Monetary Control: Detailed Arrangements Consequent on the Publication of the Green Paper 1980

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The progress of consultations on the Green Paper on Monetary Control

A Introduction

1 Since the Green Paper was published in March, written comments from the main banking associations, a number of other financial institutions and from individuals have been submitted to the Treasury and the Bank (see Appendix). In addition, there have been two open conferences at which senior officials have spoken, and two seminars organised by officials (one limited to UK participants, one drawing on overseas experience). The Select Committee of the Treasury has published an interim Report, a Working Party of EEC experts (WHMPI) drawn from central banks and finance ministries has studied the Green Paper at length and the Bank of England's Panel of Academic Consultants has also debated the subject. This note attempts to summarise the responses to date.

2 Inevitably, in what follows, there is a somewhat arbitrary choice and ordering of subject heads. The first two - the choice of target (Section B, paras 3-4) and the time horizon for control of the money stock (paras 5-6) - are perhaps clearly distinguishable as prior questions on which a particular stance was assumed in the Green Paper. The approach subsequently is to note briefly the extent of agreement on the abolition of direct controls and on the need for flexibility of interest rates (Section D, paras 7-8) and then to switch to the question of whether the authorities should operate a discretionary monetary policy or opt for a greater degree of automaticity (Section E, para 9). This leads on to views on the monetary base control (MBC) (Section F, paras 10-27) and indicator systems (Section G, paras 28-32) of various kinds discussed in Chapters 4 and 5 of the Green Paper. Finally, in the light of comments here, it is possible to summarise the views on the use of the main existing instruments of monetary policy (debt sales, lender of last resort facilities, MLR and the reserve asset ratio), Section H, paras 33-40. Only insofar as they are directly related to questions of monetary control are comments on the Bank of England's discussion paper on banks' liquidity considered. Throughout, unless otherwise stated, the analysis assumes that the exchange rate is floating.

B The choice of target aggregate

3 The Chancellor of the Exchequer's introduction to the Green Paper was written on the view that (i) a target should be set for only one monetary aggregate, that (ii) this aggregate should be sterling M3 but (iii) that account of the movements of other aggregates should also be taken in the formulation of policy.

4 A wide range of views was expressed on all these points during the consultations. All the overseas and some of the domestic proponents of MBC saw the ideal solution as setting a target for the base (MO) instead of the money supply because only MO was directly under the influence of the authorities. They acknowledged the case for a money supply target in the immediate future but tended to argue for an aggregate narrower than sterling M3. Pepper wanted to revive M2; Griffiths supported an M1 target but this aggregate otherwise attracted little interest. Many UK commentators (particularly those hostile to MBC) accorded considerable relevance to credit aggregates, notably DCE, and to measures of liquidity and credit encompassing a wider range of financial institutions than the present sterling M3. Others, however, took the view that sterling M3 is familiar and important in its own right or because it bears a "fairly simple relationship to credit counterparts which are economically significant" (Phillips & Drew). There was little apparent support for multiple targets.

C The time horizon for monetary control

5 The Chancellor's introduction to the Green Paper said that it was "desirable for the authorities to have at their disposal instruments to moderate short-term fluctuations in monetary growth." The main paper commented that month-to-month control was not necessary but that there would "be advantage in shortening the period within which it is possible to exercise control if it were practicable to find ways of doing this."

6 There was near universal agreement that it was very important to ensure adequate monetary control in the "medium-term". However, this view was accompanied by an almost total denial of the value of short-term control (Bain, Coghlan) or, at the other extreme, heavy

emphasis on the harm done by "massive" swings in monetary growth in recent years (Griffiths). The overseas experts were concerned overwhelmingly with the growth of MO. Brunner saw fairly close week-to-week or month-to-month control of that aggregate as desirable, others were more relaxed on the question. Majority opinion fairly clearly considers short-run control not to be of "fundamental importance" (Accepting Houses Committee); but there was extensive agreement with the argument that whatever the importance of short-term control it would be reduced once the credibility of government's medium-term aims had been established. ("If longer-term requirments are met, the short-term choice is less vital" - the Select Committee). Several writers (the EEC Group of Experts, a member of the British Overseas and Commonwealth Banks' Association) went on to assert that undue regard for short-run control could be counter-productive.

