

5. Monetary Control Consultations

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19 August 1980

HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

COMMENTS BY MIDLAND BANK

REVIEW

Note by the Secretaries

The attached article from the Midland Bank Review, Summer 1980 is circulated for information.

M D K W FOOT

M L WILLIAMS

H M Treasury

Monetary Control

Spring in Threadneedle Street this year has seen consultation blooming all over the place. The Bank of England has scattered its seed with documents on control of the money supply and on the liquidity of banks. As we go to press, one is awaited on the cash that banks are to be required to hold at the Bank of England. Although these issues are intertwined at certain points, this article is concerned primarily with the first, and with the treatment of it in the Green Paper on Monetary Control (Cmd. 7858).

This document opens up several levels of official thinking. It seems that there are some matters about which the authorities are sure and intend to take action; some about which they seem almost to have made up their minds; and some on which they are simply seeking opinions. In the first category, quantitative control of bank lending is to remain out of favour and, as the Chancellor of the Exchequer confirmed at the time of the Budget, the Supplementary Special Deposits Scheme or 'corset', penalising excess growth of banks' interest-bearing deposits, is discontinued from June. It is proposed that banks should no longer be required to hold the 12½ per cent minimum Reserve Asset Ratio, but the need for liquid assets for prudential reasons is laid down in the separate paper on liquidity. Although the relation of liquid assets to deposits will cease to be a minimum requirement on a day-by-day basis and become a norm, the difference this makes in practice will depend upon how frequently it is monitored and how generous are the tolerances allowed. While the existing Reserve Asset Ratio is to be dropped, the banks will be required to hold some cash in the form of bankers' deposits at the Bank of England, and this will no longer apply (as hitherto) to the London Clearing Banks alone. The Bank of England will also retain its power to call for Special Deposits from the banks, and thus to sterilise any excess holdings of cash. The authorities' objective will continue to be to control sterling M3 (or roughly speaking the sterling deposits of UK residents plus notes and coins in circulation) within a pre-determined range while taking into account the growth of other monetary aggregates. The objective will be pursued over the medium-term through fiscal policy and interest rates appropriate to a progressive reduction of the rate of growth of the money stock, and the Green Paper is mainly concerned with how to 'achieve a smoother path in the growth of the money supply from quarter to quarter'. (6.2)*

A system on a monetary base

Below this first level at which the Green Paper appears to be of a firm mind, the going becomes somewhat opaque. It is important to note that under the arrangements described above the authorities will be dealing with a system which rests upon a 'monetary base' in the form of a cash ratio. But the clear conclusion of the Green Paper (4) is that it is difficult for the authorities to control the base. This would appear to suggest that in attempting to control the superstructure of deposits, and hence EM3, the

authorities should not seek explicitly to control the size of the base. The alternative the authorities appear to be canvassing is an indicator system linked to EM3 (5, and Annex B 37-41), whereby the rate at which the Bank of England will lend to the discount market would be adjusted up or down from Minimum Lending Rate (MLR), on a pre-set graduated scale, according as EM3 was above or below target. But it is recognised that, in order to make this 'operative' lending rate effective throughout the money markets, it might be necessary to conduct open market operations '... to reduce the cash base and thus to bring pressure on controlled institutions' cash balances' (Annex B, 40). In other words, the system might fail to work unless the authorities are able to influence the size of the monetary base. Elsewhere (6.3), the cash requirement is said to be needed 'to act as a fulcrum for the Bank when it wishes to generate interest rate changes'. Yet the leverer surely levereth in vain against an uncontrollable fulcrum.

Thus there appears to be a certain ambivalence about the Green Paper, which might be caught by caricaturing its argument as follows: 'It is difficult to control the monetary base, and so we propose instead a system for adjusting MLR which we shall make effective by controlling the monetary base'.

A cynic might explain the ambivalence by the fact that monetary policy in the UK is divided between Threadneedle Street and Whitehall; and as Kipling said: 'East is east and west is west, and never the twain shall meet'. But the public, and the practical banker peering through the bars of his infelicitously-designated 'controlled institution', are bound to be puzzled. It may be useful to approach the question by examining first the problems which attach to controlling the monetary base,* and then the extent to which they cease to be relevant under the indicator system which the Green Paper expounds. Behind this there lies a broader question: in a system on a monetary base, such as we now seem likely to have, if it is not possible to control the base, how is it possible to achieve a target for EM3, in the absence of direct quantitative controls, which the Green Paper dismisses as not an alternative on the grounds that 'they tend, over time, to divert and change the forms of liquidity and credit without affecting underlying credit conditions?' (6.1)

Difficulties of controlling the base

There are essentially two sources of pressure which may cause the base to be larger or smaller than the authorities intend. The first is that 'there are frequently large unforeseen swings on any day in cash flows between the public and private sectors' (Annex B, 22). Clearly this makes it difficult to control the base day-by-day, and complicates the task of controlling it over a defined period. It might be remarked that these large unforeseen swings affect the base because the Exchequer keeps its account with the Bank of England rather than with the commercial banks. There is no necessary reason why this should be so. Perhaps the holding of

*References throughout are to the chapter and paragraph numbers of Cmd. 7858.

