

17. Monetary Control

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MONETARY CONTROL CONSULTATIONS


COMMENTS BY DR MAX HALL

Note by the Secretaries

The attached comments on the Green Paper and the Bank's liquidity proposals by Dr Max Hall (Loughborough University) are circulated for information.

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A Critique of The Green Paper : "Clutching At Straws?"

Before disentangling the major points of controversy from the policy document, it is important to note the assumptions, implicit or explicit, that underlie the present conduct of monetary policy. First and foremost, there is widespread belief in the adequacy of medium-term control of money stock growth, as pointed out in the Green Paper. Unfortunately, there must be some element of doubt about this, given the authorities' inability to positively identify stable demand functions for any monetary aggregate, be it M1, M3, £M3, DCE or wider measures of liquidity. For, even if all aggregates, either targetted or monitored, are seen to be moving along their desired courses, there can be no guarantee that nominal incomes are responding in the desired fashion because of the inherent susceptibility of demand-for-money functions to structural change.⁽⁹¹⁾ Secondly, control of the money stock is assumed to be necessary for the control of inflation, despite the unresolved debate concerning the direction of causation between changes in the money stock and changes in nominal incomes. Thirdly, as present policy conduct exemplifies, control of monetary aggregate growth is regarded as being sufficient to control inflation, despite apparent evidence to the contrary. And finally, the reduction in the inflation rate is firmly established as the prime, ultimate goal of policy, in preference to full employment, payments balance, and exchange rate alternatives.

(91) See, for example, Artis, M.J. and Lewis, M.K., 'The demand for money - stable or unstable?', *The Banker*, March 1974 and Hacche, G., 'The demand for money in the United Kingdom : experience since 1971', *BEQB*, September 1974. Even the latest attempt to identify a stable demand function for M1 (Coghlan, R.T., 'A transactions demand for money', *BEQB*, March 1978) has been shown to be of very poor, predictive quality.

Accepting, for the moment, these propositions, one may move on to a consideration of the main part of the text. The first, crucial item that emerges is the planned switch to almost exclusive reliance on the interest rate mechanism as the means to attain closer short-run control (given that that is necessary to retain market confidence in the government's anti-inflation package) of the money stock. This arises as a direct result of the authorities' apparent acceptance of the "cashier's view" of debt management policy, which, together with the reluctance to index bonds or sell a greater variety of short-term public sector debt instruments, will allow gilt sales to continue on an irregular course, and the decision to do without all forms of quantitative control. The last decision is undoubtedly right, given the resource misallocation, the distortion to monetary aggregates - particularly since the abolition of exchange controls - and the damage to the competitive environment that they induce, if one takes a long-term view, but in the short-run the move leaves a void in the area of monetary/interest rate control (eg. in the control of bank liability management and round-tripping, and the shielding of politically-sensitive interest rates, including the traditionally "sticky" rates on certain forms of public sector debt, from a full exposure to market forces). The crucial question, however, is whether or not interest rates can take the additional strain.

Unfortunately, for the authorities, the interest rate instrument (short term) under a considerable cloud as to its ability, even in the long-run, to restrain growth in the money stock⁽⁹²⁾ and there is a growing body of

(92) E.g. See Hotson, A.C. 'The Forecasting and Control of Bank Lending', Paper presented to Money Study Group Conference, Oxford 1979. The authorities' influence over bank lending is of supreme importance because of the way in which policy is currently conducted towards controlling the demand for money.

opinion that high interest rates actually breed inflation! The theoretical backing to this view consists of the following strands: that a rise in interest rates - (1) will increase the PSBR, an important counterpart to money stock (£M3) growth, by virtue of enlarged debt interest payments; (2) will induce short-term capital inflows which, even under a pure floating exchange rate regime, can cause movements in the domestic money stock;⁽⁹³⁾ (3) will cause the domestic money stock to rise by virtue of outflows from ("sticky") non-marketable public sector debt instruments; (4) may cause bank deposits to grow because of the differential effects on banks' lending and borrowing rates, lending rates (tied to base rates) tending to react more sluggishly (perhaps as a result of cross-subsidisation of wholesale business by retail profits) and creating the possibility for companies to engage in "arbitrage" operations; (5) may cause banks to manage their liabilities and bid for deposits through the CD and interbank market; (6) may cause an increase in bank lending, particularly to the corporate sector, as the equity and debenture markets dry up as a result of a general expectation of a future drop in rates, the only alternative source of finance being the banking system; (7) by depressing demand, may induce an increase in bank lending to the corporate sector as the only course of action open to the latter to finance "involuntary" stock holdings; and (8) may cause prices to rise directly as a result of the cost-plus mentality of many British firms, including nationalised industries, who are keen to pass on higher operating expenses, in the form of debt interest payments, to their customers, if at all possible.

