10.[B] Monetary Control

Consultants

16 June 1980

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16 June 1980

COPY NO.

HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

PHILLIPS AND DREW

Note by the Secretaries

The attached comments on the Green Paper by Phillips and Drew are circulated for information.

M D K W FOOT
M L WILLIAMS

H M Treasury

MCC(80)23

20 June 1980

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HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

COMMENTS BY DAVID HOWARD

Note by the Secretaries

The attached paper is circulated for information; it has been prepared by David Howard of the International Finance Division at the Federal Reserve Board. The views are those of the author, not the Fed. Mr Howard has written a supporting and rather longer paper entitled "The British Banking System's Demand for Cash Reserves". Copies of this paper are available from the Secretaries.

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20 June 1980

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Mr. Williams.

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Pl. circulate.
JWS

Dear Michael

MONETARY CONTROL CONSULTATIONS

We have now received the London Clearing Banks' preliminary submission in response to the Green Paper on Monetary Control and I enclose a copy, for your MCC circulation.

As you will see from the banks' covering letter, their submission is 'preliminary' in the sense that they reserve the right to make further comment when they have had time for fuller consideration of the consultation paper on banking liquidity and the forthcoming paper on the cash requirement.

Yours sincerely

John Fforde

Submission on Bank of England/Treasury Paper

'Monetary Control' Cmnd. 7858

1. In March, HM Treasury and the Bank of England jointly published a consultative paper on monetary control. The paper addressed the problems of short-term control of the monetary aggregates and discussed two broad sets of proposals for the reform of official techniques of monetary management, namely, the adoption of a base control system and the introduction of an automatic link between movements in the money stock and in the Bank of England lending rate. Views were invited on whether the difficulties of a monetary base control system could be surmounted and on whether an automatic system of adjusting the Bank of England lending rate would, on balance, be advantageous. In this paper, we present our conclusions on these questions.

The Policy Context

2. Any discussion of the practical problems attending reform of the authorities' monetary control techniques must begin by setting the operations and objectives of monetary policy in the context of wider policy requirements. It should then count against a proposal for change in the way in which monetary policy is conducted (although not necessarily decisively) that, if implemented, such a change would render more difficult the satisfaction of these wider requirements.

3. The consultative paper suggested certain areas where there might be potential conflict between the achievement of smooth short-term control of the monetary aggregates and other policy objectives. These objectives included the exchange rate, the minimisation of prudential risk, the avoidance of significant disintermediation flows and the maintenance of confidence in the structure and efficient working of the financial system.

4. The Government currently disavows an active intervention policy in the exchange markets. In accordance with this policy, the interplay of market forces is allowed to determine the trend in sterling's exchange rate, the authorities' intervention in the foreign exchange markets being limited to what is required to smooth erratic fluctuations. However, the attractions of a more active intervention policy, for example, the type of policy which would be implicit in eventual membership of the exchange rate mechanism of the European Monetary System (EMS), would be severely reduced if a system of monetary control were in operation under which external flows, arising in large part from official exchange

market intervention, had a substantial impact on the authorities' operational target-variable. The EMS exchange rate mechanism requires the authorities in member countries to enter the foreign exchange markets to maintain their currencies within intervention limits. The scale of such operations may, from time to time, be very large and would have a destabilising effect on domestic monetary conditions under a base control system, where currency flows would represent a more substantial proportion of the base than they do, under the present system, of the money stock.

5. Furthermore, even on the current limited scale of exchange market intervention, there is likely to be some disadvantage in the authorities' adopting a system of monetary control which would tend to magnify the impact of external flows on deviations between the actual money stock and the level of money stock consistent with the officially-established guideline.

6. It is desirable, moreover, that the form of monetary control exercised by the authorities should not add to the prudential risks incurred by financial institutions. A change in the arrangements for control which increased the risks attaching to existing loans would probably encourage the financial institutions to adopt more conservative lending policies and would thereby run counter to the Government's aim of regenerating UK manufacturing industry. On the other hand, a change in the system which provided an incentive to financial institutions to expand or contract their assets or liabilities solely, or in large measure, to conform with pre-set official targets for those assets or liabilities would tend to increase the prudential risk of the financial system as a whole.

