16. Monetary Control

Consultants

18 June 1980

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18th June, 1980.

Mr. T. Kamoshida,
Deputy Chief Representative
in Europe,
The Bank of Japan,
27-32 Old Jewry,
London, EC2R 8EY.

Dear Mr. Kamoshida,

We have pleasure in enclosing a short note of our views mentioned in 6.4 of Chapter 6 of Monetary Control (Green Paper).

Yours sincerely,

T. Inouchi

T. Inouchi
Deputy General Manager.

We have reviewed the discussion paper entitled "Monetary Control" (Cmnd. 7858) and are pleased to give you our views on the points posed at Paragraph 6.4.

(a) "Whether the difficulties with monetary base control outlined in section 4 and developed more fully in Annex B could be surmounted. If so, whether there would, on balance, be advantage in a change to such a system".

The main objective underlying the proposed change to monetary base control is, basically, to move away from the artificial system of credit control used in the past and towards a monetary policy that derives more support from interest rate changes. At the same time, the basic policy remains controlling the money supply (M3) at the desired level.

Quantitative controls such as the Supplementary Special Deposits scheme (SSD) have been adopted as temporary expedients intended to last only until such time as permanent measures became effective. If SSD had been adopted for use over a long period of time, the scheme would have brought unfairness in competition and/or economic inefficiencies. Thus, SSD was to be discontinued at the appropriate time.

As a policy to replace SSD, monetary base control should therefore be welcome in the sense that banks can expect interest rate changes to provide a more accurate reflection of changes in market conditions and can avoid the detrimental consequences of artificial credit controls.

The paper has pointed out several difficulties on which we have the following comments:

1. If a lead accounting basis were adopted, it would be necessary to forecast a future balance sheet with precision. Since this appears to be an insurmountable obstacle, lagged accounting would seem to provide the only practical approach.

2. In view of (i) the risk of extensive disintermediation arising from the exercise of the option described under Paragraph 15 (b) and (ii) the risk of a deviation of the money supply from the desired trend arising as a result of the option under Paragraph 15 (a), we think that the option under Paragraph 15 (c) will be the best alternative. The difficulty with this last option is that the link between the growth of base assets on the one hand and monetary growth on the other weakens as the volume of excess base assets fluctuates. This difficulty

will, however, be relatively less serious since the small deviation resulting therefrom will not negate the underlying economic principle.

In our opinion, therefore, it will be preferable to adopt lagged accounting and to structure the mandatory base such that the banks would normally hold substantial excess balances, for example by establishing a low required ratio with interest paid on such balances.

(b) "Whether the system outlined in Chapter 5, of automatically adjusting the Bank's lending rate, would, on balance, be advantageous".

The merit of the system lies in the avoidance of any bias resulting from a delay by the authorities in taking action; under this system, the authorities can react quickly and, indeed, automatically in accordance with a pre-established formula. Of course, this formula should include a figure in respect of deviations of an actual indicator from a targeted one.

However, we concur that the override referred to in Paragraph 5.10 is indispensible to the extent it is not used to excess. Purely automatic adjustments would carry the risk of making the deviation larger; such adjustments should also be executed in the context of other official policies (e.g. fiscal policy) when such an overriding view is required.

We believe that an automatic system is highly advantageous provided that its operation is not entirely rigid.

MONETARY CONTROL, MARCH 1980

An interesting paper - it appears to be divided into three separate sections. The introduction by the Chancellor is purely political and the Bank and the Treasury would want to distance themselves from it in case of "U" turns,

The consultation paper which is a joint affair and, therefore, a committee effort and finally an Annex A and B probably written by the Bank.

The paper is divided into two parts: a summary of the existing method of controlling the Money Supply with comment on how successful or otherwise they have been. It goes on to say that several of the methods of control have now outlived their useful life and should be replaced, namely:-

a) the supplementary special deposits [the corset scheme];
b) the requirement to maintain a 12½% reserve assets ratio;
c) ~~that~~ the existing requirement that the Clearers should maintain 1½%.

The paper appears to favour the retention of the Special Deposit Scheme presumeably to allow the Bank to put the brakes on very quickly if necessary. and also wishes to extend the cash requirement, now only the concern of the Clearers, to probably all the recognised banks and licensed deposit-taking institutions - I would imagine at a slightly more reduced rate than the existing 1½%.

This brings the reader to Chapters 4 and 5 which are concerned with new ideas to replace the controls that are being dropped. Chapter 4 is concerned with Monetary Base Controls and starts off by saying "that the concept is very simple" and some fifteen paragraphs are devoted to explaining the system, covering such points as the scheme without a mandatory requirement, along the lines achieved by Banque Nationale Suisse, to a scheme with a mandatory relationship between base and deposits which could be expressed in three ways:-

a) lagged accounting - as in the U.S.A.

b) current accounting - as with the Reserve Assets Ratio

c) lead accounting

Paragraph 9 of this chapter concludes that the scheme without a mandatory requirement will not work and paragraph 16 concludes that there are so many difficulties, in spite of the opening remark, that even a mandatory requirement scheme would not produce the desired results. If this is the considered opinion of the Bank/Treasury there would really seem to be little point in pursuing this particular idea. This brings one to Chapter 5 introducing Indicator Systems. Under this method Sterling M3 or the monetary base would be used to trigger changes in the Bank of England's lending rate according to a predetermined formula. To be successful this scheme really requires weekly not monthly data and the experimental scheme at present in use, whereby certain banks provide weekly figures, would have to be extended to all.

