13. Monetary Base IV
Part C

Comments on Green Paper

28/10/1980 – 30/10/1980

MERITS of the PRESENT RESERVE ASSET SYSTEM

M. 1. Manageability

The present system was created in 1971 from a desire of the Treasury and the Bank of England to manage the markets by establishing the reserve asset ratio for the banking system. The management of this system is:-

(a) Direct
(b) Simple to operate
(c) Uniform for all Banks (except as to the 1½% cash requirement)
(d) Obligatory for Discount Houses.

No case can be made for change if as a result of such change the contribution which the L.D.M.A. can make in the manageability of the new system is likely to be either ignored or excluded.

M. 2. Marketability

The identification and definition of the instruments called "reserve assets" are all market instruments and the price of each is determined by the market with reference to either the M.L.R. or the Clearing Bank BASE RATES, which up to May 1978 as far as the former was concerned was linked to the weekly Treasury Bill tender price.

If cash ratios were to be imposed one has to discover what price will apply to the above assets required at present as to 12½%:-

(a) Treasury Bills (if they are any longer a required form of short-term Government borrowing).
(b) Bank Loans secured to the Discount Market.
(c) Local Authority Bills.
(d) One year Gilts.
(e) Eligible Bank Bills

At present the L.D.M.A., because of the definition of Defined Assets and Undefined Assets, and the obligatory multiples laid down by the Bank of England, makes a continuous two-way market in Treasury, Local Authority and Bank Bills, acceptable for re-discount at the Bank.

If this valuable stabilizing method of pricing was removed by the imposition of monetary base, local authorities would have to deal direct with the Banks and there would be no secondary market in their paper, with a consequent increase in the cost of borrowing. The advantage of the present system is that the Central Bank can, and does, ration the amount of money borrowed by the local authorities through Bills, variable Stocks or Bonds, and the Discount Market provides an efficient and effective secondary market place for both the purchase and sale of such stocks.

3. Experience

Under the control of professional managers, £181M of disclosed resources is used under the present system to support total books of some £4.8BN. These books are comprised of many varied instruments - Government and Local Authority Stocks, Bonds and Bills, Certificates of Deposit, Bank and Trade Bills, to mention the principal ones - and all need considerable dealing experience from the managers. The experience gained since 1971 in the marketing of these assets, the returns submitted by Houses on mid-monthly Make-up Days, have established very fine techniques of money management, always scrutinised and monitored by the Central Bank. To implement a radical new system would devastatingly throw away the many years of expertise and knowledge of a capable and skilful market, which surely would be a massive waste of talent and expertise. Although recently under-remunerated through the appallingly violent gyrations in interest rates in the past year or two, the personnel in the Discount Market have proved resourceful, resilient and industrious. To demolish the present system would be negative in the sense of discarding intuitive and ingenious skills of market oriented capability, displayed daily through the well learned commercial acts of profitable survival and the invaluable contribution to an effective and efficient market making process useful in Central Bank monetary control techniques.

R. 4. Responsibilities

Unlike the secondary bank collapse of the late seventies, the L.D.M.A. has at all times shown that it is both responsive to and responsible for the system as controlled by the Central Bank. The saying "my word is my bond" is carefully cherished and expressly and implicitly the definition of the Association's standard of conduct, and reflects the absolute responsibility carried by its members. None has collapsed, none has failed to honour the responsibilities placed on them by the operation of the Reserve Asset System. Strains there have been, but the extent and acceptance of a high degree of responsibility has been an enduring success of members' industry and enterprise.

I. 5. Industry

The most important part of a Discount House's portfolio is the Bill of Exchange, originally the Bill on London, but now also embracing foreign currency Bills, For centuries the link between the City's money market and Banking system has been the Bill of Exchange, which has provided an alternative source of finance for industry - efficient and useful, uncomplicated and marketable. Is the Bill on London to disappear? Will the attraction of discounting cash flow be destroyed? It is hard to imagine or formulate a sturdy, consistent substitute under a monetary base form of control. Bills assist exporters, importers, manufacturers, finance companies, in short the whole industrial base of this country. And the Discount Houses are the acknowledged experts

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in assessing risk on Bills and the marketing of such valuable instruments. Will the Bank of England cease to discount such instruments?