*See also this Review Spring 1980 pp. 3-6.

the Exchequer's account might be opened up to tender, in line with the Government's philosophy of encouraging competition. If it happened to be spread among the commercial banks, swings in the monetary base itself might be damped, although swings in individual banks' cash would be larger. Short of this change, the problem is one which attends but does not rule out a policy of attempting to control the base; and the authorities are not without means of offsetting the swings, such as the call and release of Special Deposits and arrangements for the sale-and-repurchase of gilt-edged securities which have been used recently.

However, even if the authorities have correctly calculated the flows between public and private sector referred to above, and have set the base at exactly the level they intend, it can come under a second source of pressure as a result of an upswing in the demand for bank loans from the private sector. If the banks meet the demand, deposits and advances both rise. For some banks advances rise less than deposits and bankers' deposits rise, and for others the opposite happens; but for the banks collectively the monetary base is initially unchanged. But it may tend to expand as a result of market forces which then come into play. What happens will differ somewhat according to whether the cash requirement which banks must meet is defined by 'lagged accounting' or 'lead accounting'. The Green Paper pays a good deal of attention to these systems (4.10-4.16, Annex B 10-24) and it is worth analysing them separately:

(i) *Lagged accounting*

Under this system the banks' higher level of deposits requires them to hold more bankers' deposits ('base assets') at a specified future date, say next month. Banks which fail to obtain the requisite amount might be subject to some kind of penalty, perhaps in the form of a high rate of interest on a lender-of-last-resort facility at the Bank of England. In order to avert this, individual banks will bid for funds in the wholesale money markets, where rates of interest will rise. As this happens, however, it will be tempting for non-bank holders of Treasury bills or gilts which mature during the month to take repayment in cash from the Bank of England in order to deposit with the banks. As they do so, the total of bankers' deposits rises, so that the banks collectively are able to satisfy the cash requirement. But the monetary base will then have expanded above the level the authorities had intended for it to meet the higher level of deposits resulting from the upsurge of the private sector's demand for bank loans.

(ii) *Lead accounting*

Under this system the banks need to reduce their deposits again next month to conform to this month's unchanged level of bankers' deposits, and again there may be a penalty if they do not. The banks' most obvious expedient is to run down some of their secondary liquid assets in the form of market loans to non-banks, which include local authorities as the largest takers but also some large corporate customers. The proceeds of their repayment can be used by the banks either to redeem maturing Certificates of Deposit or to re-lend in the inter-bank markets, thus bringing their deposits (calculated net of inter-bank lending) down to the required level. But in order to repay the banks, local authorities and others must attract deposits to themselves from other customers of the banks by offering higher interest rates. As in (i), these rates provide a temptation for non-bank holders of maturing Treasury bills and gilts to take repayment in cash. Although they subsequently transfer the bank deposits they have acquired to the accounts of the local authorities and others bidding for them, the repayment of maturing Treasury bills and gilts still leaves the banks with a higher level of bankers' deposits than the authorities intend, and this will support a higher level of advances and deposits in the following month.

In both of these cases the operation of market forces confers upon the monetary base a capacity to expand in response to an increase in loan demand in the private sector which the authorities are even less well placed to foresee than they are the swings that occur in the public sector's finances. The Reserve Asset Ratio has been criticised for the same rubbery qualities. Nevertheless the story need not end there. The chapter above ended with fewer willing holders of Treasury bills and gilt-edged securities outside the banks. For a given Public Sector Borrowing Requirement and a given issue of Treasury bills by tender, it will now be necessary for the Discount Houses, if they are expected to cover the tender, to take up more Treasury bills. The banks, with their cash ratio under pressure, are unlikely to make more funds available to the Discount Houses. Indeed, they may already be making less, if they have decided (under (ii) above) to adjust by taking back some money at call with the Houses. The Houses must therefore turn to the Bank of England and borrow from it at Minimum Lending Rate. The Bank of England can then set Minimum Lending Rate at the appropriate level. The appropriate level will be the level which, through its influence on the Discount Houses' tenders, lifts the discount rate on Treasury bills in line with the inter-bank rates of the same term, so that there is no longer any inducement for non-bank holders of Treasury bills to take repayment in cash. The essential requirement is that the yields on assets which are readily convertible into cash, like maturing Treasury bills, should be kept competitive with the yields on wholesale bank deposits; and the authorities have to decide the size of the Treasury bill issue with this in mind. For this reason, it may be necessary to develop a wider spectrum of terms for Treasury bills (other than three and nine months) to match the variety of terms available for wholesale bank deposits. It goes without saying that Minimum Lending Rate will have to be adjusted upwards in line with wholesale money market rates and Treasury bill rates.

