File FEA/0000000099, Part B – Monetary Base Control

Original reference FEA\C\650\1440\02 B

PART 2

15/4/1981 – 30/6/1981

Pages 8-34

MONETARY BASE CONTROL: WHERE NOW?

Introduction

The papers prepared for the PM's Seminar last autumn identified a number of problems with the system of monetary control, as it then was. Since then, a number of innovations have been announced which have been publicly justified both as "desirable in their own right" and as contributing to a possible eventual move to some system of monetary base control. A companion paper by Andrew Turnbull explains what these changes might be expected to contribute to monetary control, when they are fully implemented, and discusses what further improvements might in their own terms be worth making. This paper looks at where we now stand on the question of MBC. Part 1 reviews the current state of the debate about MBC, and tries to narrow down the serious options, in the light of the internal discussions over the last six months. Part II discusses whether the recently announced changes in monetary control techniques are consistent with an eventual move to MBC, and how much we can expect to learn about the feasibility of such a move from the operation of the new system. The main conclusions are summarised in the final section.

I MBC: CURRENT STATE OF THE DEBATE

(i) Monetary base control: as a technique of control

2. The debate that followed the publication of the Green Paper was dominated by the value of monetary base control as a technique of control. In the absence of direct controls on credit, the main way in which the Bank has sought to influence monetary conditions is through its operations in short term money markets* - ie. "by supplying cash to or withdrawing cash from the banking system through open market operations with a

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*It also operates in other financial markets, notably the foreign exchange market and the gilt edged market. While it now uses a quantitative rule to determine its operations in foreign exchange (ie no net intervention) it has traditionally acted as a price taker in the gilt edged market, without formulating precise quantitative objectives.

safety valve, which may be used to a greater or lesser extent, in the form of discount window lending" (E George, 4 February). Traditionally, money market operations have been directed towards securing the Bank's objectives for short term interest rates. Monetary base control was seen, above all, as providing an alternative quantitative basis for these operations, according to which the Bank would focus on the amount of cash supplied rather than on its price.

3. The technical case for MBC is that it would provide a more appropriate and reliable means of controlling the targeted monetary aggregate than the alternative technique of manipulating interest rates to influence the demand (and supply) of money. Discretionary control of interest rates was said to have the following disadvantages:-

(i) if the authorities fix interest rates, errors and unexpected shocks will show up in the target variable - money. There is a risk of giving misleading signals to the market. Policy may, unwittingly, be given an inflationary bias, as inflationary shocks are accommodated and prove hard to reverse;

(ii) the authorities can only directly influence short rates but broad money depends on relative interest rates. The link between the level of short rates and broad money (and possibly other aggregates) is tenuous and poorly understood;

(iii) interest rates are too political an instrument to use flexibly (there will be a"bias to delay" at least in the case of upward movements).

4. Is MBC really the answer to these problems? Whether (i) is a serious problem at all depends on the nature of the shocks to which the demand for money is most frequently subject. In some cases it may be desirable to allow

the money supply to respond to unforeseen events. Failure to accommodate unexpected changes in the demand for money, relative to nominal incomes, will involve unnecessary changes in interest rates which will destabilise the real economy. On the other hand, the appropriate response to unforeseen movements in nominal incomes will typically be an offsetting movement in interest rates. Whether interest rates or the monetary base provide a better operating guide is therefore an empirical issue.

5. It is sometimes argued that choice of a money supply target establishes some presumption in favour of the base as an operational rule. It is true that similar questions arise in choosing between the monetary aggregates and interest rates as intermediate targets; and that one implication of setting money supply targets is that unpredictable shifts in velocity are less of a problem than unforeseen movements in nominal incomes. But separate issues are involved in adopting some form of MBC. Choice of a money supply target assumes only that velocity is relatively stable. Choice of MBC requires the additional assumption that the relationship between the monetary base and the money supply (the money multiplier) is fairly stable, at least compared with the link between interest rates and the demand for money. In principle, there is nothing inconsistent in opting for a money supply target, and attempting to achieve it by manipulating interest rates.

6. Nor is MBC necessarily the best answer to (ii). An alternative solution would be to target one of the narrow aggregates which has a better defined relationship with short term interest rates. Even if this is not possible, the case for MBC depends not just on the empirical weakness of the link between interest rates and the demand for money, but on the demonstrable superiority of the relationship between base money and the target money supply. In pratice, however, institutional arrangements have made it impossible to judge this point in the UK.