T. 6. Treasury

Treasury borrowing through Bills and Stock has been for many years the specific method of Government borrowing. The Treasury Bill has been the preferred instrument of short-term cash for the Government, and the issue has been underwritten by the L.D.M.A. in exchange for last resort facilities at the Bank. Any attempt to change this foundation stone of the present (and past) system would be disastrous. What alternative method is likely - Bank lending to the Government with lack of identifiable cash flow? The present flow of money to the Treasury is carefully controlled by the weekly issue. The L.D.M.A. plays an important part in that control, sometimes for a negative return as to yield against borrowed money, compensated for by investment in other higher yielding assets. Similarly, a market is made in short-dated Treasury Gilt issues. Is this essential contribution to the Government's debt-funding programme to be discarded and thrown away as useless in the name of monetary base control? It would be irresponsible of any Government to do so. The support to the Gilt Market and the participation therein by the L.D.M.A. is valuable and therefore to consider its destruction would be irresponsible and short-sighted.

Conclusions

The above analysis of the present role played by the L.D.M.A. has been based on the letters of the word MERIT.

The past contribution made by the L.D.M.A. is surely too valuable to be consigned to the scrap-heap.

The proposals to manage a new system of monetary control without its expertise and market awareness would be short-sighted, dangerous and fundamentally unworkable. Far better to build on the present known, understood and workable system, utilising fully the skills and contribution of a respected, efficient and satisfactory Association of Discount Houses. The controls can be made more efficient, the requirements of monetary targets be made more effective, and the restraint of inflation can be tightened up if the present structure between Banks and Discount Houses is used as the cornerstone of an improved market system. The Association has proved its flexibility in adapting speedily to changes of a successful nature. It finds the threat to its existence unpalatable and unnecessary.

B. M. Savill

28th October, 1980.

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MONETARY BASE CONTROL

"The question's very much too wide,
And much too round and much too hollow,
And learned men on either side
Use arguments we cannot follow."

Hilaire Belloc.

Submission to
The Bank of England
from
Seccombe Marshall & Campion Limited

1. In a pure monetary base system there is no Lender of Last Resort facility except under codified arrangements to avert a crisis that might threaten the financial or banking system.

2. In all sophisticated money markets (e.g. London, New York, Australia) the Central Bank both provides a regular L.L.R. facility to the money market as well as operating in the market on a day-by-day basis.

In London the L.L.R. facility is extended on an open ended basis against proper security to the Discount Houses in return for their under-writing the Treasury Bill tender. In the United States the facility (the "open window") is available to all member banks of the Federal Reserve System. The so-called "Money Market Banks" also have this facility but, since they can bid in the open market for funds, they are expected by the Federal Reserve Bank of New York only to use it very sparingly. Transgressions can and may incur penalties. It should be noted that in the United States banks may only operate "in-state" while here they operate nation-wide. A very important difference.

In London, historically, the day-by-day operations of the Bank of England have been used primarily to smooth the flow of funds into and out of the system and secondarily to influence interest rates, but sometimes this differential can appear blurred.

In New York, until October 1979, the daily operations by the Federal Reserve Bank were used primarily to influence interest rates and, secondarily, to smooth money flows. The intention now is, I understand, to operate daily to influence an "M" target aggregate while, secondarily, influencing interest rates. From a distance this new approach has seemed to achieve mixed results and considerable fluctuations in market interest rates, and in practice it seems that they are still keen to influence these rates.

3. In any monetary base system there will, apart from a codified L.L.R. facility as suggested in paragraph 1., have to be further and more immediate interventions in the money markets by the Bank of England.

Necessarily, it will have to operate to control the "base money" by injecting into or withdrawing funds from the market. This is implicit in the proposed system, and can probably only be done by active purchases and sales of Treasury Bills by the Bank of England.

Without intervention by the Bank of England, interest rates will be "wild" - so wild that many market practitioners may be unable to exist. All power could well rest in the hands of the big money operators, the Clearing Banks, eventually for they will become the real lenders of last resort to the banking system. If it became too costly some institutions would have to cease trading, some overseas banks might leave London, secondary markets could disappear, and London might cease to be an international financial centre. In the final event there might be the perfect opportunity for bank nationalisation.

If interest rates become as volatile as some predict, Government funding through the gilt market must become enormously expensive as investors seek returns that give some protection.