Bearing in mind the many factors that have to be taken into account we question whether the automatic indicator system will in fact be any more successful than previous attempts to control money supply by mathematical formulae, However, we will of course be prepared to give the necessary information and would hope that the data form can be kept as simple as possible to reduce the additional work to a minimum.

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17th June 1980

Mr. T. Kamoshida,
Deputy Chief Representative in Europe,
The Bank of Japan,
27/32 Old Jewry,
London EC2R 8EY

Dear Mr. Kamoshida,

Re: COMMENTS ON THE GREEN PAPER

With reference to the above matter, our thoughts are as follows:-

.4 (a) No comment, but we are pleased to submit our returns without delay which, the Bank thinks, are necessary to implement the monetary control in this country.

.4 (b) We think the interest rate scheme would be used for the external, as well as internal economic factors.

We, therefore, would like to say that the interest rate scheme would not only be adjusted automatically to a certain system, but also it should contain allowance for the Bank's discretion.

Sincerely yours,

H. Sekiguchi

H. SEKIGUCHI
Deputy General Manager

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17th June 1980

Dear Sirs,

In all the circumstances it is inappropriate for us as a London Branch of a Japanese Bank to comment on these matters in view of our very small sterling base.

However, for what they are worth our short comments would be:-

6.4 a These difficulties could be achieved in theory but the result would on balance produce very little advantage.

6.4 b We do not think that the system outlined in Chapter 5 of automatically adjusting the Bank's lending rate would be advantageous on balance.

Yours faithfully

Y. Nakaide

MCC(80)29

22 July 1980

COPY NO.

HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

COMMENTS BY THE TUC

Note by the Secretaries

The attached comments by the TUC's Economic Committee are circulated for information.

M D K W FOOT

M L WILLIAMS

H M Treasury

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YOUR REFERENCE

OUR REFERENCE LM/BC/KB/BL

DEPARTMENT Economic

CH/EXCHEQUER	
REC.	21 JUL 1980
ACTION	Mr Bridgeman
COMES TO	CST
	FST
	Sir D. Wass
	Mr Burns

July 17 1980

Mr Ryrie
Mr Middleton
Mr Britton
Mr Riley
Mr Ridley

Dear Sir Geoffrey

Monetary Control

The General Council's Economic Committee considered the Government's Green Paper on 'Monetary Control' at a recent meeting and have asked me to write to you to convey their views.

The Committee's views on the Green Paper and related issues are outlined in the statement attached to this letter. I trust you will take the Committee's views into account in further consideration by the Government of new monetary control methods arising from the Green Paper.

Yours sincerely

Lionel Murray

General Secretary

Enc.

MONETARY CONTROL

The General Council's Economic Committee have considered the Government's Green Paper (Cmnd 7858) on "Monetary Control" published in March. Their views on the Green Paper are outlined in the statement below:

"The Committee wish to underline the views that the General Council's representatives have expressed at recent meetings of the National Economic Development Council that they do not accept the Government's single minded commitment to reducing inflation by means of a strict monetary policy. The objective of reducing inflation cannot be seen in isolation from policies needed to achieve growth, full employment and a sustainable balance of payments position. The Committee wish to emphasise the uncertainty over the effects of monetary policy on inflation and, especially, the time lags involved. In their view this means that new methods for applying monetary policy are most unlikely to bring about a reduction in inflation.

As they have also pointed out on previous occasions, the Committee do not consider that a reliance on market forces in the allocation of credit is in the best interests of the UK economy. Wider economic and industrial policy criteria have a major role to play in the allocation of finance. For example, a reliance of firms' ability to pay the market rate of interest will, in their view, be seriously detrimental to the interests of small firms, and to firms who have major innovations deserving of finance but whose financial record in the immediate past is unacceptable to the banking system.

The Committee consider that the latter will be especially serious given the reduction in assistance to industry from the NEB, the Development Agencies and through the Industry Act. Such a market based approach will cause a major loss to the economy as the need for investment in innovation and technology is constantly increasing, and flies in the face of the evidence from competitor countries.

Underlying the proposals in the Green Paper is an assumption that the Government's monetary policies should be determined by detailed rules set out in advance. The Committee's firm view is that the monetary authorities should retain the flexibility to intervene in the markets when required. If the proposals in the Green Paper for semi-automatic changes in interest rates were implemented the Bank of England's ability to influence the exchange value of sterling will be yet further reduced. Control of the exchange rate has an important part to play in ensuring the competitiveness of UK products on the home and world markets.

The Green Paper's suggestions, in particular for "monetary base" or "indicator" systems, would, if implemented, result in increased volatility of interest rates with a disruptive effect on industry, which will be discouraged from investing in long term capital projects. Increased volatility will affect mortgage interest rates, house prices, and the construction industry and have destablising effects on the economy as a whole.

The Committee do not agree with the view expressed in the Green Paper on the potential role of quantitative controls in monetary control. Quantitative controls, backed by stronger and more frequent qualitative guidance than in the past, have a major role to play in allocating credit in the economy. The Committee also believe that the Supplementary Special Deposits Scheme (the "corset") should be retained since it provides a means of controlling bank lending without an acceptable increase in interest rates, and their corollary which is increased "windfall" profits for the financial institutions. An earlier TUC statement, issued in March of this year, called for the effective taxation of "windfall" profits of banks and oil companies. The "corset's" effectiveness is reduced by the absence of exchange controls, and the Committee strongly take the view that exchange controls should be reintroduced, both to help provide some control over sterling's foreign exchange value and in the interest of domestic economic policy. The re-introduction of exchange control will go some way towards improving the "corset's" effectiveness."