However, the general requirement extends beyond this. If, in order to forestall their encashment when the banks are short of base assets, Treasury bill yields are levered up in line with inter-bank and wholesale money rates, the necessary upward movement could be reversed by a switch into Treasury bills of non-bank funds which would otherwise have gone into new issues of gilt-edged securities, but now find Treasury bills more attractive. So this too has to be forestalled by the Government broker cutting the price of the existing tap stocks. Thus the upward movement of interest rates is transmitted further along the term structure of assets. At the same time, if the banks' base rates have not risen in line with wholesale money rates, there may be a development of 'round-tripping', in which large customers draw on their overdraft facilities to deposit in the wholesale markets. This will add an additional tranche to the original upsurge of loan demand putting the banks' cash ratios under renewed pressure and leading to a further tendency for the monetary base to expand, as already described, beyond what the authorities intend. If this is to be averted, banks' base rates must also play their part in the generalised upward movement. This would suggest that, if it were official policy to control the monetary base, the authorities might wish to see banks' base rates set much less by managerial decision than by a market-related formula. The implication for the banks' customers would be that their borrowing costs would become somewhat (although only somewhat) less predictable.

What emerges from this is that control of the monetary base can in principle be protected from infringement by an upsurge of private sector loan demand which the authorities may find it difficult to foresee, provided that the first evidence of its appearance in the form of upward pressure on inter-bank rates is quickly appreciated and translated into a general upward movement of rates in which decisions on the Treasury bill tender, on M.L.R., on the prices of existing tap stocks, and on bank base rates all play their part. Clearly the appropriate co-ordination of

these decisions adds a problematic dimension to the authorities' task in making control of the monetary base effective. Furthermore there is the problem that, if the base itself is effectively controlled, there may still be a certain looseness of leverage between the base on the one hand and total deposits and lending on the other, since the penalties which may be applied to banks failing to satisfy the cash requirement would lead to precautionary holdings of base assets which can be run down if need be. This problem should be eased, however, if the authorities retain the right to call Special Deposits. At the same time the problem remains of achieving the intended level of the base against movements in the flow of funds between public and private sectors.

Problems of an indicator system

The verdict of 'difficult but by no means impossible' on a policy of monetary base control has nevertheless to be considered against the alternatives, of which the one the Green Paper seems inclined towards is that of an automatic adjustment to MLR according to the degree of overshooting (or undershooting) of the £M3 target. The question which arises here, however, is whether it would not involve the authorities in acting very similarly to the way they would act if they were aiming explicitly at control of the monetary base. Some passages from the Green Paper have already been quoted in support of this view; and we have seen that the authorities would have to lift MLR as part of the defences against the base becoming larger than they intended. Imagine that the £M3 target has been overshoot and this has led to an automatic increase in the Bank of England's operative lending rate. The overshooting may well have occurred as a result of an upsurge of private sector loan demand or of a flow of funds from the public sector, expanding the banks' base assets (bankers' deposits) in the way described earlier. Consequently the overshooting of the £M3 target will not have involved the banks in any shortage of base assets. The automatic rise in the lending rate will thus be a mere gesture; nobody needs to borrow from the Bank of England at that or any other rate, and the 'operative' lending rate does not actually operate as a restraint. If the rise is to become effective, somebody has to be made to borrow from the Bank of England. To that end the Bank of England will have to operate against the monetary base, draining off bankers' deposits by means of open-market operations. The intention will be to force the banks to recall funds from the Discount Houses, so that the Houses are forced into borrowing from the Bank of England at its higher operative rate. But the banks' reaction may be to intensify their bidding for funds in the inter-bank markets; and as inter-bank rates rise, the monetary base may be restored as a result of the encashment of Treasury bills and maturing gilt-edged securities by non-bank holders attracted by the rates available on wholesale bank deposits. There may be no need for the banks to call back funds from the Discount Houses; they may prefer not to do so anyway, since money-at-call with the Houses will still be an element in primary liquidity. Thus the expansibility of the monetary base may get in the way of making the Bank of England's higher operative lending rate effective, just as it may thwart a policy of attempting to control the monetary base itself.