It will be extremely difficult for the Government to fund by Treasury Bills. With very volatile interest rates they will become highly speculative paper and, as such, often unwanted except at a protective rate to the purchaser.

In the light of the above it is probable that, unless the Authorities are prepared to see interest rates even more volatile than they have been recently in the interbank market, there will have to be some form of intervention to smooth money flows into and out of the system.

Additionally, if the Bank is reducing "base", there will have to be some form of "instant" L.L.R. unless some bank is going to be left without any base at the end of the day.

Both of these may, however, well be in conflict with the original intention.

4. There are four possible ways that an "instant" L.L.R. facility can be provided and, quite separately, smoothing operations can be carried out:

(a) an "open window" for all banks,

(b) an "open window" for domestic banks,

(c) an "open window" for the Clearing Banks,

(d) through the Discount Houses.

A combination could conceivably be used but it would lead to great complications.

5. In (b) and (c) above those with no L.L.R. "open window" facility will feel as disadvantaged against those with the facility as some banks at present appear to feel about the Discount Market, and there could be considerable complications under E.E.C. law.

6. For L.L.R. purposes (a) and (b) would be cumbersome and costly in man-power.

7. Proposition (c) is conceivably workable. However, Clearing Banks are nationwide institutions and, as such, are immensely powerful. (In the United States banks' domestic operations are

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restricted to one State.) Historically they have always liked to maintain their distance from the central bank. There would also be great political pressure against such favour being shown to such a powerful group of institutions.

8. For smoothing operations propositions (a) and (b) would be cumbersome and complicated.

9. Again, proposition (c) is conceivably workable. However, the Clearing Banks are responsible for huge movements of money daily through the banking system. They purchase and sell funds in the market in the most profitable way they can. At present they are required to maintain a Reserve Asset ratio of 12½% and they stay as close to this figure as they can since they claim that Reserve Assets cost them money.

The question must be asked that whether, if they had access to the "open window", they would be prepared to deal at all times with the central bank, making a market in short-dated paper which, as they claim about Reserve Assets, could cost them money?

If the banks maintain minimum Reserve Assets and true liquidity "because it is costly", are they any more likely to make a proper paper market which might be costly to them?

10. Proposition (d) works remarkably smoothly and has done so for at least sixty years, years which have seen immense alterations in the banking system and in market conditions.

The Discount Houses are the secondary market in short paper. They have an expertise in handling such paper that is unrivalled. They underwrite the Treasury Bill tender in return for the L.L.R. facility. Because of their close relationship with the Bank of England they are co-operative and easily disciplined. They are immensely flexible and adaptable and react to innovations in market techniques with the minimum of fuss. Competition and Credit Control was a major innovation and the Houses, not unpainfully, adjusted to it. The first purchase and resale agreement in bills by the Bank of England with the Discount Market in 1975 was set up by discussion one afternoon between the Bank's broker and senior men in each House and was carried out with great smoothness next day. On the 24th of October 1980 another new technique was introduced by the Bank when it bought bank bills from the Houses on a "bid" basis - the Bank asking Houses to offer these bills and to make offer prices. The Bank then selected those offers and prices which suited it. A very large quantity of bills was bought by the Bank in two tranches on that day. This innovation was explained to the senior men of each House at a meeting at 11.45 a.m. and was operating smoothly one hour later.

That both these innovations were so quickly and easily adopted illustrates the close co-operation between the Discount Market and the Bank. It also reflects the knowledge of the Discount Houses of the New York market where similar techniques have been used by the Federal Reserve Bank of New York for many years in conducting its open-market operations.

11. If the Authorities wish to adopt a new system of monetary control and, at the same time, retain control of short-term interest rates then they must seriously consider the benefits, if any, to be obtained by altering the present system violently, say by adopting propositions (a), (b) or (c) in paragraph 4. above.

As I have already said, the present system works remarkably smoothly and well, has been tested over the years and is very adaptable. The system has been under strain in recent months but those strains have been caused by the considerable sales of gilt-edged stock by the Government which put severe pressure on liquidity and secondly, on bank reporting days, by the pressures on Reserve Assets, pressures which have caused the Bank of England to issue a letter reminding banks that Reserve Assets are a day-to-day requirement and are not a one-day a month phenomenon.

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The present system is evolutionary, and perhaps a more restricted and penal L.L.R., operated as at present, could overcome some of the recent problems and answer some of the recent criticism, but any move in this direction should be taken slowly and cautiously thus avoiding sudden disruption in the market as portfolios are adjusted.

