4. Monetary Base IV
Part C

Comments on Green Paper

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HER MAJESTY'S TREASURY

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 minumum 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.

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* 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 stablisation through control of £M3, 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 exessive 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 £M3 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 enviroment 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 liklihood 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 propects 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 £M3 at all, but should rather focus on regulating the principal channels of monetary creation (PSBR, debt sales, bank lending etc), we believe that a £M3 target ought to be specified and pursued. The value of £M3 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 responsbility 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 purpetuate 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.

BRASENOSE COLLEGE
OXFORD OX1 4AJ
Telephone 48641

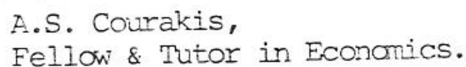
ASC/CR

25 September 1980

Dear Mr. Middleton,

I enclose a copy of a paper I wrote some time ago (and which is due to appear - complete with footnotes, tables etc. next month in a volume I have edited) which bears very closely on some of the issues that, according to your circular (particularly paragraph 10 p.3) of 18 September, will be discussed at the seminar next Monday.

Yours sincerely,



A.S. Courakis,
Fellow & Tutor in Economics.

P.E. Middleton Esq.
Deputy Secretary
H.M. Treasury
Parliament Street
London SW1P 3AG

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HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

PAPER BY MR A G COURAKIS

Note by the Secretaries

The attached paper "Monetary Targets: Concep[illegible] Antecedents" by Tony Courakis is circulated f[illegible] information.

M D K W FOOT

M L WILLIAMS

H M Treasury