Nevertheless the problem can still be coped with by means of the same follow-through described above in connection with a policy of controlling the base. Inter-bank rates will already have risen, but not necessarily as much as the Bank of England's operative lending rate, since the open-market operations intended to make this effective may have been parried by the banks acquiring cash through the encashment of Treasury bills and maturing gilt-edged securities held by non-banks. However, the requirement on the Discount Houses to cover the tender means that they must absorb these non-bank holdings, and this will force them into the Bank

of England and make the operative lending rate effective. Indeed, the Bank of England can force the pace by setting the Treasury bill tender somewhat higher; this is the point of including in the scheme for an indicator system, as it is described in the Green Paper (Annex B 37), the provision that the Bank of England would simultaneously announce not only the figures for £M3 and the adjustment to MLR triggered by them, but also the size of the following day's Treasury bill tender. This would be the instrument for ensuring that the Treasury bill rate followed inter-bank rates up, so that no relativity would develop which might encourage encashment of Treasury bills by non-banks and thus thwart the Bank of England's efforts to make its operative lending rate effective by open-market operations against the banks' cash. Nevertheless, it would probably be necessary for two other things to happen. The first would be for the Government broker's prices for top stocks in issue also to be reduced in line, in order to prevent switches into Treasury bills which would inhibit the necessary rise in Treasury bill rates. The second would be for banks' base rates to rise in line in order to avert 'round-tripping'.

The fact that in this case the initiative had come from an automatic adjustment to MLR should make it easier for the banks to follow suit and join the general upward movement of rates required. In the early stages of operating an indicator system it might be necessary for the authorities to arrive at an understanding with the banks that this is what they would do. However, from the point of view of competition among the banks, the authorities would wish to avoid giving too much encouragement to a conventional link between base rate and MLR, and might prefer to urge the banks that their base rates should follow more closely a market-related formula.

Base control or an indicator system?

If thus appears that, if an indicator system is to work effectively, the authorities will find themselves facing very similar problems, and having to act in a very similar way to cope with them, as they would if they were explicitly seeking to control the monetary base. In particular they will have to co-ordinate their policy on a number of fronts to achieve the necessary movement in interest rates across the board. This is inevitable in a system which rests on a monetary base, untrammelled by controls, as the system envisaged by the Green Paper appears to. So it is difficult to see why the Green Paper appears at the same time firmly to reject control of the monetary base and to prefer an indicator system, when much the same things would need to be done to make either work. It may be that what the authorities have in mind is a distinction between the following two possibilities:

- (i) controlling the monetary base continuously and precisely to a pre-determined path, which is difficult to achieve successfully enough to make it sensible as an explicit objective, bearing in mind the dangers of adopting policies which arouse expectations they fail to fulfil; and
- (ii) influencing the monetary base as necessary from time to time to support indicated adjustments to MLR in a way which may be possible with enough success to be worth trying when the money figures require.

If this distinction is intended, it is far from being clearly drawn in the Green Paper. Perhaps this is best the second possibility, with its slight suggestion of the world-weariness of the old pro, be too clearly identified as the preference of the eastern arm of monetary policy.

It is difficult not to share a preference for the second and more cautious approach. But it raises the following question. The ultimate objective is the control of £M3. Under the indicator system interest rates are to serve as an intermediate objective for

this purpose. But what change in interest rates will bring about any given adjustment required of EM3 is difficult enough even for an old pro to determine from average experience, let alone in the middle of unforeseen movements in the economy and in the moods of financial markets. If the formula which brings about changes in MLR when the EM3 target is not achieved, fails to set interest rates at the level actually required in the prevailing circumstances to achieve that target, the financial markets will be subject to speculation and tensions which will greatly complicate the task of achieving any of the objectives. But even if the adjustment of MLR is the correct one, it is still liable to have to be made effective on the general level of interest rates by operating on the monetary base. Why, then, if the authorities need to take much the same action either way, do they not cut out the intermediate objective of interest rates and aim directly at the monetary base which underlies EM3 ?

Part of the answer to this question is that although the monetary base underlies EM3 , the leverage it exerts upon it is not sufficiently well-known or reliable. It may become so as a result of the authorities' experience in operating the indicator system, which (as pointed out above) will cause them to influence the monetary base and enable them to observe the consequences for EM3 . It is also desirable to hasten slowly towards greater fluctuations in interest rates, which will certainly be the consequence of achieving a tighter control of the money supply in a system on a monetary base without a 'corset' or other direct controls. But if the intermediate objective is control of the monetary base itself, it postulates the acceptance of whatever general level of interest rates is required to keep the base at the predetermined level, given the forces which can expand and contract it. Under the indicator system, on the other hand, the monetary base will have to be operated upon so that the indicated adjustment of MLR is supported by the movement of the general level of interest rates, but this movement will not be open-ended. It will be limited by the nature of the formula related to EM3 , by the authorities' proposed power to override it, and by their control of MLR itself.

The need to accept a greater variability of interest rates is, of course, fundamental to a commitment to tighter monetary control under a system on a monetary base; otherwise it will not work. But those who have to live in it, the borrowers and the lenders, may be brought to accept it more surely if they are broken in more slowly. Essentially this is what the indicator system seeks to do; and it is to be welcomed as a step which will enable the water to be tested. Under it, interest rates are liable to move less than they might but more than they have, and this should provide the Bank of England and the controlled institutions with useful experience of living in a world of more variable rates. But since the authorities will have to operate in support of an indicator system in much the same way as they would have to operate to control the monetary base, a further step to this latter objective would be more bearable if it were subsequently decided to take it; and it is quite likely that it would be.

