May 1981

N Monck Esq
H M Treasury
Parliament Street
London SW1P 3AG

Dear Nick,

Your letter of 10 April raises questions on various aspects of monetary control.

On the future of MLR (your paras 2-4), I will write to you separately after further discussion here. As you know, it would in my view be prudent to make the institutional changes proposed in "Monetary Control: Next Steps" and to have had some experience of operating in the money market under the new arrangements before MLR is suspended or abolished so that if, before we have had further discussion about this, you feel you must prepare Departments for the possible abolition of MLR (your para 5), I suggest that you avoid giving the impression that it will inevitably happen in the immediate future. Where you are being pressed for advice - as I believe is the case in respect of a Ministry of Agriculture Standing Order which is about to be amended and which currently contains a reference to MLR - perhaps the best option would be to find a market interest rate suitable to their purpose and suggest they use that. There need be no presumption that what you recommend here sets a precedent for all other cases.

In paragraph 7 of your letter, you raise a number of points about information needs. With respect to daily reports by us on money market conditions, you now have Tony Coleby's letter of 16 April to Andrew Turnbull on what we intend to put out daily via Reuters. This will in fact be fairly comprehensive, but if you find there is more you need we can of course discuss this.

You now have a mock-up of the monthly report we propose for the Ryrie meeting, on which we would be happy to receive any suggestions you may have.

Our daily information on the gilts market (also your para 7) has already been augmented on the lines you requested.

Para 8 of your letter asks "for a definition of the changes which the new arrangements are intended or expected to bring about and of the terms in which these changes might be measured". I confess that I have some difficulty with this - especially with respect to measuring the changes - as I tried to make clear at one of our meetings back in February.

The reasons for making the changes in our money market arrangements which are now in train were set out in the paper which the Bank prepared in response to the Prime Minister's request in October. I enclose a copy of that paper which, I believe, still reasonably reflects our view.

We have had two main things in mind.

The first is to allow market pressures to have a greater influence than hitherto upon the term structure of short-term interest rates. In the past we have, as you know, often found ourselves in the position where we were seeking (through seven-day lending or through a refusal to follow the market with our own dealing rates) to influence three-months interest rates, particularly as reflected in the Treasury Bill tender, in order to avoid the level of MLR being called into question. Under the proposed new arrangements we would hope to avoid having to interfere to the same extent at the longer end of the money market.

Secondly, and partly because of the greater scope for market forces in determining longer-term money market rates as above, we hope to be able to bring about appropriate changes in the general level of short-term rates - in accordance with the undisclosed band at the very short end - more smoothly than in the past. The point here is to seek to avoid the market hiatus that can develop in

anticipation of (sizeable, eg, 1-2%) changes in MLR and which can cause pressure for a larger move than might otherwise be judged appropriate. At the same time we hope that the new arrangements might help to ease the political tensions that surround decisions on MLR.

Essentially what we are seeking to achieve is an arrangement that will allow changes in short-term interest rates to be brought about more smoothly than hitherto, and we will only be able to judge how successful we are in achieving this in the light of our experience in the particular circumstances at the time.

A likely consequence of the changed arrangements that we have envisaged is that the banks would tend to price their loans more flexibly, which would hopefully reduce the scope for round-tripping. But it will be for the banks to decide how their lending practices should evolve in the new environment.

Finally (your para 9), you now have, from John Fforde, a report of the monetary control negotiations so far. We will keep you up to date on developments here and let you have a draft of our definitive proposals when it is ready.

Yours sincerely,

Eddie.

INCREASING THE FLEXIBILITY OF OFFICIAL OPERATIONS IN MONEY MARKETS

The Bank have prepared a technical paper (attached) describing the possibilities for introducing more flexible official operations in the money markets. This note is in part a summary, but its main purp is to illustrate the steps that would be necessarily involved in taking this approach.

Feasibility

It would be possible to move cautiously from a system where the authorities maintain an adjustable peg for short-term interest rates, by setting MLR, to a system in which they floated much more freely. But inevitably the direction and momentum of any such float would be quite largely determined by the readiness with which we provided the system with cash, whether by open market operations or through the 'discount window'. So the system would be a 'dirty' rather than a 'clean' float, unless or until the discretionary element in official operations could be reduced or removed.

Market Involvement

Despite the disappearance of MLR itself, markets would continue to look for clues to the authorities' intentions, and the movement of very short-term interest rates would still be seen as largely the consequence of official actions. But there might develop more room than now for the rates for longer-term money, three months and over, to reflect market judgments about the level of rates needed to secure official objectives.