7. Whether MBC is a solution to (iii) is more open. On the one hand, it can be argued that the mere fact that interest rates are so highly political makes it impractical to relinquish control over them, as implied by MBC. On the other hand, similar arguments apply to exchange rates, and the Government has managed to convince an important section of opinion that there is little it can do to reverse a highly unpopular movement in the rate over the past two years.

8. Before leaving techniques of control, it is worth noting another group of problems which we identified last autumn which have an indirect bearing on the case for MBC - the shortage of effective monetary policy instruments. The authorities have no direct control over long term interest rates - though whether this is self-imposed or an inevitable corollary of the Government's domination of UK long term capital markets has been hotly debated. The range of available debt instruments is limited (though it is now being widened). The RAR, never very useful, has now effectively been abolished; special deposits have been zero since the middle of last year. The scope for directly influencing banking sector liquidity (other than through open market operations) is correspondingly limited. The scale of the distoritions revealed by the removal of the SSD scheme has, for the time being, seriously discredited direct controls, while the abolition of exchange controls has severely limited their potential usefulness in the future.

9. There are a number of implications for the MBC debate. First, the lack of alternatives underlines the need to conduct money market operations as effectively as possible. Second, if MBC could increase the range of monetary policy that would be an important advantage. It is sometimes argued for example, that MBC would be a way of putting pressure on the banks to modify their behaviour in ways that would be helpful to monetary control (eg. by encouraging their customers to limit their reliance on short term borrowing, and raise more medium term finance) rather than, as at present, responding passively to the demands of their

customers. (This was the Mervyn Lewis argument). Attractive as this argument is, however, it has been treated with considerable scepticism by almost everyone who has ever had anything to do with practical banking - and while that is scarcely conclusive, there is no evidence on the other side either.

10. Thirdly, the objections to direct controls extend to some forms of MBC as well. We concluded last autumn that the abolition of exchange controls made it impractical to attempt to control £M3 (or any other broad money aggregate) by mandatory MBC.* The reasons were spelt out at length in the TCSC Report on Monetary Policy. While in principle it might be possible to use MBC to control a narrower aggregate, like M2, there would still be scope for domestic distortions and leakages from the control aggregate, especially if building society deposits were excluded from the definition of M2. The value of so doing, despite these problems, also depends, of course, on whether the narrower aggregate was thought to be sufficiently well related to final objectives to be suitable as a target.

(ii) Monetary base: as an intermediate target

11. The debate about control techniques took it for granted that the intermediate objectives of monetary policy would be defined by a target for the money supply. But internal discussions have ranged more widely. The unexpectedly rapid growth of £M3, at a time when other indicators were suggesting that policy was very tight, raised fundamental questions about the way in which monetary policy objectives were defined. Was £M3 a suitable target? Was it sensible to rely only on one measure of the money supply? Was it even right to define monetary policy exclusively in terms of a money supply target and ignore other indicators of monetary stance like real interest rates and the exchange rate? Monetary base control

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*Or by a negotiable entitlements scheme.

as defined above (a rule for determining the basis on which open market operations are conducted) has a place in this wider debate, since what should be controlled turns, at least in part, on what can be controlled. But the monetary base was also considered not as a short term operating target, but as a longer term intermediate target - a proposal which does not necessarily involve radical changes in techniques of control (though it might).

12. The case for the monetary base as an intermediate target is that it is at least as well related to final objectives as other monetary aggregates, and that it has the advantage of being more directly controllable. The internal papers prepared earlier this year cast doubt on both these propositions.* It is only the currency component of the base that appears to be systematically related to GNP or prices: but since currency has been entirely demand determined it is difficult to see this as evidence of a causal link from the base to nominal incomes. In the short term at least, it would be surprising if the relationship between the base and nominal incomes were as good as that between broader measures of money and GNP, since (as noted in para 5 above) the base/GNP relationship will be disturbed by shifts in the money multiplier as well as by the shifts in velocity which upset the link between broad money and GNP.

