1. Monetary Base Control III

4/11/1980

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cc Mr Ryrie
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MONETARY TARGETS AND MONETARY CONTROL

1. We may not have seen the Bank's papers before the meeting with the Governor on Thursday. But there are two Treasury papers:

a. Mr Monck's minute on the roll over of the target

b. Mrs Lomax's minute on next steps towards monetary base control.

2. The presentational problem is: what do we say on these two subjects in late November and what do we leave for the Budget? We have to say something on both in conjunction with the Industry Act forecast, and possibly in close proximity to a reduction in interest rates to help companies.

3. The substantive problem is that with the present forecast for the PSBR this year and next, a natural uncertainty about what might be possible in the Budget, and the growth so far experienced in the money supply during the present target period, all the options for rolling the target forward are difficult. And with the possibility of having to risk a reduction in interest rates it is not too easy to announce moves to improve the system of monetary control which in present circumstances would indicate a move in the opposite direction. Current worries about the exchange rate compound these difficulties.

4. In these circumstances major moves must await the Budget. We can then reset the annual target, and relate it to the MTFS which can itself be reassessed at the same time. Effective changes in the system of monetary control can then be made against the right sort of background - one in which we have reformulated the strategy and its main components, rather than at a time when it is out of balance and when the strains on interest rates are too great to allow much of a role to the market.

5. To carry conviction and maintain confidence, what is announced in November must be a clear step in the direction of re-establishing

iv. The Bank could also then carry forward their discussions on prudential control. It is clear that any liquidity norm, to be consistent with a new method of control of the sort outlined, would have to apply to both primary and secondary liquidity combined. But the main thing is to put new force behind the consultations following a decision in principle on the sort of control system we might wish to adopt.

v. It should also be possible to say that changes in the Bank's lender of last resort facility will need to accompany effective changes in the system of monetary control, but that these will not take place until the new cash ratio is in place. After that there would be a gradual widening in the margins within which interest rates moved as the authorities direct increasing attention towards controlling the base.

c. This could be further bolstered if we could say more about our intentions on marketing tactics and funding. It might be possible to say more about:

i. National Savings. A note on the next stages in indexed National Savings is being prepared in HF. This would be a popular move. It directs funding towards the personal sector at some risk to the mortgage rates. If it was decided to bring down MLR, these risks would be greatly reduced.

ii. A restricted indexed gilt. Work on this is practically complete. It would be another moderate step in the direction of exercising more effective monetary control. It would be sold by tender and thus would introduce a method of directly influencing the quantity of debt sold into the gilt-edged armoury.

iii. New methods of gilt funding. The announcement of more aggresssive tactics would help but indications are that the Bank would still oppose this. It remains essential if a MBC type regime is to be associated with controlling one of the wider aggregates.

This note describes the minimum changes to the present system of control that would be needed to give the authorities the option of allowing the market a greater role in the determination of short-term interest rates consistent with the Government's wider objectives for monetary growth. The papers for the Prime Minister's Seminar suggested that this means, in practice, moving in the direction of monetary base control. The note also considers what further steps would be involved in a transition to the fully fledged illustrative MBC scheme outlined in Annex I to the main paper, and how far along this road it would be sensible to go before taking and announcing a firm decision in principle to move to MBC.

The present system

a) Reserve asset requirement

2. Would it be possible to avoid institutional upheaval simply by operating the present system differently? For example, the authorities might have an eye to reserve asset growth in determining the movement of short-term interest rates, or they might use the existing reserve asset requirement deliberately to squeeze banks' liquidity, in the hope that this might affect the way they manage their portfolios (including lending to the private sector). Some of those who have criticised the amount of assistance the Bank has provided this year to enable the commercial banks to meet the reserve asset requirement clearly think this is a real option.

3. The arguments which are used against a more aggressive use of the reserve asset ratio are:-

(i) the authorities cannot control the supply of reserve assets. As currently defined they embrace assets which are also held by the non-bank private sector including claims on the private sector. Indeed, the banks themselves can create reserve assets by issuing CD's and placing the funds thus obtained at call with the

16/3/10

Sticky base rates would of course cause the same problems under MBC. The definition of the denominator might be changed - though it would not be sensible to make a major change in the control total without also moving away from £M3 as a target variable.