Institutional Change

Were we to embark on official operations in the inter-bank market, the size and central position of the big four clearing banks would be likely to involve us in daily negotiations between us and them. This would run quite contrary to the aim of allowing a free and open market more say in the determination of rates. It is largely in pursuit of that

921/5

aim that the Bank sees a need for the retention of market intermediaries, notably the discount houses.

This has several consequences. First, it implies that the Bank's open market operations should continue to be conducted in bills, including both Treasury and Commercial Bills, rather than in the inter-bank market. Second, it suggests that it would be wise to go on confining access to the discount window to the discount houses, albeit at a floating and "penal" rate. Third, the Bill markets would be required to adapt efficiently to new conditions in which the Bank operated at much more flexible rates. This adaptation would take time and care.

Operations

If the system sketched above were adopted, whether in practice as a transition to monetary base control or not, the important policy question would be how to set the guidelines for operating it. There must, of course, be a strong presumption that any persistent deviation of the money supply from its targeted path would require us to operate so as to encourage interest rates to move in the appropriate direction; and a key question for decision would be how quick and how large such moves should be, and whether any surrounding circumstances (other than the money supply) should be taken into account. We would also need to decide the upper and lower limits (if any) needed to prevent an excessive change in interest rates. There would be a strong case for not announcing such limits, partly to keep banks uncertain of the future cost of their money and partly to avoid, de facto, reintroducing a peg.

Supply Side Controls

It is often said that a "supply side" constraint on banks' cash would have an effect different in kind from a change in interest rate as such. But in a fully competitive system, which ours is, any sing bank will always reckon to be able to attract extra reserves by bidding for them in the market. Thus a limitation on the quantity c cash would impinge on an individual bank in the form of a change in the price of cash rather than of some outright shortage or famine.

But the _expected_ future price of cash can be made more variable and less predictable. Greater flexibility of official operation in the money market could help achieve this. This would in turn cause _some_ changes in banking behaviour. There would be some helpful readjustment of the overdraft system. But in our view, based on lengthy consultation, such changes in behaviour would not be far-reaching in their helpful effects.

Cash Ratio

If it were to be decided to move towards a _non-mandatory_ base control, the prior introduction of a more flexible interest rate system with a managed float would represent a necessary and coherent first step. There would then follow a long period of transition. In the light of experience the guideline for the float might gradually be changed so as to concentrate upon a target for the base itself. Likewise, the limits on interest rate movements could be steadily widened if that were found in practice to be desirable.

A _mandatory_ base control relates the base by some required ratio to an aggregate money supply; and the purpose of having such a base would be to enable the authorities to respond to deviations of the money supply from target with a sizeable and automatic adjustment in interest rates.

We could operate a more flexible system with our present cash base or with one of the same kind spread more evenly between the banks. This would imply a very low ratio but there might still be some difficulties in learning sufficiently about the behaviour of a fully non-mandatory base.

We see no advantages in maintaining the present Reserve Asset Ratio and advocate its abandonment as soon as discussions with the banks, regarding the prudential need for liquidity, are complete.

Bank of England
14 November 1980

INCREASING THE FLEXIBILITY OF OFFICIAL OPERATIONS IN MONEY MARKETS

A Introduction

1 At the seminar with the Prime Minister on 13 October, the Bank were asked to explore ways in which their present discount window operations[1] could be modified, and the Reserve Asset Ratio replaced, so as to permit a greater flexibility in short-term interest rates which was generated as far as possible by market forces.

2 This paper first outlines the main features of the present system (Section B). The changes that would be necessary, together with the implications of particular options, are the subject of Section C. There follows, in Sections D and E, consideration of how far the changes might:

(a) affect the rôle of the authorities in influencing interest rates: and the motivation of their operations;

(b) alter banks' behaviour in ways helpful to monetary control;

(c) facilitate evolution towards a form of monetary base control.

3 Because it is generally agreed that the Reserve Asset Ratio (RAR) should be abolished, the analysis which follows assumes only the existence of some prudential guidelines regarding banking liquidity. The nature of these prudential guidelines is not explored in this paper. Following the outcome of the present review of monetary control, discussions within the banks about the consultation document on banking liquidity, issued last March, will need to be brought to completion.

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[1] The phrase "discount window operations" is used in this note to describe the sort of facilities currently offered by the Bank to the discount houses at 2.30 pm each day: these generally involve the Bank in supplying funds on request at MLR. They are to be distinguished from loans to institutions in financial difficulties, which are genuinely last resort loans, and also from assistance which is applicable only under the present Reserve Asset system and involves the Bank in swapping reserve for non-reserve assets to limit upward pressure on short-term interest rates.