13. We concluded that the wide base might even be more difficult to control that M1. True there is daily information about the base. But 85% of the base consists of the public's holdings of notes and coin. The enormous disparity between the banks holding of cash and the public's means that a simple policy of offsetting movements in one against the other would not be practical. Control of the wide base would not be different in principle from control of M1 or £M3, whether the Bank's operating rules were formulated in terms of prices or

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*Subsequent work on the relationship between Mo prices and nominal incomes (including work on annual data for 1880-1979) has reinforced these doubts.

quantities. A surge in the public's demand for notes and coin would require the Bank either to squeeze the supply of cash to the banks (or equivalently, to drive up interest rates), until the banks bid notes and coin away from the non-banks (or, what amounts to the same thing, the public's demand for notes and coins is reduced to the required extent). The problem is that the relationship between the wide base and interest rates seems to be considerably weaker, less stable and more poorly determined than that between M1 and interest rates. Control of the base would probably be <u>less</u> certain, and require wider swings in short term interest rates, than control of M1.

(iii) <u>Narrowing the options on MBC</u>

14. Recent discussions have probably put us in a position to rule out some options altogether viz:-

> (i) MBC as a technique for controlling broad money (£M3 and the PSL's) certainly in mandatory form;
>
> (ii) targeting the monetary base as an alternative to the money supply proper (M1 or £M3).

That leaves mandatory MBC as a means of controlling narrow measures of money; and non-mandatory control of bank holdings of cash (ie bankers' balances and, possibly, till money). Memories of the corset make all forms of mandatory MBC fairly unattractive. But the main problem is the lack of a suitable target aggregate. Disintermediation would almost certainly be a severe problem with M1. Even if figures for M2 are available later this year, it will be a number of years before we can tell whether it will be a suitable target aggregate. For practical purposes, therefore, we can rule out an early move to <u>any</u> form of mandatory monetary base control.

15. The main problem with non-mandatory control of banks' holdings of cash is that there is no guarantee that it would lead to improved monetary control. That would depend on the stability of the money multiplier.* While we can infer something about the money multiplier by observing the stability of the relationship between the public's holdings of notes and coins and total deposits, present institutional arrangements mean that the banks do not have a well determined demand for bankers' balances: their demand for cash is dominated by their precautionary holdings of till money. There is every reason to expect changes in the terms on which cash is supplied to produce a radical change in the nature of the bank's total demand for cash. In our present state of knowledge we are in no position to judge whether or not the money multiplier is likely to be more stable than the relationship betwen short term interest rates and the relevant measure of the money supply.

16. Non-mandatory MBC might also raise the question of the appropriate monetary target. The narrow base might turn out to be well related to M1 or M2, but not to £M3. But the value of such a link with narrow money would depend on the significance attached to targeting these aggregates.

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* The money multiplier M, is defined as $\frac{M}{B}$, where M is broad money, and B is the monetary base. It can be expressed as:

(i) $$M = \frac{1 + c}{r + \dot{c}}$$

Where c is the ratio of the non-bank private sector's holdings of currency (Cp) to total bank deposits (D), and r is the ratio of bank holdings of base money (in the form of currency C_B and deposits at the Bank of England R) to total deposits D.

((i) is obtained by manipulating the identities:-

$M = Cp + D$ and

$B = Cp + C_B + R$)

17. The fundamental issue is, however, the continued definition of monetary policy in terms of money supply targets. It clearly makes no sense to evolve in the direction of any form of MBC if the commitment to using targets for the monetary aggregates as the basis for setting interest rates is wavering. The Budget marked a re-affirmation of broad money targets as a basis for setting <u>fiscal</u> policy instruments: but the decision to take a wider range of factors into account in determining interest rates seemed to imply a move away from money supply targets as the basis for determining <u>monetary</u> policy instruments. There is an obvious tension between making interest rate decisions more discretionary (as is involved in widening the range of relevant criteria) and making them more endogenous to decisions about quantities (as implied by MBC).

II RECENT CHANGES IN MONETARY CONTROL TECHNIQUES

(i) Consistency with an eventual move to MBC

18. In this critical respect, developments since the autumn have not been favourable to the eventual introduction of MBC. On a more technical plane, however, some of the changes announced in November would be helpful if we did decide ultimately to adopt MBC, in the sense of a quantity based approach to money market operations:-

(a) The abolition of the reserve asset ratio. This is the most important: a primary liquidity requirement is quite incompatible with any form of MBC as it involves treating certain short term liquid assets as effectively as good as cash.

(b) Steps to broaden the bill markets, by widening the range of eligible bills. By improving the flexibility of the Bank's open market operations, this should make it easier to control the supply of base money in the face of large, and often unpredictable, swings in the CGBR.

(c) Reduced reliance on discount window lending. This is a necessary step if interest rates are ever to be fully market determined, given the target for the base. As long as discount window operations are a regular feature, the rate at which the Bank are prepared to lend to the market will tend to put a ceiling on short term rates.