David Campion.

D. G. Campion
30th October 1980

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The role of the Discount Market in the conduct of monetary policy and some comments on its usefulness in general.

1. It is assumed that the Reserve Asset Ratio system is coming to an end and that its proposed successor, Liquidity Adequacy, is under examination.

2. Historically the Discount Market has always quickly reflected the monetary policy of the Bank and through its contacts with the whole banking system has made that policy and any variations widely known.

3. To date the Discount Market has been able to cope with the increasing movement of balances between the banking system and the Bank.

4. The Discount Market has provided a permanent and continuing outlet for bank acceptances in particular from the Accepting Houses.

5. Items 3 and 4 have contributed to the popularity of London as an international banking centre and to the increase in employment and invisible earnings that this entails.

6. The Discount Market has shown its adaptability under changing conditions and in continuing to act as

intermediary between the banking system and the Bank. It has, however, always been totally dependent on the lender of last resort facility at the Bank. Without that facility the Market's resources would inevitably be inadequate to perform this role.

7. There is no reason to believe that the Discount Market cannot continue to act as the agent for monetary policy or to continue as the buffer for the day to day flows of money between the banking system and the Bank. The flexibility of the market, assuming the present levels of intervention by the Bank, appears to be adequate to accommodate these day to day flows. The Market's ability to absorb larger or more abrupt flows resulting from a more rigid basis of control is open to doubt given the existing outlets for and suppliers of the Market's traditional investments.

8. No method of conducting monetary policy can be perfect. Whatever system is chosen it must be adapted from time to time in the light of circumstance. A violent change is likely to have unforseeable and undesirable consequences on the whole system and on the entire financial community. It is wiser to build on the good foundations that already exist whilst replacing only those bricks that are worn out. For example a system which caused the end of overdrafts and their replacement by loans would initially bring about a sharp rise in the money supply.

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9. In general terms, the control of money by a system which acts on the price of the total stock of money should provide a more orderly market than a system in which deposits are subject to base control and in which only marginal balances are subject to market rate.

10. This paper has been kept deliberately short. Supporting evidence and minor points have been omitted. Any request for an enlargement on some or all of it would be welcomed.

J.F.E.S.
27.X.80

THE FUNCTION OF THE DISCOUNT MARKET

(A paper by the Union Discount Company of London Limited)

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"That essential link and cog in the financial machine which we call the Discount Market invented and brought to perfection a side of business peculiar to the City of London, and unknown practically in other places ...... without which the City would never have reached the position of international eminence which it undoubtedly has reached."

Mr. Montagu Norman,
Governor of the Bank of England - 1935.

The keystone of the credit structure is the general public's belief that its bank deposits can be converted into cash. If this belief is undermined and there is a run on the banks, the economic repercussions can be disastrous. The experience of the U.S.A. in the early 1930's, when thousands of banks had to close their doors, industrial output collapsed by 47% and unemployment reached 15 million, is a graphic demonstration of the dangers.

In Britain a number of arrangements evolved, mainly in the nineteenth century, to ensure that a serious crisis of financial confidence could not occur. They have survived until the present day. Their essence is that the banking system has ready access to cash. (Cash is defined as notes and coin, and bankers' balances at the Bank of England. Notes and coin are legal tender, while bankers' balances are a liability of the Bank of England and therefore totally free from default risk.)

This access to cash takes two main forms - routine assistance to the banking system by the rediscounting of paper (such as Treasury bills and eligible commercial bills); and lending to the Discount Houses. The facilities are usually designated as "lender of last resort" since the Bank is the ultimate source of cash. However, this is a misnomer if it carries the implication that access to cash is exceptional and always at a penal rate. The routine assistance is generally at market rates and may be provided to the banks ("indirect help") as well as via the Discount Houses. The unique privilege of the houses is that only they are entitled to borrow from the Bank of England at Minimum Lending Rate. Its power to lend at MLR enables the Bank to determine interest rates. The hope is that by variations in MLR it is possible to influence the "credit counterparts" (bank lending to the private sector; and the difference between the Public Sector Borrowing Requirement and public sector debt sales to non-banks) to bank deposits and, hence, the money supply.