B The present system

4 The present system can be likened to an exchange rate regime of the "adjustable peg" variety. MLR is fixed by the authorities; certain key interest rates may diverge from it but in response to sustained pressure the Bank has the choice of intervening to validate the level of MLR (the peg) or of adjusting it. Continuing the analogy, the changes being sought would amount initially to a form of "dirty" floating in the money markets: dirty rather than [illegible] because, as is explained later, official operations would have to continue being both active and discretionary rather than automatic.

(a) Minimum Lending Rate

5 MLR is the rate at which the discount market expect to be able to borrow from the Bank at 2.30 pm under the discount window provisions. When these facilities are used, the Bank usually lends overnight but on occasion offers funds only for seven days.

6 The effect of such lending is to inject cash into the system; and the fact that the discount houses can obtain funds at MLR provides some anchor for short-term rates generally. But, as recent experience has emphasised, it is quite possible for overnight rates in the interbank market to go some way above MLR before 2.30 and far above MLR later in the day. The present system does not, therefore, invariably protect the banks against the risks of volatile rates at the very short end of the market.

7 The influence of MLR is most powerful in the setting of very short-term rates by the market but it also affects slightly longer rates. This is because operators take the level of MLR and the associated tactics used by the authorities as saying something about official intentions for the future. For example, whenever MLR is raised three-month rates tend to reflect the new level fully, because the market have come to expect that a rise in MLR is unlikely to be followed by a fall in less than, say, 8-12 weeks.

8 Clearly the determination of short-term interest rates could be significantly different if MLR could be made to "disappear". But it is also clear that, deprived of one source of information about official desires and expectations, money market operators would look for another, and would expect to find it in the conduct of our open-market operations.

(b) Open market operations and the cash ratio

9 Two features in the present system complement discount window operations. The first is the cash ratio of 1½% Eligible Liabilities (ELs) which applies only to the London clearers. In the language of the MBC discussions, this is a form of cash requirement based on lagged accounting. There is no absolute obligation on the banks to reach a particular target balance at the Bank on any one day. A degree of averaging is allowed.

10 The second feature is the conduct of open market operations. Changes in the banks' cash will depend in the first instance on net flows between them and the Bank arising mainly from the transactions of the Exchequer and from movements in the note circulation. The Bank normally seeks to offset such flows, wholly or in part, through open market operations. These are usually conducted in Treasury, Local Authority, and Prime Commercial Bills (the Bank offering to deal at existing market rates rather than to move them up or down). The principal counterparties to the official operations are the discount houses, although Treasury and Local Authority Bills are also traded directly with the banks. It is by declining to buy paper to the full extent of the shortage of bankers' cash, and thereby causing the banks to withdraw call money from the discount houses, that the Bank can ensure that the discount window will be used. This provides the opportunity to exercise a desired influence on interest rates and is known in the literature as "making Bank Rate (MLR) effective". The discount window may however also be used if the market prefers, on a commercial judgment, to borrow at MLR rather than offer enough paper to the Bank.

11 It is normal official practice to engineer an initial position of moderate cash shortage week by week. This may be done if necessary by increasing the quantity of Bills offered at the weekly tender and relying on the obligation undertaken by the discount houses to bid for the whole amount.

C Options for Change

12 One change has already been assumed, namely the disappearance of the Reserve Asset Ratio. This Ratio did not feature in the above description of the present system because it is neither necessary nor efficient as an instrument for the control of short-term interest rates. It has however affected the operation of the money market and its disappearance would affect the environment in which open market operations are conducted.

13 The outcome will depend significantly upon the final form of the prudential guidelines on banking liquidity. But the most important effect now foreseen will be to release the banks from the obligation to hold a minimum quantity of, for example, Treasury Bills and call money. Hitherto the effect of the RAR has been to keep yields on reserve assets stable and relatively rather low even when pressures on other rates are strongly upwards. With the abolition of the RAR, banks would be much freer to reduce their holdings of call money and Bills at times of stringency. The differential with, for instance, comparable inter-bank rates would accordingly be more stable; and it would need to narrow considerably if call money and Bills were to continue to be held by the banks on the present scale. Such a narrowing of the differential might come about relatively eas in the Treasury Bill market but how in the new circumstances holding of call money with the discount market - which in recent experience has provided a higher yield than Treasury Bills - would be adjusted is more problematic. The ability of the discount houses to accommodate periodic large fluctuations in the volume of call money would depend on the general level of the banks' holdings, the relationship between the call money rate and the yields on other mon market assets, the degree of volatility in those yields, and the nature and terms of their access to the discount window at the Bank. These matters are discussed further in paras.16-27 below.