(d) The proposal to let interest rates fluctuate within a band (2% in the first instance). This should familiarise market operators with more day to day volatility in short term interest rates and could cause them to differentiate more sharply between cash and other liquid assets. If the position of the band is changed relatively more frequently, the private sector might be prompted to make more far-reaching changes eg. to the terms on which loans are extended - though this would be more likely if there were a clear declaration of intent to move to MBC on an announced timetable. Of course unless interest rate bands are somehow related to quantitative targets (eg. for the base) they will mark a very partial move in the direction of MBC.

(e) The proposal to abolish MLR as a posted rate. This is essential if the interest rate bands are, to be, as intended unpublished, (at least so long as MLR continues to have some operational significance): and, <u>a fortiori</u>, if the authorities were to operate without any interest rate bands at all (in a fully fledged MBC system).

19. The proposal not to publish the interest rate bands has been attacked by Prof. Griffiths as irrelevant to MBC and as creating uncertainty for its own sake. Griffiths overstates his case. Uncertainty about interest rates <u>is</u> a likely

(d) The Bank will operate so as to keep very short term interest rates - up to 7 days - within an unpublished band. Where the authorities felt prevailing interest rates were satisfactory, the Bank will buy sufficient paper at prevailing rates to achieve the level of bankers' cash consistent with those rates. This would be done by inviting offers of paper at existing market rates and accepting what was offerred. Where an upward movement in rates was required, the market would be left with less cash than it wanted. Banks which were unsuccessful in obtaining cash by selling paper would have to resort to the discount window, i.e. borrow at penal rates. If rates reached the unpublished ceiling rate, the discount will be operated freely or open market operations would be undertaken freely.

(e) All banks will have to observe a minimum (non-interest bearing, non-operational) cash ratio of half a per cent.

3. In order to complete these arrangements, the following steps are needed:

(a) a decision on when to launch the interest rate band;

(b) the decision on its width (the proposal on the table is plus or minus one per cent averaged over a week with plus or minus 2 per cent as the actual limit;

(c) abolition/suspension of MLR.

4. The target aggregate will continue to be sterling M3 on the grounds that its closer links with fiscal policy make it a more suitable target for a medium term strategy. However,

consequence of introducing MBC, though it is not the purpose of doing so. Moreover, greater uncertainty about the terms on which cash will be abailable may be required to give cash the special status vis-a-vis other liquid assets which is implicit in the MBC approach to monetary control. But Griffiths has a point. The failure to couple the announcement about unpublished interest rate bands with some statement about the new (possibly quantity based) rules by which the authorities would be operating in future did lay the Government open to a charge of gratuitously increasing uncertainty.

20. One of the recent changes which is not obviously consistent with a move to MBC is the Bank's proposal to ask institutions whose bills will, under the new arrangements, now class as eligible to place an average agreed level of funds with the discount houses. The objective is to ensure that the ending of the RAR does not cause a sharp decline in call money, which would undermine the discount houses ability to discharge their present role as market makers in bills. A well functioning bill makret would make it easier to move to MBC. However, viewed as an attempt to shore up the discount market, these proposals raise problems.

21. During the monetary control consultations, it was widely accepted, not least by the Discount Houses Association, that using MBC as a control technique would almost certainly mean the end of the discount market in its present form. The special position of the discount houses stems from their priviledged access to cash. If discount window facilities are granted less freely, and on less predictable and favourable terms, while the terms on which other assets can be turned into cash become more uncertain as the by-product of operating an MBC system,the discount houses may find it impossible to make a profit from accepting money at call. We cannot be certain that the discount houses would fail to adapt to the changed circumstances under MBC. It appears that the Discount Houses

themselves now take a more sanguine view of their ability to survive a move towards MBC, though what has caused them to change their original assessment is less clear. But even if these proposals are not positively inimical to an eventual move to MBC, they cannot be seen as a significant step in that direction.

(ii) <u>New Evidence on MBC</u>

22. We cannot expect to deduce from the operation of the new system how well a fully fledged system of MBC would work. We will only learn that by making the switch. But, on a less ambitious plane, there are a number of things we may hope to learn in the next few years. First, we shall start collecting figures for M2. That will tell us whether there is a narrow aggregate which is suitable as the denominator of a complusory cash ratio in a mandatory MBC system. Second, we should be able to see how responsive the banks demand for cash is to changes in the way the Bank conducts its money market operations. At present we do not know if there is likely to be a stable money multiplier at all. Even though the value of the multiplier would certainly shift as we moved closer to MBC, observation of the behaviour of of the base under the new system may help us to decide whether there is likely to be a reasonable behavioural link between bank cash and deposits. The existence of such a link is important information, even if the parameters cannot be determined in advance of a full move to MBC.