(93) See Hall, M.J.B., op. cit., 'A Review Of The Direct Monetary Effects Of The Balance Of Payments'.

In view of the above, it may be argued that the reliance placed on the interest rate mechanism is misguided, particularly if the present structural environment remains largely intact - which seems likely given the lack of enthusiasm the authorities display towards the adoption of either a base control system or indicator schemes.

On the issue of base control, and ignoring the questions of feasibility and accounting detail raised by the Green Paper, it is important to realise ^{the} ~~what~~ fundamental changes ^{that} would have to accompany such a policy switch. The first prerequisite is a floating exchange rate for, although complete insulation of the domestic money stock from capital flows can never be achieved, a pure floating regime goes a long way to fulfilling that objective. Secondly, in order to guarantee tight control of the base, the authorities must stand prepared to tolerate equilibrating rates of interest of whatever magnitude necessary to clear markets. This would seem to herald the danger of greater interest rate instability than at present and involve a repudiation of the Government Broker's assertion that, in fixing a new tap stock price, it is important not to impair the long-run capacity of the gilt market by penalising existing stock holders, while the exchange rate requirement demands that the UK continue to remain outside the European Monetary System, in contravention of one criterion laid down by the Green Paper against which reform proposals should be assessed.

In practice, however, acceptable tolerance levels must be considered. For example, interest rates could never be allowed to proceed to levels that threatened liquidity crises or large-scale financial collapse and surely there must be an upper limit to the level to which sterling, as a

petro-currency, may appreciate without irreparably damaging the UK's export capacity and future prospects for recovery.

Finally, whatever ones' subjective evaluation of what life would be like under a base control regime, it is undeniable that the system would prove ineffectual unless the authorities were simultaneously to institute major reform in both the area of tactical operations and on the institutional front, particularly in the discount market and with respect to lender of last resort facilities.

With regard to indicator systems, one must weigh-up the potential advantages of automaticity of response against the possible dangers that could arise from exposing the authorities' reaction function to the market in advance, such as a greater variability in interest rates resulting from induced, destabilising expectations.

Turning to the role of monetary aggregates as indicators and targets⁽⁹⁴⁾, one might cast aspersions on the choice of £M3 as the target aggregate. In theory, the final selection of a monetary aggregate from all potential control variables should be influenced by the following considerations: (1) how closely and reliably changes in the total are related to the ultimate policy objective i.e. output, full employment, price stability etc.; (2) how accurately the total can be measured; (3) how precisely, and at what costs, including undesirable side effects, the authorities can control the total;

(94) A subject more fully discussed in Chapter

and (4) the exogeneity of the potential control variable with respect to nominal income (or whatever the specified ultimate policy variable may be). Considerations (1) and (4) together form the essential criteria to be satisfied by potential target aggregates yet, unfortunately, serious problems confront the econometrician in attempts to establish the direction of causality and the closeness of fit between target and ultimate objective; the major difficulty is that the money-income relationship is susceptible to structural change in such a way as to raise serious doubts about the reliability of any results gleaned from econometric testing.⁽⁹⁵⁾

In the light of the above taxonomy the relative merits of competing aggregates may be assessed. What clearly emerges is that in the case of £M3, the very foundation of a targetting policy is missing, namely a stable demand-for-money function (M1 would appear to be the least unsatisfactory on this score).⁽⁹⁶⁾ Moreover, £M3 suffers from the drawbacks that it tends to respond perversely to interest rate changes and suffers from distortions (irrespective of whether or not the corset is in operation) as a result of balance of payments transactions now possible since the abolition of exchange controls.⁽⁹⁷⁾ Taking this evidence together with the doubts that have been raised about the wisdom of pursuing singular control of one aggregate - the so-called "Goodhart's Law", which embodies the idea that as soon as policy is directed towards the control of any one aggregate

(95) The introduction of CCC in September 1971, the floating of sterling in June 1972, the general monetary accommodation of "inflationary" deals in the latter part of the seventies, the abolition of exchange controls in October 1979, and the removal of the corset in June 1980 are all examples of factors responsible for unsettling such a relationship.

