

8. Monetary Base Control III

The Emerging System

3/4/81 – 8/4/81

Filer

MR MONCK

cc Mr Middleton (for information)
Mr Britton
Mrs Lomax
Mr Grice
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Mr H Davies

MONETARY CONTROL: THE EMERGING SYSTEM

I attach a draft paper which looks at the system of monetary control as it will be when the present discussions are complete. It considers whether that system can provide an adequate degree of monetary control or whether it makes sense only as a transitional stage to something else. Some modifications falling short of MBC are discussed.

2. It is very much a preliminary effort and I would welcome comments on its scope (having seen Mrs Lomax's companion paper it is clear there are some areas of overlap) and on the conclusions it reaches.

AT

A TURNBULL
3 April 1981

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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, what advantages for monetary control the changes are expected to bring, and what the weaknesses of the system might be. It considers whether the emerging 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.

(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 offered. 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 operated freely or open market operations would be undertaken freely.

- (e) All banks will have to observe a minimum 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 link with fiscal policy make it a more suitable target for a medium term strategy. However, 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 been constructed.

5. The new system will represent the completion of a major move away from Competition and Credit Control and the various devices that were introduced to strengthen it.

(a) The MLR formula will have gone;

(b) there will be no RAR nor any other reserve ratios apart from minimum cash requirements;

(c) there will be no credit controls or direct controls on bank liabilities;

(d) there will be no exchange control.

6. The instruments of monetary control will thus have been pared down to short term interest rates operated through the money markets, 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 fundamentally we remain without an instrument for altering long relative to short interest rates.

Operation of the new system

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

(i) will the system, with its limited range of instruments, actually deliver an acceptable degree of monetary control?

(ii) What were the advantages claimed for the changes - "desirable in their own right" - and will they actually materialise?

(iii) Is there any possibility that the system will introduce new problems?

8. 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 this claim has any real content. The new system is clearly one in which the bank retains 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, it is not clear that this is a significant change in terms of monetary control. The setting of the band will still be the prerogative of the authorities and the criteria for this will be pretty much the same as if an MLR system were being operated. The behaviour of the chosen aggregate,

whatever it is, will continue to be the principal determinant in the decision to provide or withdraw cash from the system.

9. 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 the 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 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.

10. It is sometimes claimed that the new system will inject a welcome degree of uncertainty into the money markets and that this will have two consequences. First, the banks, being less sure about the terms on which they can obtain cash will tend to hold more of it. Holdings of excess reserves might become a feature of the system and from this it would be possible to

learn something about the properties of a monetary base system. However, it seems doubtful if this claim has any substance. It is not clear that a band of plus or minus one per cent is a sufficient range to trigger any significant changes in bank behaviour. They will still operate in the knowledge that at the upper limit of the range they can get a unlimited cash.

11. Secondly, it is claimed that the banks will be forced to pay more attention to asset management/less freely. A shift from base related to market related lending would improve control by reducing the extent of round-tripping. Again it is not clear that the amount of interest rate variability that would be injected into the system would be sufficient to induce banks to make significant changes, given the popularity of overdraft facilities with their customers.

12. It would appear, therefore, that the advantages of the new system may be rather small. The reduction in the bias for delay in adjusting interest rates may be limited; little or no knowledge relevant to the function of a monetary base system might be required; and little progress might be made on reducing the scope for round-tripping. The ineffectiveness of short term interest rates as an instrument for controlling a wide monetary aggregate which is apparent under the present system would remain and our techniques for funding have been only slightly improved.

13. Indeed, it can be argued that the new system could inject some new problems. For example, the policy of operating through the bill markets might cause substantial fluctuations in non-bank holdings of bills, the counterpart of which would be distortions in the path of sterling M3. Also, there is a possibility that increased variability of interest rates might be sufficient to create more scope for round-tripping but insufficient to induce the changes in bank lending policies which would be needed to eradicate it.

14. The emerging system does not appear to hold out the prospect of being a durable system which will be able to deliver effective monetary control over a sustained period. It will be heavily dependent upon the defective instrument of short term interest rates.

Nor does the emerging system have much merit as a transitional stage since it does not provide much usable information about the characteristics of a monetary base system.

Further developments

15. This negative conclusion provokes examination of developments which could be undertaken to provide an adequate degree of control 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.

A different aggregate

16. In the view 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 sterling M3 but could be used in support of a different aggregate. A case for M1 was considered in January. It was accepted that M1 would be easier to control as it is sensitive to the absolute level of interest rates rather than a differential between the rate on bank deposits and non-monetary assets. For many years the received wisdom was that sterling M3 was superior in terms of its relationship with future inflation but incorporation on more recent data redresses the picture somewhat. It is no longer clear that sterling M3 retains its margin of superiority. Apart from the tactical problem of switching to an aggregate at the very point at which it could be expected to accelerate, the main difficulty was thought to be its vulnerability to institutional change. Nevertheless, examination of the experience of other countries 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.

A wider band

17. 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 considered 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 would 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.

18. 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 offered 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.

18. Further discussion of the funding issues will be necessary to see if there is a consensus on the need for further changes. Improvements in funding techniques have greater urgency if £M3 remains the target aggregate. 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.

Conclusions

19. The emerging system appears to leave us heavily dependent on discretionary changes in short term interest rates for controlling an aggregate which we believe to be insensitive, at least in the short run, to interest rate movements. At the present time we are without workable rules for the setting of interest rates though work is in hand on this.