23. We may also learn something about how the system responds to more flexible, and possibly more volatile, short term interest rates. That includes the effect on financial institutions - discount houses, banks, building societies - and possibly on companies. It could also include the Government - it is for example, quite possible that Ministers will be unwilling to distance themselves from interest rate movements, in practice - at least when the direction of change happens to be acceptable. We may also be able to observe the effect on other economic variables - notably the exchange rate. Even if there is no visible response to a 2% interest band,

that will be information of a sort - at present we have very little idea what degree of interest rate volatility would provoke significant changes in economic behaviour.

24. More ambitiously, we might discover more about the significance to be attached to different monetary aggregates. The divergent behaviour of the broad and narrow aggregates in 1979 and 1980 is not entirely unprecedented, but it was very striking. It will be interesting to see whether the apparent lessons of 1972/75 receive any confirmation. If they do, then our relative neglect of the narrow aggregates in setting monetary policy instruments will be vindicated. Since the case for MBC (in both mandatory or non-mandatory forms) depends in large part on the relevance of the narrow aggregates to monetary control, that is in many ways the most important issue to be decided before passing a final verdict on MBC.

(iii) <u>Further Steps to MBC</u>

25. The most important single development needed to transform the new system of control into a proper MBC regime would be for the authorities to formulate objectives for some measure of the monetary base, and to allow interest rates to respond more closely to divergences of the base from the target. That would mean both widening the bands and setting them with movements in the base in mind. Ultimately operating instructions might be couched entirely in terms of quantities (targets for the supply of cash to the banks) - rather than prices (short term interest rates). These changes would not require institutional changes in the system of monetary control, though they might provoke institutional changes in the private sector.

26. There are two possible changes to the existing framework that might in some circumstances be needed. The first is a change in the cash ratio, which would need replacing if it were decided to adopt a mandatory system. The second concerns the way in which the Bank organises its interventions

in the money markets. If changes in the terms on which cash is supplied cause a sharp contraction in the discount market, the Bank will have to deal directly with the banking system. At present they see real difficulties with this, because the interbank market is dominated by the clearers, who (like the Bank) are net suppliers of cash to the rest of the system. With such a market structure, the Bank have argued, it is unrealistic to look for interest rates which are, in any meaningful sense, market determined.

27. It is not clear what the answer to this problem is, or even if it is a real problem since the discount houses might survive a move to MBC. One possible solution would be for the Bank to influence the base by operating in a short term asset market which is less dominated by the oligopolistic clearers. An obvious candidate is the foreign exchange market, since the base can be influenced by sales and purchases of foreign exchange, as well as by open market operations in bills. One immediate objection to this course is the effect on the exchange rate which, unless domestic and foreign assets are perfect substitutes, would be more affected by operations in the foreign exchange market than in the domestic short term money markets. No doubt there are other problems. But the idea might be worth exploring further, if the problems of operating in the interbank market looked like posing a major obstacle to further movement towards MBC.

III CONCLUSIONS

28. A move to MBC is sometimes presented as the logical operational consequence of adopting money supply targets. The corollary certainly holds - the case for MBC presupposes a strong commitment to formulating monetary objectives in terms of monetary aggregates rather than prices - interest rates or exchange rates. Monetary base control has little to offer a Government which, as a matter of principle, wants a wide range of factors to have a bearing on movements on short term interest rates. There is room for discretion in operating an MBC system

of course, but if a move in that direction is to mean anything at all, it must mean a switch of emphasis away from interest rates, as important economic indicators, towards quantities (some measure of the base).

29. The analogy with the foreign exchange market is illuminating. Between the extremes of pure floating and totally fixed exchange rate regimes there is a wide range of "dirty floating" options. The opposite ends of the spectrum are however clearly defined. Similarly, MBC is, in principle, at the opposite end of the spectrum from a purely discretionary interest rate regime. It is far from clear which direction along this spectrum the authorities currently wish to move.

30. Nor is it obvious what MBC could offer, as long as the authorities continue to define their monetary objectives primarily in terms of £M3. It is fairly clear that MBC is unlikely to be an effective instrument for controlling broad money. Moving to MBC would involve adopting a target for a narrow aggregate, possibly one for which we do not yet have figures. The merits of such a target would need examining in its own terms.