Negotiable entitlements

But it would still be desirable to stop short of the extreme form of control which the Green Paper describes as 'negotiable entitlements' (Annex B 34-6). These entitlements would in effect be licences for the creation of credit, which all banks would have to hold in proportion to their deposits. Since the entitlements would be negotiable, individual banks would be able to buy them from other banks, at a price determined by the market which would develop in them; but the total amount issued would be determined by the authorities. In the event of a general upsurge of loan demand, the banks as a whole would need more cash and demand in the inter-bank markets would rise. As a result of rising rates of interest in the inter-bank markets, it might be that the total of bankers' deposits would rise, through the mechanism

described earlier, as a result of switches from maturing Treasury bills and gilt-edged securities into bank deposits. This would provide the banks with the extra cash they required, but they would also need more negotiable entitlements in proportion to the increase in deposits. If the authorities decided not to expand the issue of these entitlements, the bidding for them would lift their market price above their nominal value to the point at which it would no longer be profitable for the banks to meet the increase in loan demand.

Such a system would not amount to control of the monetary base as such, but would create a mechanism for blocking the consequences of any variation in it in which the levers would be wholly in the hands of the authorities. It has the theoretical neatness of a 'final solution'. But its operation in practice, when (for example) loan demand showed the unexpected strength it has recently, might be attended by an unnerving scramble for entitlements, sending tremors through the financial markets as bids were laid against a fixed stock, and perhaps forcing the authorities' hand. The cost of money to banks, although liable under either of the possibilities discussed earlier to be more variable, might become extremely volatile; and the risk of not being able to obtain the requisite entitlements would make banks more reluctant to sustain their flexible overdraft facilities.

The system of negotiable entitlements could also be a source of increased disintermediation, for the following reason. If banks were required to switch some of their assets into negotiable entitlements, which would presumably carry a relatively low rate of interest, their overall margin on lending would be reduced. It is possible that this might be offset by holding less cash in the form of bankers' deposits; if, for example, the cash requirement imposed by the authorities under the system discussed earlier was in excess of the banks' prudential requirement and was no longer imposed under negotiable entitlements. But if there were no such offset, it would be necessary for the banks to restore their overall margin by raising their lending rates. This would lead to a wider differential between the rates offered to depositors and the rate charged for loans, and, as under the 'corset', would give an incentive for bank deposits to be borrowed and lent directly between large corporations and local authorities. In this way transactions would be financed without their being reflected in the figures of bank lending and the money supply. No such encouragement to disintermediation would arise under control of the monetary base or under the indicator system, when the banks' borrowing and lending rates move up and down in line.

The answer to the Green Paper's questions

The Green Paper states (6.4) that views would be welcomed on:

- (a) whether the difficulties with monetary base control could be surmounted, and, if so, whether there would, on balance, be an advantage in a change to such a system; and
- (b) whether the indicator system would on balance be advantageous.

The foregoing analysis suggests the following conclusions:

- (1) since the banking system, after the abolition of the 'corset' and in the absence of other direct controls, will be resting on a monetary base, the size of this base will clearly have to be attended to;
- (2) the difficulties with monetary base control can be surmounted, provided that the authorities are able to ensure that the appropriate adjustment occurs to the general level of interest rates;
- (3) but this proviso also attaches to the successful operation of the indicator system, and so there is no clear choice of advantage in changing to a system of monetary base control as against changing to an indicator system;
- (4) there would, however, be advantages in initially adopting the indicator system.

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MONETARY CONTROL CONSULTATIONS

COMMENTS BY POST OFFICE STAFF
SUPERANNUATION FUND

Note by the Secretaries

The attached comments on the Green Paper by Messrs Schwob and Jankowski are circulated for information.

M D K W FOOT
M L WILLIAMS

H M Treasury

OBSERVATIONS AND VIEWS ON THE GREEN PAPER ON MONETARY CONTROL

R J Schwob
M H Jankowski*

I INTRODUCTION

The publishing of the Green Paper witnesses the authorities' concern that short term money supply growth can be regulated in a manner consistent with the meeting of the medium term targets for money supply growth. It is argued that medium term control is already exercised effectively through interest rates and restrictions placed on the Public Sector Borrowing Requirement (PSBR), therefore the purpose of the paper is to examine the scope for control over short term fluctuations in the rate of growth of the money supply. On the basis of its discussion of the main current instruments of control, limited firm proposals for change are put forward:

- the Supplementary Special Deposits scheme or 'corset' should be phased out;
- the 12½% reserve asset ratio which requires banks to hold 12½% of their assets in specified liquid form is no longer needed for the purposes of monetary control;
- a consultative document on alternative means of ensuring that adequate prudential standards of liquidity are maintained was to be issued (the paper has subsequently been published);
- the present requirement on the clearing banks to hold balances of 1½% of eligible liabilities at the Bank of England should be extended to all banks and deposit taking institutions above a minimum size.