D The abolition of direct controls and encouragement of flexible interest rates

7 There was a widespread welcome to the end of the corset and agreement with the analysis of the Green Paper on the disadvantages of direct controls. The only dissent came from the TUC (who consider that such controls have an important part to play in the allocation of credit) and one clearing banker who thought it would prove politically impossible for banks to operate solely with regard to market forces.

8 There was also general acceptance of the view - and it was stressed by the overseas contributors - that for monetary policy to operate properly, the authorities must be prepared to let interest rates move flexibly and, if necessary, rapidly. A number of reservations were, however, expressed about how far this could be carried. The Building Societies Association would not view significantly faster swings in interest rates "with equanimity"; while the Local Authorities' Borrowing Committee called for a smoother and more predictable money market than in recent years. Several commentators noted the "stickiness" of the banks' base rates in the present structure and considered that this would have to be changed if interest rates were indeed - at need - to move more freely.

E Discretion versus automaticity in the operation of monetary policy

9 The only general agreement in this crucial area could be found over the proposition that, at least at particularly difficult times (eg, in a banking liquidity crisis), the authorities should be able to exercise discretion. On wider use of discretionary powers, there was no agreement. All those favouring monetary base control (MBC) regarded it as an important feature of a new system that, so far as possible, the market should be left to establish the interest rates necessary to achieve the Government's policy aims. Those hostile to this view did not then necesarily find themselves agreeing with every aspect of the present system; but they argued either that markets could not be relied upon to set interest rates which cleared the market or that these interest rates would not necessarily be those appropriate to achieving the Government's monetary target. This issue reappears in a number of the sections to follow.

F Attitudes to Monetary Base Control (MBC)

(i) General issues

10 There was no general agreement over the question of whether MBC would significantly affect the volatility of short-term interest rates or not. Proponents, talking usually in the context of a non-mandatory scheme, generally stressed that very short-term rates of interest might become more volatile but that there need be no reason why these swings should carry over into longer-term rates. Indeed, they hoped that the cyclical swings in interest rates apparent from the operation of the present system would diminish in size, as the new system of control came to give greater assurance about the Government's ability to control the base and helped to avoid major swings in inflationary expectations. The opponents of MBC generally disagreed, though some accepted that the details of a new scheme and the way in which it was operated would be of crucial importance in this respect. Several opponents, notably Johnson, went on to argue that instability in short-term markets would spill over into the longer-term markets for credit as (they claimed) it had done in the United States over the last year.

11 A second important question, relating to any form of MBC, emerged during the consultations: would MBC change banks' behaviour significantly by encouraging them to ration loans independently of any interest rate effect on the demand for credit, by making the banks uncertain about the future availability of base? Put another way, is MBC just another method of adjusting interest rates to achieve a given policy aim?

12 Those sceptical of or hostile to MBC essentially answered "no" to both these questions ("A pure monetary base system would operate through the same mechanisms as other systems; control would be effected ultimately through the generation of changes in the level and structure of short-term interest rates" - the CBI). A number - bankers and academics - suggested that various forms of MBC would put at risk particularly valued elements of flexibility in the banking system, notably the overdraft. They went on to posit that in response, customers and banks might change their behaviour to the extent of establishing new ways of providing flexibility and, in the process, perhaps significantly changing the significance of, and demand for, sterling M3. They did not think the banks would change so much as to subordinate their lending function to the management of their base position and this was the essential change if banks were to ration lending in the way implied by the arguments of some proponents of MBC Dudler reported that such a change had not happened when the Germans experimented with a form of MBC in the early 1970s.

