8. Monetary Base IV
Part C

Comments on Green Paper

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HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

COMMENTS BY THE INSURANCE COMPANY ASSOCIATIONS

Note by the Secretaries

The attached, somewhat inconclusive, comments by the Insurance Company Associations is circulated for information.

M D K W FOOT

M L WILLIAMS

H M Treasury

INSURANCE COMPANY ASSOCIATIONS

RESPONSE TO THE CONSULTATION PAPER ON MONETARY CONTROL (CMND.7838)

The Insurance Company Associations appreciate the invitation to respond to the Consultation Paper on Monetary Control, published by HM Treasury and the Bank of England in March (Cmnd.7838). We are fully aware that the success or otherwise of official actions in the area of monetary policy is of major importance to our members, both as investing institutions and as business organisations sensitive to the pressure of costs. We therefore strongly support efforts to improve the mechanisms for monetary control. However, bearing in mind that many issues of monetary theory and policy are unresolved, we are not close enough to a conclusion to express firm opinions on the direction of possible changes in the control mechanisms. When consultations on the Paper have progressed further, we should be happy to discuss any implications which may arise for the longer-term capital markets, particularly as regards the management of the gilt-edged market.

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MONETARY CONTROL CONSULTATIONS

PAPER BY DR MAX HALL

Note by the Secretaries

The attached paper by Dr Hall "Monetary Reform: A Critique" is circulated for information. The section "A Critique of The Green Paper: 'Clutching at Straws'" is very similar to that included in the paper Dr Hall has already sent us commenting on the Green Ppaer and liquidity proposals, and circulated as MCC(80)30.

M D K W FOOT

M L WILLIAMS

H M Treasury

MONETARY REFORM : A CRITIQUE

Occasional Research Paper No. 50

by

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August 1980

MONETARY REFORM ; A CRITIQUE

Introduction

The recent publication (March '80) of the joint consultative paper by the Bank and the Treasury on 'Monetary Control'[1] has stimulated considerable debate on and inquiry into the role of monetary management within macro-economic policy and the merits/demerits of alternative techniques of monetary control. To date, most of the academic discussion on the latter topic has been focussed on the advisability and feasibility of switching over to monetary base control, the accounting and technical detail tending to obscure the more fundamental prerequisites for the successful adoption of such a control mechanism. This paper attempts to rectify the imbalance but, more importantly, in the assessment of the material contained in the above document raises serious doubts as to the ability of alternative reform proposals to achieve closer short-run control over monetary aggregate growth. Similarly, with regard to the manner in which monetary policy is presently utilised within the broader framework of macro-economic policy, little chance of success is held out for decelerating the rate of price inflation, other than through a full-scale deflation of the economy. For the benefit of the reader, a brief synopsis of the Green Paper is provided.

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(1) Cmnd 7858.

The Green Paper

Synopsis. Having defined the main role of monetary policy as the need to achieve a progressive reduction in the growth of the money stock over a number of years in order to reduce inflation, the document asserts that adequate medium-term control of money stock growth is already achieved through the fiscal policy (including a progressive reduction in the size of the PSBR as a proportion of GDP) and interest rate instruments but that there is some scope for improvement in the short-term. Thus, the bulk of the paper concerns itself with the problems of effecting greater short-run control - say from quarter to quarter - over the money stock, the question of how to achieve more regular sales of gilts being specifically excluded as full justice is assumed to have been done to the subject in an earlier Bank paper.(2)

The general theme of the Green Paper is a desire to place minimal reliance on direct, quantitative controls, using, instead, the market instrument of interest rates (and fiscal policy in the medium-term) to control money stock growth. In reaching this conclusion, the document notes that, although direct controls may be used to some advantage in the short-run, by bridging the time-lag before the main policy instruments take effect, in the longer-run they all tend to misallocate resources, damage the competitive environment of the banking system and divert business through uncontrolled sectors, thereby distorting the aggregates most directly affected by controls and hence reducing the significance of monetary targetting policy itself. Moreover, a persistent use of direct controls tends to lead to the anticipation of the reactivation of controls which, at worst, might precipitate the action the institutions were expecting, while the dangers of reintermediation make the controls increasingly more difficult to dispense with.

(2) The gilt-edged market, pp.137-148, BEQB June 1979.