These proposals are intended both to improve the efficiency of the financial system as well as to facilitate smoother monetary control within the amended regulatory environment. Our impressions concerning these proposals are given in Section II.

The Green Paper also considers the practicality of introducing monetary base control within the U.K. financial environment. Our impressions concerning the feasibility and efficiency of the various alternatives are given in Section III.

* Mr Schwob and Mr Jankowski are Chief Economist and Economist, respectively, of the Post Office Staff Superannuation Fund; however, the views expressed in this paper are entirely their own.

The authors would like to express their thanks to G Barrett (South Yorkshire County Council), R Coghlan (International Bank Credit Analyst) and R Kyprianou (British Petroleum Company Limited) for helpful comments leading to the formulation of the ideas expressed in this paper.

Section IV summarises our general observations concerning the difficulties inherent in attempting macro-economic stabilisation through control of fM3, or monetary base within the U.K. financial structure. Our suggestions are also summarised in this section.

II THE EFFECTS OF THE PROPOSED CHANGES

a) Termination of the "Corset" Arrangements

The difficulties encountered subsequent to the lifting of the corset serve to emphasize the risks involved whenever restrictions are imposed on the London money market. Owing to the restrictive tax imposed on excessive interest bearing eligible liabilities, the banks 'deflected' business through other channels not accounted for in the monitored statistics. Since access to these alternative channels of finance was not as free as to bank finance (under normal conditions) the corset was not only ineffective in reducing the total supply of credit within the economy, but also was responsible for provoking an inefficient allocation of credit.

The lifting of the corset has left the fM3 measure of the money supply exceptionally sensitive to changes in interest rate differentials between domestic inter-bank rates, Euro-sterling rates, and rates on trade bills; this undoubtedly limits the authorities' discretion over the use of short term interest rate changes in pursuit of monetary control. The legacy of the corset convinces us that the corset has no place as an instrument for short term money supply regulation.

b) Abolition of the 12½% Reserve Asset Ratio and the Introduction of New Prudential Liquidity Requirements

The present current accounting reserve asset ratio system, since it is a mandatory requirement, does not directly give the individual banks prudential liquidity reservoirs; it operates only as a blanket tax on the banking system as a whole. Because of the limited ability of the banking sector to manufacture reserve assets at market rates, the effective level of this tax is marginally variable, changing according to each bank's costs of and returns to reserve assets. This variability is, however, exceedingly small and for most purposes we may assume that the 12½% requirement together with the commercial bill ceiling, imposes a uniform tax. In view of the differing activities of U.K. banks and the different risks associated with each type of activity, it would not appear that a uniform reserve asset tax is either efficient (if the reserves are to be viewed as a liquidity reservoir held against the risks of default), or revenue maximising.

The consultative document on the measurement of liquidity hints that the Bank is considering the welfare gain that might accrue should a variable primarily liquidity requirement system, assessed with reference to implicit risk, be established. While we support the principles underlying the various suggestions in that document, we are concerned that the proposed regulatory environment could damage the standing of the City of London as an international

financial centre. It is clear that the proposed system's differential treatment of inter-bank banking and retail banking would adversely affect the competitive position of U.K. branches of overseas banks.

c) Extension of the Requirement to Hold Balances at the Bank of England

The requirement on the London Clearing Banks to hold balances with the Bank of England is not, as it now stands, an efficient 'fulcrum' on which to influence short term interest rates through money market operations; the requirement is too restricted within the banking sector. While we favour the principle underlying an extension of the central bank balances requirement across all of the banking sector, we would hope that the forthcoming proposal addresses itself to the difficulties of spreading the tax element, inherent in such requirements, equitably through the banking sector.

III MONETARY BASE CONTROL

Both the mandatory and non-mandatory versions of monetary base control and the two variants of an indicator system, as described in the appendix to the Consultative Document, share the characteristic that the short term rate of interest is the principal variable which adjusts to clear the money market subject to the Bank of England's short term monetary targets. Since above or below target growth of the monetary aggregates generally stems ultimately from demand and supply conditions in markets which may not be principally responsive to short term interest rates, a heavy dependency on variations in short term interest rates to clear markets may result in undesirable destabilizing effects.

These effects can arise either because of specific technical institutional features of the London money and capital markets, or because of institutional arrangements connecting the financial markets with other major markets.