31. Our previous discussions allow us to narrow down the options on MBC. Targeting the wide base has no clear advantage over targeting M1, and some disadvantages. Mandatory MBC, in any form is not an immediate option, because there is no suitable aggregate against which reserve requirements might be set. Even if there were, the risk of creating unnecessary distortions make it fairly unattractive. That leaves (non-mandatory) control over the narrow base. The only serious objection is that we cannot tell whether moving in this direction would improve monetary control or not.

32. Compared with these issues, the technical questions raised by a further move to MBC are relatively minor. As far as we can tell a move to non-mandatory MBC would not require further major change to the framework of monetary control. The main practical question is how rapidly it is sensible to move along the spectrum - from thinking in terms of interest rates, to thinking in terms of quantities. That is something which we may be better able to judge when the financial system has had a chance to digest the changes we are currently in the process of making.

MR RYRIE

cc Mr Burns
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MONETARY CONTROL - THE EMERGING SYSTEM

I attach a paper on the system of monetary control as it is emerging as the changes announced last November are put in place. It considers the properties of such a system, what degree of control it might be expected to bring and what improvements the changes are expected to make. It concludes by identifying the areas in which further work is needed.

AT

A TURNBULL
24 April 1981

1180/4

MONETARY CONTROL: THE EMERGING SYSTEM

Introduction

This note looks at the system of monetary control as it will be when the changes currently in hand have been completed. It examines the characteristics of that system and what advantages for monetary control the changes might bring. It considers whether the emerging system can be considered an end state, i.e. whether it could be expected to deliver a reasonable degree of control for a number of years, or whether it makes sense only as a transitional step to something else. Finally, the note considers what developments could be made within the same general framework. It forms a companion paper to that being prepared by Mrs Lomax on alternative systems of monetary control.

Characteristics

2. By the time the present discussions are completed, a new system will be in place for the Bank's operations in the money markets. It will have the following characteristics:

(a) there will be no Reserve Asset Ratio for the purposes of monetary control but banks will be asked not to make major changes in their holdings of liquid assets pending completion of talks on a new prudential system.

(b) Access to the discount window will be much less freely available and then only at a rate to be varied from day to day which would be penal in relation to those established in the market. MLR will be abolished or suspended.

(c) The Bank's operations will be conducted mainly in bills through the discount houses. The criteria for the eligibility of bills will be widened and arrangements will be established to ensure adequate supply of bills to the discount market. Call money will continue to be an important feature of the system.

interest rates will not be set solely by reference to deviations of sterling M3 from the target. A variety of other factors including the behaviour of other aggregates, real interest rates, and the exchange rate will be taken into account. No weighting system for these other factors has yet been constructed, though work is in hand to make the criteria more precise.

5. In some ways the new system will represent a return to the spirit of Competition and Credit Control - avoidance of direct controls and a greater role for market forces. There will, however, be a number of differences:

(i) in addition to short term interest rates, emphasis is now placed on fiscal policy and funding as instruments of monetary control;

(ii) there will be no MLR formula and no RAR;

(iii) there is no exchange control.

6. The instruments of monetary control will thus have been pared down to short term interest rates operated through the bill market, fiscal policy and funding. In the case of the latter, there have been some developments, e.g. the indexed gilt, a more aggressive approach to National Savings, and possibly the short dated gilt will improve our control over the flow of debt sales but we remain without an instrument for altering long relative to short interest rates.

<u>Operation of the new system</u>

7. There are a number of questions raised by the new system:

(i) Will it, with its more restricted range of instruments deliver an acceptable degree of control?

(ii) What are the advantages of the changes - described as "desirable in their own right" and will they actually materialise?

(iii) What further developments can be made?

(i) Degree of control

8. It is necessary to establish how close a degree of monetary control it makes sense to aim for. As a minimum, the Government is likely to want some assurance that it can come within, or at least not miss by much, the target ranges set year by year. Although it is generally recognised that movements in the monetary aggregates over a period shorter than this have little economic consequence, there is some merit in trying to ensure a reasonably smooth path during the course of the year in order to prevent destabilisation of market expectations. There would be little point in achieving a smooth path for the monetary aggregates month by month if this were at the cost of injecting instability at some other point in financial markets. Removal of potential distortions such as round-tripping would, however, be advantageous. A further factor pointing to a longish time horizon for achieving monetary targets is the relative importance as an instrument of control of fiscal policy, whose effects work rather slowly.