13 Those favouring MBC tended to answer "yes". As Milton Friedman is reported to have put it to the Select Committee, "of course, direct control of the montary base will affect interest rates but that is a very different thing from controlling monetary growth through interest rates." Lewis explored the question more fully, arguing that control of the base would enter as a new and separate factor determining banks' lending behaviour, at least for retail banks; uncertainty over the availability of base would reduce the supply of credit at any given set of interest rates. The UK proponents of MBC put considerable weight on the view, arguing that the present nature of the banking system was the result of the present market signals and that change would come rapidly as the management by a bank of its base position came to affect profitability significantly. The overseas experts agreed that banks would have to adjust their behaviour under MBC much faster than opponents feared but did not endorse, to any significant extent, Lewis' argument.

(ii) Non-mandatory MBC

14 The Green Paper described non-mandatory MBC as a system in which "the bankers' need for base assets stems from their own requirements for operating their business, rather than from a mandatory requirement imposed by the authorities. If such schemes are to control the growth of the money supply by the authorities controlling the size of the base, bankers' requirements for base money must bear a fairly stable relationship over time to their total liabilities." The essence of the summary was not challenged during the consultations. Instead debate revolved around the central questions of the stability of the base: money relationship, the relevance of targeting wider aggregates at all, and the implications (particularly for financial markets) of moving to such a system.

15 Switzerland is the only example of a system operating along non-mandatory lines and the Swiss National Bank have published evidence which suggests a predictable relationship over time (not, say, from month-to-month) between the base and the subsequent level of M1. (They have, however, also noted that this relationship appears to have become somewhat less stable in the last couple of years.) It was widely accepted that a major factor in the establishment of this relationship was that Swiss banks hold prudential as well as transactions balances with the Swiss National Bank, because Switzerland does not have developed markets in high-quality short-term debt; thus balances at the central bank are held instead of the portfolios of money at call, Treasury bills and other short-term 'near-cash' assets held by banks in the UK.

16 A number of UK academics (notably Griffiths) and the large majority of our overseas contributors favoured the creation of a similar system in the UK, which - if it were designed to reflect the Swiss approach fully - would imply the end of the provision by the authorities of funds through a "discount window" at a pegged rate of interest (though the central bank could still choose to intervene to provide more base) and a complete reappraisal of the concept of liquidity for banks.

17 Criticisms of non-mandatory MBC systems were expressed on a priori grounds by a number of other academics and on a priori and/or practical grounds by all the banks who commented on this question. The relevance of Swiss experience was questioned by several, the Accepting Houses Committee in particular arguing that the Swiss record of low inflation and very limited need for government debt greatly facilitated monetary control, while the existence of large amounts of high quality short-term debt in the UK would greatly reduce the chance of a stable relationship between the base and the money stock. The fact that the Swiss consider M1 rather than M3 as the important aggregate to control was also picked up, indirectly, by Lewis who - although a proponent of MBC - felt it could be applied only to retail deposit banking. Several other commentators (Alford, Johnson) argued that many non-clearers would have little or no voluntary demand for base assets; while the Committee of London Clearing Banks (CLCB) and the Co-operative Bank both doubted strongly whether a relationship between base assets and their deposit liabilities could be expected. ("Our own experience shows that the expected level of cash requirement and the outturn of our cash balances(s) are extremely volatile and could not be taken as an indicator of the level of our own deposit liabilities" - the Co-operative Bank.) This view was also expressed by the EEC experts, while Phillips & Drew talked of "insurmountable difficulties relating to the probable instability of bank demand for base assets".

18 The proponents of a non-mandatory system responded by arguing that a reasonably stable relationship might develop between the base and M1 (Griffiths) or, less certainly, wider aggregates. (Certainly as Brunner put it, wider aggregates would not rise by 10% year in year out, if the growth of the base was kept to, say, 2% a year). However, (and the overseas contributors felt this particularly strongly), the absence of a stable relationship would not greatly matter, because control of the base was far more relevant to the final objective of controlling prices and nominal incomes than was any single monetary aggregate like sterling M3.