Turning to the role of aggregates as indicators and targets, the Green Paper reaffirms the need to monitor all aggregates (such as M1, £M3, DCE and wider concepts of liquidity) in order to obtain a general view of prevailing "monetary conditions", but stresses that, in order to give the clearest guidance to financial markets and industry about the direction of government policy, targets and policy are best designed to impinge on one aggregate alone, the selection of which should remain £M3 if, for no other reason, than that it is understood by the market and can be readily related to key credit counterparts such as bank lending to the non-bank private sector (NBPS), gilt sales to the NBPS, the PSBR, and reserve flows.

The rationale of ratio controls is taken to be the part they play in the provision of a fulcrum against which interest rate changes may be rapidly affected through official market transactions to the extent required to ensure money stock growth remains on target. Within this context, the (1½% of eligible liabilities) bankers' deposits ratio is taken as having been the effective fulcrum throughout the seventies (and not the reserve asset ratio itself), as forecasts of banks' cash requirements were made by the Bank in order to determine the extent of official discount market operations required to keep the market "in the Bank".

Finally, the document lays down two further criterion against which any proposals for monetary reform should be judged: the need to minimise incentives to disintermediate and to ensure that proposals are compatible with future entry to the European Monetary System, should that materialise.

Specific Proposals. In the light of the above the Green Paper recommends that:

(1) the corset be terminated (in June 1980).

(2) the reserve asset ratio be scrapped;

(3) new liquidity requirements be imposed upon all recognised banks and licensed deposit-takers;

(4) a new cash ratio be designed, along the lines of the present clearing banks' bankers' deposits ratio but extended to all banks, to serve as a fulcrum to enable official market transactions to act more predictably on interest rates - a future paper will discuss the amount, form and calculation of the ratio;

(5) the special deposit scheme be retained as a safeguard against excess liquidity in the banking system.

In addition to making specific proposals, the Green Paper also considered the relative merits of two, hypothetical control schemes - an "indicator system" and "base control". As monetary base control has been covered extensively elsewhere[3] only the former is dealt with in depth, although the authorities' broad scepticism about both (and in particular base control) is brought out below.

On base control, the paper distinguishes a mandatory from a non-mandatory base requirement, the latter being rejected on the grounds that the uncertain benefits of closer control over the money supply that might emanate from base

(3) e.g. Monetary Base Control, pp. 149-156, BEQB June 1979.

control do not outweigh the significant costs that would be attached to the structural reform necessary to ensure that banks' requirements for base money bear a stable relationship to their liabilities through time.[4] Even with a mandatory requirement, exacting problems would be encountered; for all lagged, current and lead accounting systems pose severe operational difficulties which can only be overcome with difficulty and at the possible expense of inducing significant disintermediation or liability management by the banking sector.

With regard to the possible adoption of <u>indicator systems</u>, two separate schemes are considered: one related to the monetary base and the second to £M3. In the former case, the proposals are designed to overcome the authorities' problems of controlling the base and of relating interest rate changes to divergencies of the base from the desired trend as they occur. Basically, the scheme avoids direct control of the base but measures it in arrears, with divergencies from desired levels used to trigger changes in the Bank's lending rates and hence other short rates. The requirement to hold base money would be mandatory and last resort facilities would be available. The desired path for the base would be calculated so as to lead to a smooth, seasonally adjusted path for £M3 growth, with the size of rate adjustment being related to the extent of the divergence according to a pre-determined scale. Hopefully, the scheme would result in speedier interest-rate adjustments than at present, dependent, of course, on the market's response.

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(4) Such structural reform would include the withdrawal of "lender of last resort" facilities.

Under the scheme related to £M3, divergencies between actual growth in £M3 and the desired trend are used directly to trigger changes in Bank lending rates. However, in order to gain a significant time advantage over the present system, weekly data for the money supply would ideally be required, which would create serious statistical problems for measurement and serial adjustment. Finally, as is the case for the system related to the base, it would be desirable to provide the authorities with an override power, to be used at their discretion.