9. With various instruments of direct control having been removed, monetary control, particularly within the target period, will be heavily dependent on movements in short term interest rates. The experience of 1980 indicates the relative weakness of this weapon, particularly if other forces are working against it e.g. the position of the company sector, or if other factors e.g. the strength of the exchange, inhibit its use. Our view on the sensitivity of £M3 to interest rate changes is in a state of flux, more recent work indicating rather stronger effects than previously estimated.

10. However, much depends on the relativity of long and short rates. A rise in short rates with long rates fixed would have only small or even perverse effects on monetary growth but a rise in long rates with short rates fixed would have a strong

effect. But there may be little scope for manipulating the yield curve. A policy of aggressive funding at the long-end may, though its impact on money markets, drag short rates up with it.

11. Thus our ability to fine tune a broad aggregate like £M3 through changes in short term interest rates is limited. The effect on monetary growth may be slow and it may even be perverse initially.

(ii) Advantages of the new system

12. One of the advantages claimed for the new system is that it will allow market forces to play a greater role in the determination of the structure of short term interest rates. It is not clear however how important a change this is. The new system is clearly one in which the authorities retain discretionary control over interest rates. While it is true that in its money market operations the Bank has arranged matters so that it responds to bids, the setting of the band will still be the prerogative of the authorities and the criteria for this will be much the same as if an MLR system were being operated. The behaviour of the chosen aggregate, whatever it is, will continue to be an important determinant in the decision to provide or withdraw cash from the system.

13. Another possible advantage of the new system is that it reduces the so called "bias for delay". There may be some element of this since the position of the band will be considered at regular monthly meetings but regular consideration of the level of interest rates could equally well be achieved using MLR. It is also claimed that the new system may "depoliticise" interest rates since there would no longer be the drama of infrequent administered MLR changes. It is sometimes claimed that the system in the US, where the FOMC gives instructions on the interest rate bands to the manager, has succeeded in reducing the political sensitivity of interest rates. However, it is not clear that this would be achieved

here where Ministers are more directly responsible for monetary policy.

14. There are two properties of the new system which are claimed to have advantages. First, there will be more uncertainty about the terms on which banks can obtain cash and secondly, the cash ratio will take the form of a minimum, with the balances held at the Bank of England being non-operational. As a result of these changes the banks, particularly the clearers, are likely to hold "excess" reserves for the first time. Under the old, averaging, system holdings of cash above the required level were tolerated as they in effect "bought" the right to go below the required level at a later date. Under the new system, any "excess" holdings will have an opportunity cost and the banks will therefore have a strong incentive to keep such holdings to a minimum.

15. It is claimed that this will force banks to pay more attention to asset management i.e. to offer overdraft facilities less freely and to shift from base related to market related lending. If this occurred, it would be advantageous in reducing round-tripping. Whether it would restrain the trend of bank lending must be doubtful.

16. It is possible, however, that increased variability of interest rates might be sufficient to create more scope for round-tripping but given the popularity of overdraft facilities with banks' customers, insufficient, initially at least, to induce the changes in bank lending policies needed to eradicate it.

17. A further advantage claimed for the new system is that it will be possible to learn something about the properties of a monetary base system from the banks' cash holdings above the minimum. However, it seems doubtful if this claim has any substance. Money at call with the discount houses, i.e. an asset only slightly inferior to cash, will still be a feature of the new system and the banks will operate in the knowledge that at the upper limit of the range they can get unlimited cash.

18. The new system can reasonably be said to be an improvement over the present system even if it does not achieve all the advantages claimed for it. First, it should permit short term interest rates to be adjusted more regularly even if it does not fully remove the bias for delay or depoliticise interest rate movements. Secondly, by imposing a cost on banks' holdings of cash above the minimum, it should encourage helpful changes in banks' behaviour. Finally, there is now a more realistic view of the time horizon within which it is appropriate to control monetary growth. It is unlikely, though, that the new system will provide much relevant information on the operation of a monetary base system; this would remain as always a leap in the dark.

Further developments

19. Despite these improvements, the new system will be far from perfect. The relationship between interest rates and £M3 is very uncertain in its effect on our ability to change relative interest rates and to accelerate the pace of funding is limited. It is therefore necessary to consider whether any developments could be undertaken within the same general framework, i.e. one where the authorities continue to operate through interest rates rather than quantitative control over the supply of cash to the banking system. The alternatives are:

(i) a different target aggregate;

(ii) a wider band;

(iii) further development of funding policy.