- 1) As the Consultative Document illustrates, the problems of dis-intermediation may frequently inhibit the effectiveness of the Bank of England's monetary policy by 'immunizing' broader credit from short term interest rate fluctuations. Furthermore, the exercise of control over narrow aggregates can provoke more than offsetting movements in the broader aggregates.
- 2) Commercial and industrial companies rely heavily on short term bank borrowing for stock finance, trade finance, and general operational finance as well as for finance for expenditure of a more capital nature. Until such time as large domestic companies become regular borrowers via long term debt issues, the variability of the short term rate of interest will put U.K. companies at a disadvantage relative to foreign competitors with more stable sources of finance.
- 3) It may be argued that any long term capital finance acquired through short term bank borrowing causes a misallocation of resources away from stockbuilding, 'working' capital, and trade; therefore a smooth and gradual shift to long term borrowing for private capital expenditure might produce an allocative gain. If this shift is

accomplished by permitting, or encouraging, a greater variability of short term interest rates, the maintenance of stable financial conditions for stock and trade finance (so as not to invite an offsetting welfare loss) would require the introduction of a wide variety of new short term financial instruments.

We feel that this 'preference' of commercial and industrial companies for bank finance as opposed to fixed interest term finance ought to be examined more closely, along with the likelihood of the emergence of the necessary financial instruments, before we would believe it advisable to coerce industry into long term borrowing by making bank finance more hazardous. The very modest use of 'drop lock floaters' and convertibles as a source of finance causes us to question the common view that industry is simply waiting for rates to decline to levels at which long term borrowing will become feasible. It may be that the prospects for continuing company profitability are simply not being viewed as secure enough to warrant taking on medium to long term financial liabilities. Adjustments to the discriminatory tax treatment of company securities (as compared to the treatment of gilts) might offset part of the disincentive for company long term borrowing; however, it is difficult to imagine that a publicised commitment to monetary targets and evidence of volatile short term rates disrupting stock and trade finance can succeed in quickly encouraging an upward revaluation of prospects for medium term company profitability.

The indicator systems and the mechanism according to which base money is absolutely controlled by the central bank (which in some versions involves a withdrawal of the lender of last resort facility) are, despite the above similarities, quite different. The operational efficiency of systems of base control in which the markets set their own rates depends on the markets' abilities to recognize their own rigidities and to adapt their operations so as not to generate potentially harmful erratic movements in interest rates and/or invite distorting penal costs. The indicator system, as described in the appendix to the Green Paper, appears to offer a compromise mechanism whose operation blends the strict adjustment of short rates following deviations in monetary growth (a fully automatic indicator system) with a somewhat more discretionary system of control, very similar to current practice. Within this compromise system, the discretion which the Bank would exercise in open market operations across a broader maturity range in an expanded Treasury Bill market would give the Bank a wider presence in the short term money markets. The effectiveness of this style of monetary control would depend upon the reliability of the weekly money stock data as well as upon the money market's ability to interpret accurately the intentions of the Bank and to adjust other market rates accordingly.

Without accurate figures and the full market appreciation of their significance and the intentions of the Bank following the weekly release, the U.K. would risk inviting the same weekly misadventures experienced in the U.S. Float can just as easily be influenced by strikes in the Midlands as by inclement weather at O'Hare Airport, Chicago; and the markets' uninformed reactions to an adjustment in shorter Treasury Bill rates to offset an imbalance could, if misconstrued, result in instability, round tripping, disintermediation, or all three.

IV GENERAL OBSERVATIONS

The processes through which money is created are very complex. Since it is our belief that the ways in which money is created determine to a large extent the resultant economic impact of the monetary growth, we believe that the authorities should address themselves to the problems associated with understanding and regulating the individual channels of monetary creation.

While some may argue, from the above that the authorities should not concern themselves with monetary base or M_3 at all, but should rather focus on regulating the principal channels of monetary creation (PSBR, debt sales, bank lending etc), we believe that a M_2 target ought to be specified and pursued. The value of M_3 and its visible targets lies principally in the information content carried both by the setting of the targets as well as through the regular release of monetary data and the official reactions to the trends.

All the same, the exercise of monetary control via any mechanism which places the heaviest burden of adjustment on any one sector will, in most real-life economies, not be efficient. The extent of the inefficiency will depend on the externalities and rigidities lodged within the various markets and operating between the inter-acting markets. Neither would it be beneficial to juggle the burden of adjustment from one potential source to another, perhaps frequently failing to impose an effective burden on the 'delinquent' sector. While the response times of the various sectors to the policy measures available to the Bank of England are different, short term control over the monetary aggregates should not amount to nothing more than placing the burden of adjustment inexorably on that sector afflicted with the shortest response times.

The traditional placing of the burden of adjustment on the U.K. financial sector has, because of the difficulties the financial sector experiences in passing on a share of the burden to the various non-financial sectors (principally the non-bank private sector, the public sector and the overseas sector), inevitably resulted in the financial sector's development of techniques designed to lessen, and in some cases take financial gain from the burden imposed by monetary control. However the authorities may alter the mechanism of monetary control, it is likely that continuing emphasis on short term interest rates and short term financial pressure on the London money market, in pursuit of this control, will stir the ingenuity of the financial sector and result in the emergence of yet new channels of disintermediation and round tripping and in recurring threats of market instability.