19 The problems of transition to a non-mandatory system naturally seemed greatest to the opponents. There seemed to be two possible approaches but one - the adoption first of a mandatory system with the aim of using information thus gained to move towards a non-mandatory system - attracted only lukewarm support from UK proponents and none from the overseas contributors. The latter, instead, thought it possible to move straight to a non-mandatory system and, to limit the difficulty that the authorities would not know how much base to supply initially because nothing is known of banks' voluntary demand for cash, the authorities should institute a floor and ceiling for short-term interest rates. Initially, these would be quite close to ruling rates but, as experience was gained, the band would be steadily widened and eventually dropped. Opponents of MBC, for their part, doubted the merits of targeting solely MO and the speed with which information about the banks' demand for base would become available during the transition. They consequently foresaw a long period in which the authorities could lose influence over both the course of the wider monetary aggregates and movements of short-term interest rates.

(iii) Mandatory MBC

20 A mandatory MBC system would require the authorities to set some minimum ratio between banks' holdings of base and their deposits*. The Green Paper noted that there were three possible ways in which the requirement could be set:

(a) Lagged accounting - where current base requirements are fixed by reference to deposits in a previous period.
(b) Current accounting - where required base assets relate to the same make-up date as the relevant deposits.
(c) Lead accounting - where the holding of base assets would put a limit on deposits at some future date.

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* Because no official paper has been produced on the cash ratio or on the aggregate to which it might relate few commentators discussed these questions although a number thought them very important. The CLCB were particularly concerned because they thought it likely that the whole burden of adjustment to any shortage of base would fall on the clearers, while the Co-operative Bank argued that a requirement on non-clearers was a tax, while a requirement on the clearers alone would be inequitable.

21 Four UK commentators [Pepper, Victor Morgan, Smithers (of Warburgs) and Lewis] plus Monti of the overseas contributors favoured some form of mandatory MBC≠, and Pepper, in particular, went into some detail as to how his scheme might operate.

22 It was clear that no-one favoured lead accounting, despite the possibility that it might give a warning about the immediate future development of the money supply as foreseen by banks. It was stressed by the CLCB, the Co-operative Bank and the Japanese Bankers' Association that banks would have great difficulty in making accurate predictions of the size of their future balance sheets. The CLCB went on to agree with the point made in the Green Paper that an underforecast by a bank of its need for base would encourage that bank to disintermediate (presumably along the lines developed during the corset) to avoid penalties for underforecasting. The Accepting Houses Committee, however, thought that banks could in time adjust to any form of mandatory MBC (though they would not welcome its introduction).

23 On lagged and current accounting systems it seemed to be common ground that the details of the system would determine such important questions as whether banks would hold significant excess reserves to guard against unforeseen circumstances. Under Pepper's and Smither's proposals, banks would indeed want to hold excess reserves; but of course, as the CLCB pointed out, the short-term link between base and money would thereby be weakened.

24 On the practicalities of such schemes, the views of the AHC have already been noted. The Co-operative Bank considered that "lagged accounting would be the easiest to manage from our point of view but could be a severe restraint on growth and in our case could be as restrictive as the corset." The Midland Bank Review thought a mandatory MBC would be difficult but not impossible to manage; while Victor Morgan (one of the proponents) argued that the difficulties foreseen in the Green Paper were exaggerated because too rigid a form of MBC had been assumed.

≠ Pepper favoured it as a necessary step towards a non-mandatory system.

25 As to the desirability of such schemes, the balance of opinion against has already been noted. Some of those averse to the proposal (eg, the CBI) said little more than that they agreed with the reservations expressed in the Green Paper. Others (notably Phillips & Drew and the AHC) were concerned that any form of mandatory MBC would encourage banks to hold more easily disintermediated assets on their balance sheets, thereby changing the nature and reducing the economic significance of sterling M3. One or two commentators (especially Lomax) were more sympathetic though on balance sceptical, while Rose deliberately left the question open.

(iv) Negotiable entitlements

26 The Green Paper noted that it had been suggested (Turner of James Capel had produced a detailed plan) that any problems in controlling the cash base could be side-stepped by creating special negotiable entitlements and requiring banks to hold these in proportion to the deposits that they wished to take. There could then be no question of deposits rising above a specified multiple of the volume of entitlements issued by the authorities.