5. It is difficult to reach a firm conclusion one way or the other. The precedent of 1972-73 is not encouraging, though a similar experiment now might stand a better chance of success, given time. But this is clearly highly uncertain; and there must be a significant risk that more aggressive use of the RAR would make short-term monetary control worse, not better. It should be noted that, insofar as short-term interest rates become more volatile, the need for institutional change would not be completely avoided. Changes in the overdraft system, for example, and implications for building society behaviour, are the result of more flexible interest rates, rather than the direct result of particular changes in the way the authorities operate.

6. There are other problems with the RAR. The status of Treasury bills as a reserve asset is often said to inhibit the development of a broader market in short-term debt. The prospects for short-term monetary control (albeit of a rather cosmetic nature) would almost certainly be better if there was a short-term debt instrument which appealed to non-banks. However, depriving Treasury bills of their reserve asset status may be neither necessary nor sufficient to bring this about.

7. The Green Paper has however established a clear presumption in favour of the abolition of the RAR.

> "It is therefore proposed, irrespective of whether it is decided in due course to introduce any of the changes discussed in Chapters 4 and 5 to end the requirement to meet the RAR." (para 3.9).

Nothing that has happened since this was written provides much justification for reversing this judgement.

This is tiny in relation to short run fluctuations in some of the counterparts to the base; daily swings in the CGBR for example can be as much as £500 million. Arguably, if banks hold surplus cash, the margin of excess holdings is more important than the size of the required ratio. Even in this case however, the ratio is important in determining how swings in the base translate into required changes in bank deposits. With a 1½% ratio, for example, a £100m change in the base signals the need for a £7 billion change in deposits or thereabouts: with an 8% ratio, the required deposit change is only £1¼ billion. For this reason our illustrative scheme assumed a ratio somewhere in the region of the old 8% cash ratio. This would be consistent with a base of several billions. (These arguments are set out more fully in the Annex).

(iv) <u>the denominator of the ratio is eligible liabilities</u>, a measure which is clearly inadequate as a control total, chiefly because of the scope for disintermediation it offers. Moreover, while it is a close approximation to £M3, it is of course not identical to this or any other measure of the money supply.

(v) <u>there are no financial penalties on banks for failing to meet the requirement</u>. As long as cash is not rationed, there is no real need for sanctions. This could change if the ratio were to be used more aggressively. (The clearers agree to observe the target on average during the month though they are expected to aim to achieve it each day.)

aggregate, when we had it, would not be leakproof, if it was used for control purposes, though offshore disintermediation is unlikely to be a serious problem.

12. The alternative is to abolish the present cash requirement and not to replace it. This could foreshadow a move to non-mandatory MBC. The authorities could still allow short-term interest rates to be generated as a by-product of controlling the monetary base. The risk, once again, is that market-determined rates would not ensure effective monetary control - though in this case, the risk arises from an unstable and initially unknown demand for cash on the part of the banking system rather than from the possibility of disintermediation.

Moving to more flexible interest rates

13. Once the RAR were replaced by a single secondary prudential norm, the cash ratio either abolished or modified as suggested in para 11, and possibly some new source of income found for the Ba further changes would depend on the authorities operating in a new way. At present the Bank influences short-term rates by announcing the rate at which it is prepared to lend to the discount market and backing this up through its operations in the money market. The discount market's agreement to underwrite the weekly Treasury bill tender, whatever its size, enables the Bank to engineer a shortage of cash, given the likely scale of cash flows between the banking system and the authorities. This shortage can only be relieved by the system as a whole either borrowing from or selling assets to the Bank through the medium of the discount market. This assistance can be given in a number of forms; that is, the Bank can choose the type and maturity of the assets in which it deals. Thus the terms on which the Bank assists the discount market enables it to influence a range of short-term interest rates.

17. Arrangements for selling Treasury bills would almost certainly have to change. The discount market's agreement to underwrite the weekly Treasury bill tender might not long survive the changes to the operation of lender of last resort facilities. To the extent that the authorities attempt to control the monetary base, they will need to develop considerable flexibility in conducting open market operations. At a fairly early stage, then it might be both necessary and desirable to drop the weekly tender and adopt new arrangements for dealing in Treasury bills probably on a daily basis.

18. Whether and when the discount market disappears, as a result of all these changes, is difficult to predict. There must be a good chance that the houses will find some other outlet for their expertise. To some extent, the outcome will depend on whether the Bank gives permission for them to be taken over.