14 Apart from the abolition of the RAR, the options for change concern

(i) the form of the cash ratio,
(ii) the nature and operation of discount window facilities, and
(iii) the structure and conduct of open market operations.

15 The question of the cash ratio is closely related to the form(s) of monetary control system that it is desired to adopt or to make available for ultimate adoption. If a non-mandatory form of monetary base control is to be made available, it will be necessary to operate for a considerable period with no cash holding obligation whatsoever for the banks, in order to learn what their purely functional demand for balances is. Mandatory forms of base control would require the cash holding obligation to be related as closely as possible to the monetary aggregate (if it were other than the base itself) in terms of which the targets were to be set. It is well established that, because of the scope for disintermediation, no workable relationship can be found with broader monetary aggregates such as £M3. If any narrow aggregate other than M1 is to be considered, it would be necessary first to discover the characteristi of the aggregate, and unwise to construct a cash ratio related to it until they had been found to be suitable. If all that is required is - as hitherto - a fulcrum against which to operate a policy based an intermediate interest rate target, the choice is wide. A fulcrum would exist with no obligatory cash balances at all, provided the penalty for being overdrawn was sufficiently deterrent; but if a requirement were to be retained, for other reasons, its form should reflect considerations of equity between banks and the need to avoid generating widespread disintermediation as a means of escape from it. Further consideration is being given to these questions in the light of very recent discussions between the Chancellor and the Governor.

16 Greater flexibility through open market operations and discount window facilities. Discussion of the discount window may be considered first. In the present system MLR serves as an anchor for short-term interest rates because market operators have a presumption that cash will be made available at that rate. The necessary condition for initiating greater flexibility in rates is to remove th presumption. It could be done in a variety of ways. It might, for example, involve -

(a) no more than the exercise of the discretion which the Bank already has in principle to lend at rates above the posted MLR - while otherwise retaining the present arrangements; or

(b) the complete abolition of MLR, with lending through the discour window provided only at rates varying from day to day and designed to be penal in relation to those earlier established in the market.

On technical grounds, the one option that is not available in a syst retaining either obligatory bankers' cash balances or normal volunta holdings thereof is the abolition of discount window facilities. Bu a combination of unattractive discount terms and active open market operations could minimise their use and eliminate their abuse.

17 If option (a) above were adopted, it would remain evident that the authorities rather than the markets were dominating the setting rates. If we attempted to create uncertainty about the rate at whi the discount window would operate, the market would act to remove th uncertainty by testing the rate. If the authorities behaved consistently in setting the rate, that would in effect set a new level of, or a new formula for calculating, MLR. If, on the other hand, the choice of rate were deliberately capricious, markets would simply become confused, so that the setting of interest rates became a haphazard process.

18 If instead option (b) above were adopted, and if MLR were actually abolished, this would shift onto the conduct of open market operations both the expression of official influence on interest rates and the attempts of the market to discern what the official intentions were. This may best be illustrated by comparir how in such circumstances open market operations might be undertaken first when the existing level of rates was regarded as satisfactory, and secondly when some upward movement was regarded as necessary.

19 In the first case (maintaining an existing level of rates), th object would be to maintain the level of bankers' cash consistent wi prevailing interest levels. If the market and the Bank took the same of the likely cash movements in the day, the Bank could readily buy

sufficient paper at prevailing rates to achieve the desired level of cash. This could be effected, as now, by the authorities inviting offers of paper at existing market rates and accepting what was offered. It could also, in principle, be achieved by the authorities making known the quantity of paper they were prepared to buy, and accepting the most favourable offers. The latter approach, which would require some development of our dealing techniques, would detach the authorities to some extent from appearing to set rates and, for that reason, would be preferable. But there would remain a need to take decisions involving at least implicit judgments about the level and prospective future developments of interest rates. In deciding which offers to accept, the Bank would have to choose between different maturities of paper, each probably offered at a different rate. The decisions reached would be eagerly studied by a market looking for indicators of official thinking.

20 In the second case, when some upward movement in rates was desired, the object would be to leave banks with less cash than they wanted at ruling interest rates. The market would then find themselves trying to sell more paper than the authorities were offering to buy and interest rates would tend to rise. Anyone unsuccessful in obtaining cash for his paper would then have to bid for it within the market, failing which he would have to take his chance at the discount window.