27 Turner apart, this suggestion found little support during the consultations (most papers made no mention of this scheme at all) and indeed several distinctly adverse comments came from those not ill-disposed towards conventional forms of MBC. Lomax saw "various and substantial disadvantages" because, as the Green Paper had argued, such a system could only encourage disintermediation of business into forms and organisations not subject to the rules on entitlements. The Midland Bank Review thought it possible that a non-bank inter-company market in deposits might well result, completely distorting the significance of sterling M3. There was also concern that a system of entitlements would lack flexibility and be more likely to cause interest rate instability than other forms of MBC. Only Victor Morgan was more open-minded, saying that he could see no reason why "the scheme should be worse than other forms of MBC [in promoting disintermediation] but it is also hard to see any positive advantages in it". At a late stage, Miller did express some interest in the proposal, in part as a new way of taxing the banking system.

G The indicator system

28 The Green Paper devoted a chapter to systems in which movements in the base or the money stock would be used as an indicator for the appropriate level of short-term interest rates. The thinking behind this idea, which was largely developed by officials in the course of preparing the Green Paper, was that it might provide the reassurance some critics sought that the authorities would not delay necessary monetary action through the use of their discretionary powers, while avoiding the major structural changes in financial markets and practices implicit in many forms of MBC. The Green Paper concluded that an indicator scheme, if adopted, should relate directly to the target aggregate, sterling M3, should contain some limit (at least initially) on how far interest rates could move without discretionary intervention and should have provision for discretionary override because of the impossibility of devising any rule appropriate to all occasions.

29 In the event, the approach does not seem to have provided reassurance to the more committed proponents of MBC. Pepper regards the indicator system as providing the worst of all worlds since it could mean disruptive and volatile interest rate changes in often unnecessary response to fluctuations in the supply of money. Griffiths also attacked it, apparently regarding it as an attempt by officials to retain the freedom to peg interest rates and because of a fear that rational speculation could be highly destabilising with an indicator system.

30 Among those favouring discretion rather than rules, criticism came in a number of forms. Several commentators thought that while, in theory the adoption of a rule might make it easier politically to accept high interest rates, in practice the Government would not find things any different. There was also concern over how often discretion could be used without undermining the whole approach (it seems to have been generally accepted that some element of discretion would be needed and that the rule should relate to sterling M3 not the base). The London Discount Market Association feared that the discretionary override would always be used at times of crisis, with unfortunate market repercussions, while the Select Committee was unconvinced that

the distinction between a discretionary system and an automatic approach with override would remain clear or helpful for long. The CLCB was one of several to note the possibility that an automatic rule could induce policy reactions in totally the wrong direction (which was one reason why the Green Paper argued for an override): it was, further, concerned that the indicator could encourage an "unhealthy preoccupation with very short-term monetary developments". The Accepting Houses Committee was also against, in part because there was a "real danger that the authorities might be inhibited by the system from a proper exercise of their judgment and in consequence lose their direct responsibility for the outcome".

31 A number of respondents - particularly in the banking sector - were, however, in favour of some form of indicator with override. The CBI regarded it as the best of the alternative systems of control under discussion, while the Association of Consortium Banks, the Japanese Banks' Association and the Co-operative Bank all said that it would be acceptable or, at the least, that they could "live with it". Sargent went further and welcomed it as a step which would enable the water [of MBC] to be tested.

32 No-one pursued the technical aspects of the scheme very far, though several respondents were chary of the Green Paper's suggestion that the rule could be related to movements in the money stock over the previous four or five weeks.

H Present instruments of policy (earlier discussion of these topics in this paper is not repeated in detail)

(i) Sales of government debt

33 Quite a number of commentators expressed regret at the lack of discussion of debt policy in the Green Paper and, among non-monetarists and monetarists alike, there is pressure for change.(1) However, there remains the uncertainty, with regard to many of the comments, whether the aim is really greater assurance of a stable level of debt sales or whether it should be a greater certainty of selling whatever the

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(1) The official response has been throughout that the Bank of England's article on the gilt-edged market in its Quarterly Bulletin for June 1979 remains on the table for discussion.