The major advantages to be derived from such schemes are:

(1) a guarantee that interest rates will adjust speedily to perceived divergencies from desired trend in money stock growth and that such adjustment will continue until growth is brought back in line with pre-set targets;

(2) given the market's increased confidence in the resolve of the authorities to control monetary growth effectively (because of (1)), greater longer-run stability in the gilt market may result;

(3) that it would remove the present policy bias towards delay in the adjustment of interest rates until divergencies are shown to be more than just short-run, erratic disturbances; and

(4) such schemes would involve little structural change, at least initially, to the financial system.

On the debit side, detractors could point to the following drawbacks inherent within all similar indicator systems: (1) the authorities must still make subjective decisions as to whether or not perceived divergencies from trend are erratic, and hence soon likely to be reversed, or represent more fundamental movements which will persist for some time into the future - hence the danger of reacting prematurely must still be weighed against the dangers of delaying and perhaps eventually finding that a greater adjustment is then required than the disturbance initially necessitated; (2) the dangers of over or under-reacting would be compounded by the necessarily arbitrary nature of the scale of response decided upon; (3) given the continuation of the market's practice of trying to anticipate official interest rate policy, expectations formation could cause greater rate volatility than at present due to the extra constraint imposed upon the authorities' discretion;

(4) the automatic linkage between the money stock and Bank lending rate would preclude the use of the interest rate instrument for alternative purposes eg. to influence capital flows and hence the exchange rate and the balance of payments; (5) frequent use of the over-ride would destroy any advantages to be gained from "automaticity".

Implementation of indicator schemes of this form raise the general issue of "rules or discretion", about which the Green Paper would appear to welcome further discussion. In practical terms, the schemes' adoption would mean a change in tactical policy from the present presumption that the onus is on the authorities to justify any change, particularly in an upwards direction, in interest rates to a presumption that the onus would be on the authorities to justify not changing rates, in whatever direction required, to bring monetary growth back on target. While the tying of the authorities hands would remove the more capricious, political elements from policy-making, its appeal should be judged in the light of the potentially far-reaching consequences of eroding official discretion, if the system is to reap any of the rewards from automaticity.[5]

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(5) A classic example of the thorny problems that can arise on this front was presented by the publication of the April 1980 banking figures which, in line with several previous months' figures, indicated that £M3 was well within the prescribed target range. A section of the financial press and certain monetarist disciples insisted that this should herald an immediate reduction in MLR since, although bank-lending to the NBPS remained uncomfortably high, £M3, not bank lending, was the proximate target. Presumably, the application of an indicator scheme - without the override being exercised - would have been wholeheartedly welcomed by such protagonists. Unfortunately, however, not being privy to the wealth of statistical data available to the authorities, the dissidents were unaware (or, alternatively, chose to ignore) that the central government's borrowing requirement was forecast to return to more normal levels in the ensuing months (ie. to higher levels, as government revenue fell back to a lower plane) which, together with the forecast of a continuation in 'excessive' corporate demand for bank credit, was most likely to lead to an acceleration in money stock growth. In the light of this, little would be achieved by a transient change in MLR. (One could also argue that the reintermediation expected on the demise of the corset in June militated against an early cut in MLR).

A Critique of The Green Paper: "Clutching At Straws?"

Leaving aide, for the moment, consideration of the role that monetary policv is being asked to play by the Thatcher administration in the achievement of broader macroeconomic goals, the first and most crucial point of controversy that emerges from the discussion paper is the planned switch to almost exclusive reliance on the interest rate mechanism as the means to attain closer short-run control (given that that is necessary to retain market confidence in the government's anti-inflation package) of the money stock (£M3). This arises as a direct result of the authorities' apparent acceptance of the "cashier's view" of debt management policy (which, together with the reluctance to index bonds or sell a greater variety of short-term public sector debt instruments, will allow gilt sales to continue on an irregular course), and the decision to do without any form of quantitative control. The latter decision is undoubtedly justified if one takes a long-term view, given the resource misallocation, the distortion to monetary aggregates - particularly since the abolition of exchange controls - and the damage to the competitive environment that such controls induce, but in the short-run the move leaves a void in the area of monetary/interest rate control (eg. in the control of bank liability management and round-tripping, and the shielding of politically-sensitive interest rates, including the traditionally "sticky" rates on certain forms of public sector debt, from a full exposure to market forces). The crucial question remains, however, 'Can interest rates take the additional strain?'