(96) See empirical evidence by Artis and Lewis (1974), Hacche (1974) and Coghlan (1978), *op. cit.*

(97) For example, certain forms of payments transaction can add to the total volume of sterling credit without raising the domestic money stock (£M3) - see Hall, M.J.B., April 1980, *The Implications Of The Abolition of Exchange Controls For UK Monetary Control In The 1980s*, *op. cit.*

that aggregates usefulness as either a target or an indicator is destroyed as a result of the destruction of any previously stable relationship with ultimate goals - one might legitimately question the merit of pursuing with £M3 as the prime focus of attention, even if notice is taken of movements in other aggregates. (98)

Perhaps more important than the optimum choice of aggregate problem, is the real burden borne by the economy for the privilege of being steered according to target guidelines. The consequential strains that are imposed on the real economy impinge upon interest and exchange rate objectives and employment, debt management and fiscal policies. Thus, interest rates are pushed to levels that threaten deflation, the exchange rate is allowed to rise to a position which threatens to destroy a significant part of the UK's export base, the PSBR is held at a level which over-rides the impact of automatic stabilisers and causes a deterioration in the standard of services provided, debt management policy is conducted in such a fashion as to burden the taxpayer for up to twenty-five years with "excessive" service charges, and unemployment is allowed to break through the two million barrier and probably proceed way beyond that mark. Moreover, efforts undertaken to validate that "monetarism is enough", through attempts aimed at ensuring a speedier feedback from money supply control to wages and prices without the use of any form of prices or incomes policy

(98) A prime candidate for concern during the latter part of 1979 and 1980 was DCE, movements in which demonstrated the growing importance of an inappropriate channel (payments deficit) through which money supply control could be maintained.

(such as the de-indexing of social security benefits and the proposal to scrap earnings-related unemployment benefit), appear at best, futile, and at their worst, socially divisive. Perhaps the time is ripe to reassess our economic priorities, and consider switching first choice of ultimate goal to an exchange rate or unemployment objective, leaving monetary policy to fulfil a more humble role such as the minimisation of the banking sector's monetisation of the national debt.⁽⁹⁹⁾ Given the lamentable performance achieved by the monetary experiment on the inflation front so far, and the considerable doubts raised herein as to its utility value under the suggested system of reform, it at least deserves serious thought.

(99) For a discussion of the merits/demerits of the more popular alternative, economic strategies open to the UK authorities see Allsopp, C. and Joshi, V., 'Alternative Strategies for the UK', N.i.E.R., No. 91, February 1980.

'The Measurement of Liquidity'

Brief Synopsis. The Bank's liquidity paper is basically concerned with a desire to ensure that the banking system as a whole maintains adequate liquidity.⁽¹⁰⁰⁾ It restricts itself almost exclusively to the "funding risk" of liability management (ie. the risk that banks have insufficient cash resources to meet their daily needs), ignoring the "interest-rate mismatch risk" that arises from maturity transformation.

The Bank asserts that the traditional measure of liquidity - the 1 : 3 ratio of "quick assets" to deposits - is inadequate when considered in isolation,⁽¹⁰¹⁾ although it admits that some account is already taken of banks' maturity transformation through the Bank's monitoring of both foreign currency business, where all liabilities and assets are compared according to their remaining term to maturity, and total business, where liabilities with a remaining term of up to three months, net of assets of a comparable maturity, are compared with holdings of negotiable instruments and firm standby facilities. Further, the reserve asset ratio, although, in effect, acting as a liquidity obligation for "primary" liquid assets, was deficient on this score in that it was related to eligible liabilities and not gross liabilities and because it represented a minimum requirement to be met on a daily basis whereas the ideal liquidity requirement should be expressed as a norm.

(100) An individual bank's liquidity needs had been adequately dealt with in an earlier paper: "The capital and liquidity adequacy of banks", BEQB, September 1975.