Government want to sell. Perhaps - insofar as there is a consensus - it is that short-term debt markets should take the greater share of ironing out short-term monetary volatility, though not - in the view of some - to the extent of appearing to undermine the significance of sterling M3 by the creation of near-money assets just outside the definition of this aggregate.

34 There was thus a call for greater use of short-term debt instruments as a form of monetary control from Pepper, Bain and Coghlan (who want a much wider range of such debt than at present), while Griffiths' views clearly ran the same way. All of these, plus Rose, Sargent, Lewis and Petherbridge in a more qualified fashion, wanted changes in gilt-marked techniques as well. Rarely were the desired changes described in detail. Rose said that the shorter the period in which monetary control was required, the more important was it to sell gilts by tender; while Bain talked about the need for the authorities and the major long-term financial institutions to devise methods for funding which would encourage a smoother flow of savings into gilt-edged. Petherbridge called for a more aggressive pricing policy on long taps in the gilt-edged market, while Lewis wanted "more positive action" in the same area.

35. Perhaps a little surprisingly, there was not any great discussion of non-marketable forms of government debt, although the AHC did anticipate the recent announcement on National Savings, by arguing the need to tap the personal savings market more vigorously.

(ii) The use of MLR and short-term interest rates

36 As noted earlier, there was fairly general agreement on the need for short-term interest rates to move flexibly when need be, and only limited interest in tying MLR directly to deviations of the money stock from target. The only other specific comments in the area came from Griffiths who called for MLR to be tied to inter-bank (ie "free market") rates and from Coghlan with the not dissimilar point that there is no need for MLR to lead market interest rates; rather, the authorities should sell the appropriate amount of short-term debt to control the money stock and this would engineer the necessary change in market rates, which MLR could then follow.

(iii) Lender of last resort facilities

37 Not surprisingly, criticism of the present facilities was concentrated among advocates of some form of MBC. Both Pepper and Griffiths argued that any official lending should genuinely be "last resort", and, except at times of crisis, should not involve the ready provision of official finance at pegged interest rates. However, under Pepper's scheme, official finance would be available fairly freely, so long as monetary developments were satisfactory.

38 Bankers were not keen to see changes in this area. The London Discount Market Association was broadly content with the present system, while the CLCB wanted an <u>extension</u> of the range of intervention techniques in the money markets available to the authorities to avoid rapid movements in interest rates during the day. Phillips & Drew also urged that lender of last resort facilities should not be abandoned.

(iv) The reserve asset ratio (RAR)

39 The proposed abolition of the RAR requirement has been accepted with virtually no comment. To the proponents of MBC, the present RAR is anathema, because the authorities cannot control the volume of reserves. Among the others, the only specific comments made were by Coghlan (to the effect that the problem of monetary control stems from the size of demands for credit not from the present definition of reserves), from Bain (who was concerned that the liquidity proposals would not keep a tight enough rein on the banking system's liquid position) and from the CLCB and Wills who considered the RAR an artificial control with "unpleasant and destabilising side effects" (Wills).

40 This is not to say that the abolition of the RAR without any other action would find general acceptance. Indeed, it is known that Pepper and Griffiths would regard the result as a control mechanism even weaker than that in force at present.

APPENDIX

CONTRIBUTORS OF WRITTEN COMMENTS ON THE GREEN PAPER

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2 Association of Consortium Banks
3 Bain, Professor A, University of Strathclyde
4 British Overseas and Commonwealth Banks' Association
5 Building Societies' Association
6 Coghlan, R
7 Committee of London Clearing Banks
8 Committee of Scottish Clearing Banks
9 Confederation of British Industry
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20 Lewis, M, University of Adelaide
21 Local Authority Associations
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23 London Discount Market Association
24 Phillips and Drew
25 Post Office Staff Superannuation Fund
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