(i) A different aggregate

20. In the Annex they provided for the paper on Non-Mandatory MBC, the Bank made it clear that their new money market procedures were not specific to the control of £M3 but could be used in support of a different aggregate. A case for M1 was considered in January. It was argued then that M1 would be easier to control as it was sensitive to the absolute level of interest

rates rather than the differential between the rate on bank deposits and non-monetary assets. However recent work indicates that £M3 may be more sensitive to interest rate changes than previously thought. By contrast, the received wisdom for many years was that £M3 was superior in terms of its relationship with future inflation but incorporation of more recent data redresses the picture somewhat. Thus the contrast between the two aggregates is no longer so marked and the case for switching to M1 on the grounds that it is more controllable by interest rates is less clear cut than it was. In addition to the tactical problem of switching to an aggregate at the very point at which it could be expected to accelerate, the main objections to adopting M1 are its vulnerability to institutional change, the fact that policy on interest rates has swung more towards discretion and away from automaticity and the increased potential for conflict between monetary policy and the exchange rate.

21. Examination of the experience of other countries however indicates that those which seek to control a broad aggregate i.e. France, Japan and Netherlands, do not seek to do so exclusively through interest rates but buttress their controls with credit ceilings. Those countries relying more heavily on interest rates e.g. the US and Canada put most reliance on a narrow aggregate. In Germany, the weighting system used in constructing CDM gives it the characteristics of a narrow aggregate. While the Bundesbank makes substantial use of interest rate policy it also has a wide variety of instruments available for influencing bank liquidity.

<u>(ii) A wider band</u>

22. A wider band, in the absence of any quantitative guidelines for the provision of cash to the banking system, would tend to increase uncertainty and make the banks less sure about the terms on which they could obtain cash. While there would be greater assurance that changes in banks asset management would result, it is doubtful whether the arrangements

which are being negotiated to underpin the discount market would survive. If they did not, the Bank will be forced to operate in either the interbank or foreign exchange market both of which are **claimed** to have serious disadvantages. However, it is doubtful if there is a great deal of merit in a wider band in the context of a discretionary policy on the limits of the band. This could increase uncertainty in money markets without delivering much additional benefit in terms of control. If one is prepared to accept more variability in interest rates, and the institutional changes this would entail, it might be preferable to move to a more quantitative system for the provision of cash.

(iii) Funding

23. The paper produced by Sir Douglas Wass's group last February has not been followed up. There was only a limited degree of agreement to some negative propositions. It was generally accepted that "aggressive" funding within the existing institutional structure was not desirable. If a large part of debt sales continue to be made to the secondary market the present procedures are probably suitable. If one wanted a system which offerred a promise of more quantitative control over debt sales, e.g. through auctions, it would be necessary to undertake a wholesale reorganisation of the securities markets. With the indexed gilt (and perhaps the short dated gilt) we seem to have more or less exhausted the scope for new instruments.

24. Further discussion of these funding issues will be necessary to see if there is a consensus on the need for further changes. Account also needs to be taken of changes taking place in the securities markets, e.g. the role of the jobbers, which may have implications for the way debt is sold.

Further work

25. There are a number of areas in which further work needs to be undertaken:

(i) In order to establish at a later date whether the new system has "worked" it is necessary to set out the changes which it is supposed to bring about, e.g. in terms of greater interest rate variability, changes in banks' cash holdings, changes in overdraft facilities. In his letter of 10 April to Mr George Mr Monck asked the Bank to prepare a note on this.

(ii) We need to consider the relationship between prudential controls and the system of monetary control. Can we be sure that prudential guidelines on liquidity will not create awkward problems of the kind created by the RAR?

(iii) What would be the consequences of widening the interest rate band? How much interest rate variability could the discount houses tolerate? What would be the consequences of a contraction in their operations?

(iv) We need to examine in greater depth the consequences of operating in the interbank market. Are there any techniques which could be used which would overcome the "giant counterparties" problem? Could part of the Bank's operations be conducted in this market?

(v) We need to complete the work in hand on the criteria for setting interest rates and settle the outstanding issues on the role of MLR.

(iv) The work on funding needs to be resumed. In particular the implications of structural changes at present affecting the gilts market need to be examined. Is there a case for a major change in the way gilts are sold? Will such a change ultimately be necessary in any case? indexed gilts

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