Unfortunately, for the authorities, the interest rate instrument (short term) is under a considerable cloud as to its ability, even in the long-run,

* to restrain growth in the money stock[6] and there is a growing body of opinion that raising interest rates actually causes £M3 growth to accelerate. The theoretical backing to this view consists of the following strands: that a rise in interest rates - (1) will increase the PSBR, an important counterpart to money stock (£M3) growth, by virtue of enlarged debt interest payments; (2) will induce short-term capital inflows which, even under a pure floating exchange rate regime, can cause movements in the domestic money stock;[7] (3) will cause the domestic money stock to rise by virtue of outflows from ("sticky") non-marketable public sector debt instruments; (4) may cause bank deposits to grow because of the differential effects on banks' lending and borrowing rates, lending rates (tied to base rates) tending to react more sluggishly (perhaps as a result of cross-subsidisation of wholesale business by retail profits) and creating the possibility for companies to engage in "arbitrage" operations; (5) may cause banks to manage their liabilities and bid for deposits through the CD and interbank market; (6) may cause an increase in bank lending, particularly to the corporate sector, as the equity and debenture markets dry up as a result of a general expectation of a future drop in rates, the only alternative source of finance being the banking system; and (7) by depressing demand, may induce an increase in bank lending to the corporate sector as the only course of action open to the latter to finance "involuntary" stock holdings.

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(6) E.g. see Hotson, A.C. 'The Forecasting and Control of Bank lending', Paper presented to Money Study Group Conference, Oxford 1979.

(7) 'External and foreign currency flows and the money supply', BEQB, December 1978.

In view of the above, it may be argued that the reliance to be placed on the interest rate mechanism, either within the present institutional environment or under the alternative systems suggested, is misguided.

On the issue of base control, and ignoring the questions of feasibility and accounting detail raised by the Green Paper, it is important to realise the fundamental changes that would have to accompany such a policy switch. The first prerequisite is a floating exchange rate for, although complete insulation of the domestic money stock from capital flows can never be achieved, a pure floating regime goes a long way to fulfilling that objective. This, however, demands that the UK continue to remain outside the European Monetary System, in contravention of one criterion laid down by the Green Paper against which reform proposals should be assessed. Secondly, in order to guarantee tight control of the base, the authorities must stand prepared to tolerate equilibriating rates of interest of whatever magnitude necessary to clear markets. This would seem to herald the danger of greater interest rate instability than at present and involve a repudiation of the Government Broker's assertion that, in fixing a new tap stock price, it is important not to impair the long-run capacity of the gilt market by penalising existing stock holders.

In practice, however, acceptable tolerance levels must be considered. For example, interest rates could never be allowed to proceed to levels that threatened liquidity crises or large-scale financial collapse and surely there must be an upper limit to the level to which sterling, as a petro-currency, may appreciate without irreparably damaging the UK's export capacity and future prospects for recovery.

Whatever ones' subjective evaluation of what life would be like under a base control regime, it is undeniable that the system would prove ineffectual unless the authorities were simultaneously to institute major reform in both the area of tactical operations and on the institutional front, particularly in the discount market and with respect to lender of last resort facilities.

With regard to indicator systems, one must weigh-up the potential advantages of automaticity of response against the possible dangers that could arise from exposing the authorities' reaction function to the market in advance, such as a greater variability in interest rates resulting from induced, destabilising expectations.

Turning, finally, to the role of monetary aggregates as indicators and targets, one might cast aspersions on the choice of £M3 as the target aggregate. In theory, the final selection of a monetary aggregate from all potential control variables should be influenced by the following considerations: (1) how closely and reliably changes in the total are related to the ultimate policy objective i.e. output, full employment, price stability etc.; (2) how accurately the total can be measured; (3) how precisely, and at what costs, including undesirable side effects, the authorities can control the total; and (4) the exogeneity of the potential control variable with respect to nominal income (or whatever the specified ultimate policy variable may be). Considerations (1) and (4) together form the essential criteria to be satisfied by potential target aggregates yet, unfortunately, serious problems confront the econometrician in attempts to establish the direction of causality and the closeness of fit between target and ultimate objective; the

major difficulty is that the money-income relationship is susceptible to structural change in such a way as to raise serious doubts about the reliability of any results gleaned from econometric testing.(8)