Advocates of monetary base control consider this system unwieldy and imprecise. They think that bank liabilities bear a stable relationship to the cash held by banks and that control over the quantity of cash also exerts control over the level of bank deposits, which are the principal constituent of the money supply. They therefore favour limiting the banks' access to cash, except in abnormal crisis circumstances. But they have not specified what such circumstances are. As open market operations would still be required to keep the monetary base on target, some of the existing institutions would presumably need to be retained. Again, however, monetary base advocates have been vague as to with whom and by what means the operations should be conducted.

It should be emphasised at this stage that most cash is at present held not by the banks, but by the general public. The banks have only one-sixth of the monetary base and the public has the remainder. The banks' knowledge that cash is readily available from the Bank of England has enabled them to economise to a remarkable degree on the amount of cash in their balance sheets. The motive for this economisation is to maximise profits since no interest is earned on cash and it is sensible to keep holdings as low as possible. The disproportion between the banks' and the general public's cash holdings is important to the subsequent discussion.

Two issues emerge from these introductory remarks. Should the banking system's access to cash be withdrawn? And what functions do the Discount Houses serve? The questions are related. If the answer to the first question is "yes", the Discount Houses' role would be quite different from now and probably very limited. If the answer is "no", some more interesting problems need to be discussed.

The banks' access to cash

A number of major structural adjustments to the financial system would occur if the banks' access to cash was restricted or taken away entirely. At present the banks know that certain assets, termed "primary liquidity", can be exchanged for cash at the Bank more or less whenever they wish. Their portfolio management therefore focusses on maintaining a safe ratio of primary liquidity to deposit liabilities. To a lesser extent, they are also concerned that "secondary liquidity" (assets which can be easily converted into primary liquidity) is at a sufficiently high level. Cash is not held as a prudential reserve, but as a stock-in-trade.

Under Monetary Base Control, the banks could not be certain that the Bank would convert the assets now regarded as primary liquidity into cash. Such assets would therefore lose many of their liquidity attributes. Because of the decline of the Treasury bill issue, the most important form of primary liquidity is currently the eligible commercial bill. Any reduction in the liquidity of this instrument should be a source of disquiet to the institutions which issue them and particularly to members of the Accepting Houses Committee. The competitiveness of the Accepting Houses relative to other banking concerns would be damaged.

More fundamentally, the focus of banks' portfolio management would shift away from the primary liquidity/deposits ratio to the cash/deposits ratio. Because it would be imprudent to economise on cash balances and some would have to be held as a prudential reserve, the banks would have to maintain a higher cash/deposits ratio. The Clearing Banks, which have to keep vault cash to meet deposit withdrawals and Bank of England balances for cheque-clearing purposes, would be most obviously affected. The size of the desired increase in banks' cash holdings would depend on the rigour of the Monetary Base Control arrangements and also on whether there was any change in the public's confidence in its deposits. If confidence weakened, the maximum expected rate of deposit withdrawal could be much higher than today and the banks would need a substantially increased cash/deposits ratio. In consequence, the banks would have a much higher proportion of the cash in the economy than the present one-sixth. Some idea of the possible upheaval is given by U.S. data in the Great Crash. In October 1929 the ratio of deposits to the public's currency holdings was 11.57; in March 1933 it was 4.44.

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Of course, it must be hoped that nothing of this kind could ever happen in the United Kingdom. But the banks would unquestionably want to hold more cash if a meaningful monetary base system were to be introduced. Unless their other assets were to contract, the extra cash would have to be matched by extra deposits and there would have to be a once-for-all money supply increase. Naturally, the Bank would have difficulty in superintending the transitional period in which this took place.

Moreover, the banks' subsequent operational room for manoeuvre would be impaired. As they could not be certain of acquiring the extra cash base which must for prudential reasons accompany the expansion of their balance sheets, they would have to end overdraft facilities. Such facilities allow their customers, rather than the banks themselves, to decide when their balance sheets grow. The cessation of overdraft facilities would reduce the non-bank private sector's financial flexibility. To compensate for this loss of flexibility, companies and individuals would probably wish to maintain a higher ratio of bank deposits to income than at present. If this additional demand for money was not accommodated by additional supply, the move to Monetary Base Control would be deflationary; if it was accommodated, there would have to be another once-for-all money supply increase.