20. The scope for making changes to the system, short of moving to MBC, also appears to be rather limited. The sophistication (and independence of Government influence) of our financial institutions indicates that quantitative control on credit would be ineffective over a sustained period, though, as in the US they might have a role in a crash programme. Substitution of M1 as the target variable would hold out a better prospect that the target could be achieved but this could be thought to have disadvantages. First, it would weaken the "disciplinary" effect which use of a wide aggregate is said to exert over fiscal policy, though it is far from clear whether these alleged benefits have been secured. Secondly, a switch to M1 would imply a greater acceptance of

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automaticity, with interest rates being determined in relation to the movements in the target aggregate.

This would represent a reversal of the current

style of policy. It would also heighten the potential for conflict in monetary policy and the exchange rate.

21. It is not clear whether widening the interest rate band in an otherwise discretionary interest rate policy would bring many benefits other than an increase in uncertainty. Further work needs to be done to establish whether improvements to funding techniques are still needed after the introduction of the indexed gilt. The priority attached to this will depend on the choice of target aggregate.

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3 April 1981

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MRS LOMAX (O/R)

cc Mr Middleton
Mr Monck
Mr Turnbull.
Mr Grice
Mr Shields
Mr H Davies

Law
MONETARY BASE CONTROL: WHERE NOW?

1. The draft you sent to Mr Monck on 2 April seems to me to provide an excellent basis for further discussion of MBC. I have only minor amendments to suggest.
2. Additional, even more fundamental, questions might well be asked either here or in a covering note. Until last year it was thought that in £M3 we had a monetary aggregate which was both controllable and closely related to nominal incomes. In the course of last year we found it was neither, at least in the short term.
3. Over the course of last year and the early months of this year, we had to re-think the position rather fundamentally, and the reassessment of MBC was an integral part of the process. If we wanted to emphasise the proposition that monetary policy should be about controlling what we can control (and leaving the rest to the market), then we urgently needed to change our control methods or the definition of the target aggregate, or both. On the other hand, if the essential requirement was to relate a medium-term fiscal and monetary strategy to the achievement of a prescribed deceleration in nominal incomes, then MBC was something of a side issue. It seems to me that it is the second formulation of policy priorities which has now been adopted with the restatement of the MTFs in the Budget Speech and the justification of base drift. I would therefore expect interest in MBC to diminish.

4. My minor amendments would be:

Paragraph 7

Do we really have a money supply target in the sense of this paragraph? When velocity failed to match prediction last year, we based our policy response on the movement of nominal income, not the money supply.

Paragraph 14 and elsewhere

"Disintermediation" is a technical term describing particular kinds of distortion to SM3. It is not appropriate as a description of all distortions to any aggregate!

Paragraph 14

During the three years before M2 is seasonally adjusted, it will still be providing useful information. If we had to, we could probably use it for mandatory MBC before the three years were up.

Paragraph 17

I agree with the sense of this paragraph, but would omit the final sentence. Conflicts of this kind are not always explicitly resolved.

Paragraph 20

This reads as if publishing the bands was now a real possibility. Is it?

Paragraph 27

It would not be necessary to change the cash ratio, but rather to supplement it by another requirement.

Paragraph 33

I agree with the way the conclusions are balanced, but beware of understating the technical problems of MBC. It would still be a leap in the dark.

Pauline Hogg
pp A J C BRETTON
8 April 1981

Mrs Lomax

cc Mr Burns
Mr Britton
Mr Monck
Mr Riley
Mr Turnbull
Mr Griee
Mr Shields

MONETARY STATISTICS

I am sorry for taking so long to reply to your minute of 25 March. I would be grateful if you could keep in touch with CSO about the way they do their tables. But I think it would be as well not to press the point about M_0 at this stage. "Total 1-3" seems to have been taken by everyone to refer to the wide base, so I think we can stick to our truce.

I am very pleased indeed to see that we are hoping to get out an article on private sector wealth - it should make life easier for all of us.

PEM

P E MIDDLETON
6 April 1981

MR TURNBULL

cc Mr Middleton —
Mr Monck
Mrs Lomax (o/r)
Mr Grice
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Mr H Davies

MONETARY CONTROL: THE EMERGING SYSTEM

1. The key element in the emerging system is fiscal policy. The emphasis has shifted to control of £M3 in the medium term (when velocity is stable) rather than year-by-year or month-by-month (when £M3 can give misleading signals). Interest rates are also relevant, mainly because they influence nominal expenditure; their effect on £M3 for a given level of nominal expenditure is now much less emphasised.
2. I am therefore less disturbed than you are by the apparent shortage of effective monetary instruments for controlling the money supply. I also feel you overstate the extent to which short-term rates are still being used to meet the £M3 target. I expect (and hope) that they will not be used for that purpose at all on a month-by-month basis.
3. The emerging system does not differ greatly from the system we have operated since the war in the gaps between the various schemes of direct credit restraint. The main change is the modification of the RAR or its replacement by prudential norms. That is a useful, if rather minor, improvement. The significance of the abolition of MLR remains to be seen. If it changes the system fundamentally, it will be by accident rather than design.
4. The other substantial change is the introduction of indexed gilts. Until we know the scale on which they are to be issued, we cannot know quite how substantial the change is, but in future years we may be able to integrate some kind of medium-term debt sales programme with our consideration of the medium-term PSBR. The crucial difference would be not that the debt is indexed, but that it is auctioned.
5. The point you make about the bill market in paragraph 13 is a new one to me. Have we here a means of inducing "disintermediation" and therefore achieving "cosmetic" control of £M3? If so, we must decide

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whether we are going to exploit it. But surely monetary control has always involved operations in the bill markets, so the effect, if it occurs, will not be entirely new.

6. I agree with everything you say about M1 in paragraph 16, but a decision has just been taken to stick with SM3 on both tactical and some more timeless arguments. The time is hardly right to re-open the issue now.

Pauline Hogg

pp A J C BRETTON
7 April 1981