19. As interest rates were allowed to fluctuate more at the short end, other changes would become necessary or would follow of their own accord. For example, as the authorities' influence on short rates diminished, both in appearance and in reality, there would have to be changes in current techniques of marketing gilt edged securities. Methods of influencing long rates directly, rather than through the medium of short rates, would have to be developed. Once Treasury bills lose their reserve asset status, the authorities may find it easier to control the money supply by selling Treasury bills to the non bank private sector. However, there is no guarantee that a non-bank market in Treasury bills will evolve naturally. Treasury bills would remain a natural dealing medium between the Bank and the commercial banking system (though not the only one); and this may give the banks a continuing special interest in holding them.

20. Other institutional changes which may occur in response to more volatile interest rates are essentially at the initiative of the private sector. Changes in the terms on which banks and other financial institutions lend (eg. changes to the overdraft

an object lesson. On the other hand, failure to make it clear to the private sector what the authorities' intentions are may compromise the success of whatever changes are envisaged. For example, a move to more flexible interest rates, even short of fully fledged MBC, can be expected to work better if the private sector adapts its behaviour (eg by ensuring that all short rates are allowed to fluctuate, not just some, by modifying overdraft arrangements, by building up precautionary holdingsof excess reserves). If the authorities are deliberately coy about the changes they are trying to bring about, either as a matter of policy, or out of indecision and lack of resolution, monetary control may be made more not less difficult than it is at present.

STEPS TO MONETARY BASE (MANDATORY)

Preliminaries

Abolish reserve asset ratio and replace it by a prudential norm for secondary liquidity.

Adapt the 1½% of cash ratio: extend to all banks and LDTs
: increase its size, to at least 5%
: pay interest on bankers' balances
: consider financial penalties for non-compliance.

Find a new source of income for the Bank (if possible)

Stage 1: targeting interest rates within a band

Operating changes

(i) money market operations would be consistent with permitting a band around the rate the authorities think is consistent with the monetary targets;

(ii) open market operations would aim to leave the market with a small surplus once Exchequer surplus/deficit had been offset (instead of as now, aiming to leave the market short);

(iii) lender of last resort facilities would be provided at increasingly penal rates - at first only slightly above general level of market rates, but the gap would gradually be widened;

(iv) the Bank might also intervene directly in the inter-bank market to influence short term rates.

THE SIZE OF THE CASH RATIO UNDER MBC

1. The Annex on illustrative MBC scheme argued that three points were relevant to the design of the cash ratio:

(i) that interest needed to be paid on required base asset holdings, but not excess holdings, in order to minimise disintermediation;

(ii) that the ratio had to be sufficiently low for the base to be controlled by feasible open market operations; but

(iii) that the ratio should be sufficiently high to prevent unintended movements in base from generating strong misleading signals to the market.

There is no dispute as to the first two of these points but the third has raised questions which are particularly relevant to the present paper.

2. Arguments in favour of a high ratio turn on making the required level of the base large in relation to unanticipated swings in the CGBR. In practice these might be as large as £m500 in a day though it would average out to less over the course of a month. If we assume stylised qualifying liabilities of £m50,000, with a base ratio of 8% as envisaged in the illustrative scheme, the required base would be £m4,000. With a base asset ratio of 1½%, the same as the present cash ratio, the required base would be only £m750. Unanticipated swings would obviously have a much greater proportionate effect on the <u>total</u> base in the second case than the first.

1½% Required Base Ratio

	£m	
Qualifying Liabilities (Qls)	50.000	
Required Base	750	(i.e. 1½% Qls)
Desired Base	1,750	(i.e. 3½% Qls)
Actual Base	1,250	

Incorrect signal to Market: reduce Qls to 35714

6. Clearly in both cases, the effect of the Exchequer swing is to reduce the base by 1% of Qls below the banks' desired position. But the banks do not know that the base shortage was unintended and the incorrect signal given to them is different. In the 8% case banks are signalled to reduce their liabilities by 10% (=1% x 1/0.1): in the 1½% case the signalled reduction is some 28.57% (= 1% x 1/0.035). The moral of the story is straightforward. The lower the required base asset ratio, the greater will be the magnification into incorrect market signals of accidental movements in the base. Raising the required ratio will reduce this effect.