This discussion of the institutional turmoil which might be caused by monetary base control is not exhaustive. Other points, including several made in the Monetary Control Green Paper, are also relevant. There is nevertheless a clear warning that the Government would find it almost impossible to interpret the money supply statistics if new arrangements were implemented. In particular, changes in both the banks' and non-banks financial behavious might require increases in the money supply unless unintended deflationary repercussions were to eventuate. Such increases could not be reconciled with the medium-term financial strategy and would raise further doubts in the public mind about the validity of the Government's overall economic strategy.

Any interference with the banks' access to cash from the Bank of England carries great dangers to financial confidence. Even in the most benign circumstances, where the structural changes described here - and others about which we cannot now conjecture - happened smoothly, appropriate changes in both the amount of cash in the banking system and the money supply as a whole would be difficult to predict. The Government's emphasis on monetary policy as an efficient anti-inflation weapon might well be discredited.

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The Discount Houses in a system with no access to cash

At present most of the Bank's cash injections are channelled via the Discount Houses even though the banks are the ultimate beneficiaries. If Monetary Base Control was introduced and the system's access to cash came to an end, the Houses would suffer more than the banks. Indeed, their rationale would seem to have been removed.

However, the banks might still need them. As we have seen, the banking system's demand for cash would be much higher under Monetary Base Control. The banks themselves may consider that they are less efficient at managing their cash than the Discount Houses and consequently they would like to leave money-at-call as at present. It would be essential that the houses then kept a significant part of their assets in the form of balances at the Bank of England so that they could meet calls with cash as and when they occurred. Whether the houses remained viable in such circumstances, in which they would be earning no interest on much of their portfolio, is doubtful. The houses would have to reconsider their activities as principals.

As monetary base advocates recognise, open market operations would still be necessary under their system because action would have to be taken to keep the base on target. If the houses no longer remained as principals, these operations would have to be direct with the banks. The manpower and other resources devoted to market intervention would not be reduced, but only take a different form. Society would gain nothing, while the institutions affected would be confronted with arbitrary and very heavy costs of change for which they are in no way to blame.

The Discount Houses in a system where access to cash is retained

The argument so far has been that removal of the banking system's access to cash is highly undesirable and, for this reason, that Monetary Base Control should not be introduced. However, we have still to consider whether the Discount Houses merit the lender of last resort privilege in a framework of the present kind where access to cash is a central feature.

The houses' utility is mainly to the banks. When a bank has deposits which it cannot use profitably elsewhere it can leave money-at-call with the houses where a rate of return competitive with money market instruments may be earned. If the bank subsequently experiences an unexpected demand for loans it can run down money-at-call and satisfy its customers. The ability to place money-at-call therefore increases the flexibility of banks' loan arrangements. Indeed, the development of overdrafts may be connected historically with the existence of the Discount Houses. Overdrafts are available on a limited scale in foreign countries, in which the money markets are less developed than in Britain where the houses play such a pivotal role. (It should be emphasised that this description of the Discount Houses' position is of their natural business role and not of the false position they enjoy under the reserve asset ratio regime. In fact, the designation of money-at-call as a reserve asset considerably abridges their traditional function. However, it is assumed here and elsewhere in the discussion that the reserve asset ratio is soon to be abolished.)

The houses must be able to respond quickly to changes in the amounts banks place with them. Suppose that banks are calling money back. The houses can sell assets, but if they do so on a large scale the price of such assets fall, causing an increase in short-term interest rates. The ability to borrow from the Bank of England is a way of offsetting withdrawals of money-at-call without the need for asset sales. It is doubtful whether the houses could accept money-at-call if they did not possess the lender-of-last-resort privilege. It follows that the existence of a lender of last resort is a prerequisite for the versatile bank borrowing facilities enjoyed by companies and individuals in Britain.

Furthermore this explains why lender-of-last-resort privileges should not be available to all banks but rather should be confined to the Discount Houses. Any bank with the ability to borrow from the Bank of England would have a competitive advantage over other banks. Because it could be certain of obtaining cash when required, whereas banks without the privilege could not, it would be able to offer more flexible and attractive loan terms. The Discount Houses, by contrast, do not compete with the banks in lending to companies and individuals. They do not initiate loan undertakings in any material sense but only discount bills which have been issued. by the banks. By directing lender-of-last-resort assistance through the Discount Houses, the Bank of England can both preserve the efficient lending facilities now granted by the British banking system and ensure that no one group of banks obtains an unfair lead over another. In this way, the activities of the Discount Houses are pro-competitive.

