

4. Monetary Base Control III

Increasing The Flexibility of
Operations in Money Markets
14/11/1980

INCREASING THE FLEXIBILITY OF OFFICIAL OPERATIONS IN MONEY MARKETS

7 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 purpose 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 the

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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 rates as such. But in a fully competitive system, which ours is, any single bank will always reckon to be able to attract extra reserves by bidding for them in the market. Thus a limitation on the quantity of 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.

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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.

(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 free 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 $1\frac{1}{2}\%$ 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 easily in the Treasury Bill market but how in the new circumstances holdings 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 money 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 characteristic 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 on 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 the 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 discount 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 system retaining either obligatory bankers' cash balances or normal voluntary holdings thereof is the abolition of discount window facilities. But 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 of rates. If we attempted to create uncertainty about the rate at which the discount window would operate, the market would act to remove the 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 comparing 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), the object would be to maintain the level of bankers' cash consistent with prevailing interest levels. If the market and the Bank took the same view 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 operated 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, however if rate variability impairs the operations of short-term markets and 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 example, likely that we would have to give up the practice of engineering recurrent shortages of cash by "over-issuing" Treasury Bills through 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 at 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 adjustments
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-determination.
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 road
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 progressively
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.

D The exercise of judgment

28 Whatever the exact form of these suggested new arrangements, the judgments exercised by the authorities in running it would, at least for some time, continue to exercise a critical degree of influence over at least part of the interest rate spectrum. For the authorities' actions would be the dominant determinant of the supply of cash, and the implicit 'lending rate' set by these operations - while it might be less easily visible than the present published MLR and could certainly be operated as a rapidly moving range rather than as a set figure as at present - would be established by the market from the price at which we conducted business.

29 There might nonetheless be greater scope for independent market forces than at present in the determination of somewhat longer (say three-month) rates. Much as now, these forces could always be expected to do part of the authorities' work, in that all rates would tend to rise as soon as the market guessed that the authorities were dissatisfied or would have to become dissatisfied with the prevailing conditions. However, the longer-term effects on market expectations of a posted MLR would no longer exist and, while the market would undoubtedly look for substitute indicators, it might be possible to avoid providing a consistently reliable substitute.

30 In practice, of course, the way in which the system was operated would be heavily influenced by the wider policy aims being sought; and it would be important to be clear what the intermediate objectives of monetary policy are at any point in time. Currently, the guidelines for operating the suggested arrangements would be set primarily with regard to the achievement of annual targets for £M3. But it would be open to the authorities in the constant adaptation of their tactics, to consider a wider range of economic and financial indicators and to change the balance of particular factors over time.

E The significance of the changes

31 The conclusions of Section D are that the changes outlined in C might permit:

- (a) some extension of the influence of independent and free market forces in the setting of short-term interest rates:
- (b) the creation of a veil over the authorities' dominant influence on very short-term money rates and the reasons for changes in the day-to-day conduct of policy.

Such development might well have presentational and psychological advantages. While moreover they would seem to do little of themselves to increase the sensitivity of £M3 to changes in interest rates they might make it somewhat easier to establish the level of rates which would produce the desired growth of £M3 over an appropriate time horizon.

32 It has been suggested that the adoption of a much more flexible system would cause the banks to modify the relative importance which currently they attach to their lending as opposed to their borrowing operations, such that a worth while restraint on the availability of credit could be obtained during a restrictive phase of policy. But it remains our view, in the light of all the consultations following the Green Paper, that such restraint would be unlikely and that banks individually would continue to respond to persistent stringency by bidding for additional resources in the money market.

33 It is, however, likely that greater volatility in very short-term rates would lead the banks either to abandon base-rate related lending in its present form or else to move base rates much more readily. Indeed, if they did not, round-tripping of the kind all too familiar in the present system could become an intolerable nuisance notwithstanding the removal of the Reserve Asset Ratio. Such a change would be a desirable development[/]

[/]Other changes might well follow, for example, more frequent changes in deposit rates, with a possibly greater need for flexibility of rates offered by building societies.

and while the arrangements set out in Section C are not necessary for it to occur, they could well lead the clearing banks to adopt lending rates more closely related to market rates than at present. This would improve the control of £M3 to the limited extent of removing the short-term distortions presently caused, on occasion, by round-tripping.

34 It has also been suggested that changes of the kind outlined in Section C would significantly reduce the relative attraction of Treasury Bills to the banks, thereby making it more likely that some useful short-run smoothing of £M3 could occur because banks and non-banks could actively and easily trade in Bills with each other. The implications of the analysis in Section C are, however, not encouraging in this respect. For the banks' need for liquid short-term assets is likely to go on dominating the demand for Bills unless the supply were increased in a manner immediately damaging to constraint of £M3. Even then, there could be no assurance that interest rate relativities would thereafter generally move so as to permit regular trading in the right direction (smoothing £M3) between banks and non-banks, in response to pressure by the authorities on the system.

35 Questions regarding evolution towards monetary base control are discussed in another paper, to be circulated by the Treasury. It suffices to say here that the changes outlined in Section C would not preclude an evolution towards monetary base control of either the 'mandatory' or 'non-mandatory' variety.

Bank of England
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