In the light of the above taxonomy the relative merits of competing aggregates may be assessed. What clearly emerges is that in the case of £M3, the very foundation of a targetting policy is missing, namely a stable demand-for-money function (M1 would appear to be the least unsatisfactory on this score).(9) Moreover, £M3 suffers from the drawbacks that it tends to respond perversely to interest rate changes and suffers from distortions (irrespective of whether or not the corset is in operation) as a result of balance of payments transactions now possible since the abolition of exchange controls.(10) Taking this evidence together with the doubts that have been raised about the wisdom of pursuing singular control of one aggregate - the so-called "Goodhart's Law", which embodies the idea that as soon as policy is directed towards the control (by regulations) of any one aggregate that aggregate's usefulness as either a target or an indicator is destroyed as a result of the demise of any previously stable relationship with ultimate goals - one might legitimately question the merit of pursuing with £M3 as the prime focus of attention, even if notice is taken of movements in other aggregates.(11)

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(8) The introduction of CCC in September 1971, the floating of sterling in June 1972, the general monetary accommodation of "inflationary" wage deals in the latter part of the seventies, the abolition of exchange controls in October 1979, and the removal of the corset in June 1980 are all examples of factors responsible for unsettling such a relationship.

(9) See empirical evidence by: Artis, M.J. and Lewis, M.K., 'The demand for money - stable or unstable?', The Banker, March 1974; Hacche, G., 'The demand for money in the United Kingdom: experience since 1971', BEQB, September 1974; and Coghlan, R.T. 'A transactions demand for money', BEQB, March 1978 - demand-for-M1 function since shown to be of poor predictive quality.

(10) For example, certain forms of payments transaction can add to the total volume of sterling credit without raising the domestic money stock (£M3) - see Hall, M.J.B., The Implications Of The Abolition of Exchange Controls For UK Monetary Control In The 1980s, Occasional Research Paper No. 46, Department of Economics, Loughborough University, April 1980.

If attention is switched to the 'role of monetary policy' alluded to in the Green Paper one may continue to assess the anxieties aroused by the government's adoption of monetary targets as the centre piece of its economic platform. Indeed, far more important than the optimum choice of aggregate problem, is the real burden borne by the economy for the privilege of being steered according to target guidelines. The consequential strains that are imposed on the real economy impinge upon interest and exchange rate objectives and employment, debt management and fiscal policies. Thus, interest rates are pushed to levels that threaten deflation, the exchange rate is allowed to rise to a position which threatens to destroy a significant part of the UK's export base, the PSBR is held at a level which over-rides the impact of automatic stabilisers and causes a deterioration in the standard of services provided, debt management policy is conducted in such a fashion as to burden the taxpayer for up to twenty-five years with "excessive" service charges, and unemployment is allowed to break through the two million barrier and probably proceed way beyond that mark. Moreover, efforts undertaken to validate that "monetarism is enough", through attempts aimed at ensuring a speedier feedback from money supply control to wages and prices without the use of any form of 'permanent' prices or incomes policy (such as the de-indexing of social security benefits and the proposal to scrap earnings-related unemployment benefit), appear at best, futile, and at worst, socially divisive. Perhaps the time is ripe to reassess our economic priorities[12], and consider switching first choice of

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(11) A prime candidate for concern during the latter part of 1979 and 1980 was DCE, movements in which demonstrated the growing importance of an inappropriate channel (payments deficit) through which money supply control could be maintained.

(12) For a discussion of the merits/demerits of the more popular alternative, economic strategies open to the UK authorities see Allsopp, C. and Joshi, V., 'Alternative Strategies for the UK', N.I.E.R., No. 91, February 1980.

ultimate goal to an exchange rate or unemployment objective, leaving monetary policy to fulfil a more humble role such as the minimisation of the banking sector's monetisation of the national debt. Given the lamentable performance achieved by the monetary experiment on the inflation front so far, and the considerable doubts raised herein as to its utility value under the suggested system of reform, it at least deserves serious thought.

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HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

COMMENTS BY CHRISTOPHER JOHNSON

Note by the Secretaries

The attached letter and note by Christopher Johnson is circulated for information.

M D K W FOOT
M L WILLIAMS

H M Treasury