(101) Because: (1) it takes no account of the maturity pattern of a bank's assets and liabilities; and (2) it doesn't distinguish different classes of liquid assets i.e. "primary" - cash or other assets (in any currency) which are in all circumstances, a ready source of cash, because the authorities stand ready either to purchase them or to accept them as collateral for last resort lending - from "secondary" (other assets which are near-cash or readily marketable).

In the light of the above the Bank concluded that:

- (i) the present tests of liquidity overlap in their coverage and are incomplete;
- (ii) the present tests do not satisfactorily ensure that the banking system as a whole holds an appropriate amount of primary liquidity;
- (iii) liquidity requirements for prudential purposes should be expressed as norms and not as minimum levels.

Proposals. To close the loopholes mentioned in its conclusions the Bank proposed 'an integrated test' for all recognised banks and licensed deposit-takers that would represent a measure of the likely liquidity needs of the institution. The measure would consist of two parts, one satisfying the need for immediate liquidity (eg. to meet withdrawals of sight deposits) and the other meeting liquidity needs arising because of unforeseeable difficulties experienced in the financing of known future commitments. It was proposed to establish an integrated measure for each bank, with the measure comprising two parts: (1) a proportion of the bank's gross maturity-uncertain liabilities; and (2) a proportion of any net liability position arising from maturity-certain liabilities and assets. For the latter requirement, the net liability position for certain time-bands was to be calculated, with varying proportions being attached to each time-band - the nearer to maturity, the greater the proportion.

The suggested scale of liquid asset cover is outlined below:

Maturity-uncertain liabilities	25%
Gross market deposits from banks up to month	100%
Irrevocable undrawn standbys given to banks	100%

Net liabilities on maturity-certain business

Up to 8 days	90%
8 days - 1 month	75%
1 month - 3 months	50%
3 months - 6 months	25%
6 months - 12 months	15%
Over 1 year	5%

The estimates presented were based on the assumption of a point of indifference between bank holdings of maturity-uncertain liabilities and maturing-certain liabilities lying somewhere between three and six months. The 100 per cent weighting given to irrevocable undrawn standbys and gross inter-bank deposits up to one month was justified on the grounds that, in the hands of the counter-party bank, these are treated as (secondary) liquid assets - see below.

For the protection of the system as a whole, banks were further required to hold part of their estimated need for liquidity in the form of primary liquidity⁽¹⁰²⁾, with banks being asked to maintain an average of 40 per cent

(102) "Primary" liquid assets comprised the following sterling assets: cash; balances with the Bank of England (excluding Special Deposits); UK and Northern Ireland Treasury Bills; local authority bills and bank bills eligible for rediscount at the Bank; British Government Stocks (including government-guaranteed stocks of the nationalised industries) of less than one year to maturity; call money with the London Discount Market Association (plus Page and Gwyther Ltd., and Gerald Quin, Cope and Co. Ltd.). "Secondary" liquid assets comprised: market loans to banks up to one month (denominated in sterling or foreign currency); secured money at call with recognised Stock Exchange money brokers and gilt-edged jobbers; loans to local authorities up to one month; non-eligible bills with less than three months to maturity (denominated in sterling or foreign currency); certificates of deposit and certain marketable promissory notes with less than three months to maturity (denominated in sterling or foreign currency); British Government Stocks with between one and five years to maturity. N. Ireland Government stocks with less than five years to maturity; local authority and public corporation marketable securities with less than five years to maturity; gold; irrevocable undrawn standby facilities from other banks (denominated in sterling or foreign currency).

of their total estimated liquidity in primary form (for licensed deposit-takers, claims on recognised banks maturing within eight days to qualify as primary liquid assets).

With regard to foreign currency business, the primary liquidity requirement was irrelevant, and, although banks were not formally asked to match both assets and liabilities by currency, the Bank did expect bank circumspection on this point. In respect of the overall liquidity requirement, however, foreign currency business was to play an important part.

Finally, the Bank turned to the problems of dealing with overseas branches of UK banks and UK branches of foreign banks. For the former group, the Bank intimated its desire to extend the liquidity framework as speedily as possible, after taking due account of any special liquidity requirements imposed by overseas authorities; and for the latter, sterling business was to be treated in an identical fashion to that of a UK bank but foreign currency business was only to be observed in cases where the Bank was satisfied that adequate reporting and control systems existed between the UK branch, its Head Office, and the relevant supervisory authority - in other cases, the Bank may seek to become more actively involved.