The strength of the argument is most obvious in the case of the Clearing Banks. They are the natural candidates for lender-of-last-resort privileges since cash flows into and out of the economy pass through them. However, if they could borrow from the Bank of England and non-clearers could not, they would be able to offer much better lending terms to their customers than the non-clearers. This would be an artificial and improper advantage. Moreover, they would have great power in the inter-bank market. Whereas other banks would have to pay market rates, which might be above MLR, the clearing banks could in principle borrow at MLR whenever they wished. (In practice the Bank would no doubt have to deny them help at some point, since otherwise it would merely be handing profits over to these banks).

The solution might seem to have two parts - the Bank should extend the lender-of-last-resort facilities to all banks; and it should consider intervention in the inter-bank market other than the Discount Market. These two suggestions may be discussed in turn.

The objection to the Bank granting the lender-of-last-resort facility indiscriminately is that its knowledge of the banks involved might not be sufficient to ensure the money was correctly used. As the Bank knows the Discount Houses well, transactions between it and the houses are conducted smoothly and with little fuss. If the Bank had to have transactions with several hundred banks, its administrative costs would be much higher and it would need to check that no particular bank was exploiting its borrowing opportunities too much. In West Germany each bank is allocated a rediscount quota based on its capital reserves. The need to obtain such a quota represents a barrier to entry for a new or foreign banks. Although perhaps a minor irritation this limits competition in the banking industry. In Britain, by contrast, any bank (or Company, for that matter) can leave money-at-call with the houses and thereby benefit indirectly from the Bank of England's lender-of-last-resort arrangements. Foreign banks' ease of entry into the City and the intensified competition which follows it, may in this way owe much to the existence of the Discount Houses.

Intervention in the inter-bank market was mentioned favourably by the Clearing Banks in their evidence to the Wilson Committee. It would immediately raise the problem, analysed in the last paragraph, of which particular banks should benefit from assistance. There is, however, another objection. Lending in the inter-bank is not secured, whereas any loans the Bank makes to the Discount Houses have to be secured against instruments which are created by a desire to borrow outside the banking system. Treasury bills, eligible commercial paper and local authority bills are all claims on non-bank entities. Frequent and systematic official intervention in the inter-bank market would encourage the belief that it is unnecessary to hold liquid assets which arise from the credit requirements of government or companies. It would be thought instead that short-term claims on other banks, generated by inter-bank transactions, are genuine liquidity. But this impression is illusory since in a crisis of confidence there may be doubts about the ability of banks to meet their obligations. (The blockages in the C.D. market after problems at the Scottish Co-operative Wholesale Bank in 1974 illustrate the point). Of course, banks might be willing to borrow from the Bank of England on a secured basis. But this would require that they hold sufficient quantities of negotiable instruments. At present the ratio of negotiable instruments to total assets is very low for most banks, particularly those, which have specialised in wholesale business. On the other hand virtually all the Discount Houses' assets are negotiable and are therefore appropriate as security for loans from the Bank of England.

Our arguments suggest therefore that the extension of lender-of-last-resort facilities to all banks has drawbacks in terms of both the reduced simplicity of open market operations and the imposition of a new barrier of entry to banking. Assistance routed through the inter-bank market would undermined the secured basis of present Bank of England lending to the Discount Market.

SUMMARY

The Bank of England's willingness to provide the financial system with cash improved the flexibility and efficiency of the lending facilities the banks offer to British industry. The intermediation of the Discount Houses ensures that no particular bank or gro up of banks is able to exploit this advantage at the expense of the others. Expressed in economic terms, the benefits from lender-of-last-resort are a "public good" and the existence of the Disc ount Houses prevents this "public good" being appropriated by any particular private institution. In this way the houses strengthen competition between banks, as well as playing an essential and recognised part in maximising the efficiency of banks' cash management.

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A move to monetary base control could have potentially grave and damaging macro-economic repercussions. The withdrawal of the lender-of-last-resort privilege from the Discount Houses would reduce the micro-economic efficiency of the financial system. In our view the Government should consider very carefully indeed whether either measure is desirable since their identifiable costs are large and certain, whereas the benefits are impossible to quantify and highly debatable.

30th October, 1980.

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