22 A vital assumption underlying the above description of a new style of open market operations was that the market's perception of the position on the day accorded with the official estimates. In the present system official estimates are frequently revised heavily during the day and still prove wrong in the event. Equally often, money gets 'stuck' somewhere within the banking system and its availability is unknown to the money markets. More resources could be devoted to improving information systems, but unpredicted influences on banks' cash would probably continue to be large in relation to the tolerance levels within which the new style of open market operations would be seeking to exert its influence. This means that the new technique would be a less precise means of bringing about a new level of

market interest rates than that of simply varying MLR. It also means that there would be some risk of market forces, under the influence of erratic shocks, producing needless gyrations in short-term interest rates. This risk could be met either by use of an unpublished ceiling rate at which the discount window operate freely, or by ceiling (and floor) rates at which open market operations were undertaken freely.

22 Some economists, commenting upon the corresponding practical problem envisaged with MBC systems, argue that variability in very short-term interest rates does not really matter, because over time markets learn how to distinguish genuine underlying influences on rates from the effects of random shocks. It does matter, howev if rate variability impairs the operations of short-term markets an makes it harder to conduct official open-market operations of the necessary size. Whether markets would be impaired in practice is difficult to judge; it would depend on how the system operated and what institutional developments there were It is, for exampl likely that we would have to give up the practice of engineering recurrent shortages of cash by "over-issuing" Treasury Bills throug the weekly tender. If so, it would be important that the market was functioning well enough to permit us to withdraw cash at once by selling Treasury Bills, because the market's starting position would be one of underlying cash surplus much more frequently than it is now.

23 The health of the money market in its present, or a new, form is of major importance if we are to have the scope for sufficient official open market operations in the existing Bill instruments. It was indicated in paragraph 13 that the disappearance of the Reserve Asset Ratio would pose significant problems of adjustment for the discount houses. It is highly doubtful whether they would the same time be able to withstand the additional load of being the vehicle through which an erratic variability in market interest rates was generated on a pronounced scale. If, in response to

such pressures they were to become only brokers in bills rather than dealers and market-makers, it would become a good deal less certain than now that official operations could be undertaken on the scale necessary to permit the desired management of banks' cash balances. Much greater weight might then have to fall on discount window lending, probably to banks directly.

24 If nonetheless the changes in fact encouraged the growth of an active market in Treasury Bills, including both banks and non-banks, the future role of the discount houses would be relatively less important. It was suggested in paragraph 13 that the banks might continue to have large - though compressible - holdings of Treasury Bills provided the supply was maintained at a sufficiently high level to preserve a reasonably attractive yield. It is questionable, however, how ample a supply could be maintained if Treasury Bill operations are to remain the residual means of financing the public sector, with the main emphasis placed, for reasons of control over £M3, on sales of debt to non-banks. Further, the only possible way we can see of persuading non-banks to prefer Treasury Bills in large amounts to CDs or bank deposits would be to engineer a steep increase in the supply. But in those circumstances, the banks would have a powerful incentive to intermediate by increasing deposits so as to hold more Bills, and the more likely outcome of an attempt to encourage non-bank holdings of Bills by this route would be to raise £M3.

25 It would accordingly be unwise to rely completely on Treasury Bills as the instrument for official open-market operations. Some form of private sector paper would therefore be needed as well. At the moment commercial bills are used. They have the desirable quality of being the most secure form of private sector paper - which explains their historic place in central banking operations. But their availability, in quantity, depends on the existence of market intermediaries to gather them together, a function currently performed by the discount houses.

26 If there were no ready market in prime commercial bills, the remaining vehicle for open market operations would be deposits with banks, either by our dealing in CDs or by our making straight deposits in the interbank market. There is no doubt that adjustme involving large sums could be undertaken by those means. But they would have two great disadvantages. There is first the presentational problem, already encountered with the existing gilt repurchase transactions, of supplying official funds directly to banks at times when their lending may appear to be contributing to difficulties in achieving the official monetary target. The second and more substantive disadvantage arises from the dominance in the inter-bank market of the operations of the clearing banks. Official provision, when necessary, of large amounts of cash would automatically coincide with large shortages to be met by three or four massive counterparties. Any structure of market rates that resulted would be inevitably the product of bilateral haggling, and would reflect the degree of official hard-headedness rather than a free market process of rate-determina Development of that process therefore requires the retention of intermediary market-makers between the giant principals on either side.

27 All this leads to the conclusion that in starting down the ro towards greater responsiveness of interest rates to free market forces, we should be careful to nurture rather than undermine the market mechanisms through which we can operate and through which the resulting market pressures can influence interest rate developments. That would imply retaining - but perhaps progressiv widening - intervention points in open market operations, and a discount window safety valve which would continue to be available to the market intermediaries. The pace at which our intervention points might be widened would depend on how successfully market rates floated freely within them, rather than bouncing around in a random way between floor and ceiling.