A Critique. Both the underlying principles and the content of the liquidity paper raise important points for concern. As regards the need for formal liquidity requirements, it is not at all clear why compulsory membership of the "protection of depositors" insurance scheme together with a continuation of banking prudence and official scrutiny of banks' books

should not suffice.⁽¹⁰³⁾ Moreover, any formal liquidity requirement entails the risk that deficits may arise and hence impose a further constraint on banking operations. In this sense, the liquidity requirement - such as the 40 per cent "primary liquidity" ratio - becomes, albeit unintentionally, a restrictive balance sheet ratio which, at times, might condition bank activity even before any base ratio - such as the bankers' deposit ratio - comes into play.⁽¹⁰⁴⁾ Under such conditions, then, the requirement simply becomes a monetary control instrument rather than a means of ensuring adequate liquidity for the banking system as a whole.

On the specific details of the document, certain worrying features emerge, not least the distortions that would be created in financial markets - notably the interbank and Eurocurrency markets. Concern about the impact on the inter-bank market has been voiced as a result of the implications of the proposed scale of liquidity cover for different types of bank and different types of activity.⁽¹⁰⁵⁾ For the proposed 25 per cent cover on maturity - uncertain liabilities when compared to the considerably higher cover recommended for maturity - certain business (e.g. 100 per cent on gross interbank deposits) obviously favours the "retailers" at the expense of the "wholesalers", while the differential rates applied to wholesale business, as between bank and non-bank wholesale, will undoubtedly cause

(103) The need for prudential management could, in itself, ensure adequate bank liquidity for the system as a whole for, even in the knowledge that the Bank would always launch a lifeboat operation to ward off imminent, large-scale financial collapse, the banks' management know that their interests would still be damaged through the impact on shareholders. Moreover, over-exposure to risk is more of a problem than inadequate liquidity cover.

(104) Note, also, that the designation of bankers' deposits as primary liquid assets would, itself, cause an overlap and intermingling of the control and prudential requirements.

(105) Such criticism emanates directly from disagreement over the Bank's selection of the point of indifference between bank holdings of maturity - certain and maturity-uncertain liabilities.

non-bank (i.e. commercial) business to trade at a premium. Further, the favoured treatment accorded to the "retail" (eg. clearing) banks is reinforced by the inclusion of cash within the definition of primary liquidity, bestowing upon them a further competitive advantage vis-a-vis banks with small retailing outlets. (106) Controversy over the likely outcome for the Eurocurrency market has arisen on two fronts: one, the view that business will move to less-regulated, Eurocurrency centres (eg. (a) as UK banks exploit, through their overseas branches, any loopholes created by the imposition of differential liquidity requirements at home and abroad⁽¹⁰⁷⁾ and (b) as a result of UK branches of overseas banks losing the privileges they used to enjoy with respect to their sterling business and moving elsewhere); and two, the possibility that, with respect to Eurocurrency business, foreign bank branches in the UK would enjoy a competitive advantage over indigenous banks due to the bank's failure to ensure equitable treatment between the two groups. (108) Finally, on a more general note, certain banks claim that the implementation of the scheme would necessitate an increase in the cost of the provision of medium-term finance to industrial and commercial borrowers, a factor that can only deepen the unparalleled squeeze currently enjoyed by the corporate sector.

In the light of the above, the most likely outcome would appear to be the introduction of liquidity requirements, sometime in late 1980 or 1981, along the lines previously suggested but adjusted (particularly the scale of cover) to remove the more serious distortions and anomalies just highlighted.

(106) The scale of operations of Stock Exchange money brokers and gilt-edged jobbers would also be affected as, unlike under the reserve-asset ratio system, money at call with these institutions would no longer be classified as a source of primary liquidity and hence would not trade at such a premium.

(107) Though it is not the intention of the UK authorities to tolerate such loopholes, some bankers feel that the marrying of domestic (parent) and foreign (host) liquidity requirements will prove troublesome e.g. - how quickly will the UK authorities respond to changes in foreign-imposed requirements and how will subsidiaries be dealt with?

(108) Again, despite reassurance from the Bank, sceptics doubt that equity will be achieved under the present proposals.