The indicator system described in the appendix to the Document, indicates to us that the authorities are concerned that the burden of short term monetary control be distributed more evenly through the financial and non-financial sectors. The proposed extension of the maturity range of Treasury Bills and the wider role of Treasury Bills within the financial and commercial and industrial sectors would, provided the bank was prepared to engage in open market operations across the full maturity spectrum, enable the Bank to encourage a more even distribution of the burden of monetary control. The wider, fuller appreciation of the significance of the Bank's open market manoeuvres would assist in these efforts.

While we believe that a broader, wider maturity range, market in Treasury Bills would be desirable, it is difficult to imagine this coming about so long as Treasury Bills command a price premium as a reserve asset or as a component of a primary liquidity requirement. In so far as an expansion of the Treasury Bill market is intended to enable the authorities to pass the burden of monetary adjustment on to more than a pin point focus of the financial markets, the success of their efforts depends on a wide distribution of Treasury Bills among the financial institutions and within the private, personal and company sector.

The activities of the long term financial institutions are significant in the determination of monetary growth and no re-structuring of the mechanisms of monetary control would be sound unless the activities of these institutions were taken into account. The major funds are distinguished by the characteristic that they pursue long term objectives but, owing to their presence in the financial markets, have a very short reaction time to changes in interest rates, particularly longer rates. While it is tempting to argue that the Bank ought not to take advantage of the institutions' susceptibility to changes in long rates in the practice of monetary control and that the Bank ought instead to fortify the effectiveness of changes in short rates so that longer rates would not need to fluctuate so wildly, this would be an unsound argument. The long term financial institutions, like all members of the U.K. economy have a responsibility to share a just burden in respect of monetary control, but because of their particular circumstances, it is difficult to imagine how the funds ought to shoulder their share of the responsibility.

The superannuation funds strive to protect the real retirement benefits of private individuals; those currently employed as well as those currently drawing pensions. It would therefore seem inappropriate to apply a tax to these funds to encourage behaviour which would assist the Bank in monetary control. The tax would ultimately be paid by private individuals, and most of these private individuals will clearly not have been contributing to excessive monetary growth.

The current mechanisms for long term funding of government expenditure are possibly not efficient given the various rigidities and inter-connections among the markets. Rises in rates during periods of funding difficulties give rise to increases in the debt burden of the public sector, continuing closure of the long term corporate fixed interest market and, since frequently the equity market responds to falling gilt prices making rights issues awkward, higher bank lending. So long as the institutions are asked to contribute their share of the burden of monetary adjustment in the current environment, externalities will continue to be a problem.

Furthermore, the frequently suggested regulation whereby the funds would be required to maintain a constant flow of funds to government debt issues provides no benefit. Not only is this a tax, which risks making employees from one sector (including those retired) 'pay' for the monetary misdemeanours of other economic agents, but it would have very little impact on stabilizing longer term yields. The fluctuations of longer rates are responsive to the public's appreciation of the authorities' difficulties in arranging funding at the margin; a mandatory flow requirement on the institutions would not ease the situation at the margin where, anxieties develop.

The recent debate over the advisability of introducing index linked government securities has touched on many issues of interest to the UK superannuation funds. While it may be possible that the general appreciation that:-

- a with the appearance of the new issues the authorities could more easily break a funding "log jam" and avoid the customary "Duke of York" tactics;
- b the new gilts would remove the presumed incentive to perpetuate inflation and replace it with evidence of the authorities' firm, financial, commitment to reducing inflation;

might encourage greater stability in long term yields, there are several "grey areas" in the debate which cause us to be more cautious.

- a Even with the presumed increased stability in long term yields there is no guarantee that the general level of yields will decline. Indeed it may be argued that current yield levels are lower than would be considered necessary (given the inflation outlook) were it not for the prospects of large capital gains following the traditional wide price movements expected of the gilts market. The adjustment to lower volatility could result in an upward shift in nominal fixed interest yields, which could be furthered by shifts in demand away from fixed interest securities.
- b The impact of the issue of index linked government securities would be felt in the private equity and capital markets. Private companies could find themselves up against even more onerous long term borrowing costs than exist now. The market's responsiveness to fixed interest issues might be subdued owing to the introduction of the inflation proofed gilts alternative, and the ratings of any possible index linked company securities being lower than on comparable fixed interest issues (because few companies prosper during a UK inflation), would require a greater real return to be marketable. This situation might be slightly eased were the discriminatory tax treatment of company debenture securities to be corrected.

However, were companies to embark on borrowing through the issue of index linked securities, the impact on "real" company gearing could be very substantial and could prove to be unsettling to the equity market. Previously, the declining real debt servicing burden experienced by companies during periods of accelerating inflation served to decrease the equity gearing ratio and helped to sustain smooth market conditions for equities. A heavy reliance on index linked company securities could deflate this risk cushion and introduce greater uncertainty into the equity market, with result that the equity market could become a more expensive source of company finance.