7. Some forms of disintermediation, for example, the channelling of lending business by banks away from advances to acceptance credit may add to prudential risk but the chief difficulty arising from substantial disintermediation and reintermediation flows is that such flows cast doubt on the significance of the monetary statistics. If it is widely known that flows between the controlled sector and the non-controlled sector of the financial system are large, then the achievement of a smooth short-term growth path for the money stock, in line with the official guideline, may not have that favourable impact on expectations which was the aim of setting the money stock guideline in the first instance. Consequently, a system of monetary control which secures smooth short-term growth in the money stock at the expense of stronger disintermediation flows is likely ultimately to be self-defeating.

'Lender of Last Resort'

8. The consultative paper lays stress on the desirability of retaining the Bank of England's 'lender of last resort' operations as a feature of the financial system. This stress is especially evident in the paper's discussion of monetary base control techniques. The 'lender of last resort' facility, as it is operated by the Bank of England, is seen as a major factor in the efficiency of the London financial markets. Consequently, there is a presumption against any proposal for change in the techniques of monetary control which would involve the abandonment of the 'lender of last resort' facility. This is a line of argument which we would broadly support.

9. There is, in our view, some confusion generally regarding the nature of the Bank of England's 'lender of last resort' operations. This confusion has given rise to the widespread view that these operations undermine the authorities' control over the monetary aggregates.

10. On the one hand, the Bank of England has shown, most recently in the secondary banking crisis of 1973/75, that it stands ready to supply funds to support the financial structure if that structure is imperilled by the illiquidity or insolvency of individual institutions. In this respect, however, the Bank of England's willingness to fulfil the requirements for maintaining financial stability does not differ from that of most other central banks, however different their day-to-day market regulating techniques may be.

11. On the other hand, the Bank of England makes effective itsmonetary stance, on a day-to-day basis, by engineering shortages of credit in the money markets and then taking out these shortages by lending at short term at officially-determined interest rates. By this means, the Bank of England may exercise an influence on short-term rates generally through regulating the cost of marginal credit in the money market.

12. The Bank of England's method of operating in the money market does not, however, validate any and every demand for credit which may arise from the financial system's lending to the public and private sectors. It is aimed, rather, at relieving shortages of credit which are created by the authorities' own actions in regulating the issue of Treasury bills. If, when those shortages have been relieved, there remains a persistent excess demand for credit which imperils the achievement of the desired growth in the money stock, it remains an option open to the authorities to raise the level ofinterest rates at which they are prepared to lend.

13. The impact of interest rate movements on growth in the money stock is indeed complex. Nevertheless, it is fundamental to the authorities' present method of operating, as it is to monetary base control system or to any technique for regulating growth in the money stock which does not rely on direct controls, that there should be such an impact.

14. Under the present system, the authorities have discretion in settin an interest rate to achieve their monetary objectives and to harmonise those objectives with wider policy requirements. A monetary base control system would allow market forces a greater role in determining a level of interest rates consistent with the money stock objective.

15. Under a monetary base control system, however, the authorities would only be able to take account of policy requirements other than the short term money stock objective by making arbitrary adjustments to the supply of base assets to the banking system. Such adjustments, undertaken in the context of a base control system, might have a much more damaging effect on general confidence in the authorities' long run resolve to curb monetary growth than would adjustments to interest rates, in similar circumstances, under the present system. The adoption of a monetary base control system might, therefore, imply the accordance of a much higher priority to the objective of short-term smoothing of the money stock growth path than is desirable in a general policy context.

16. Furthermore, it seems unlikely that, under a monetary base control regime, banks would respond in the short term to an officially-engineered shortage of base assets, in relation to the level of their deposits, by cutting back their advances to customers. It is much more likely that the normal response would be to sell short term assets, for example, Treasury bills and local authority paper, on the market. The short term securities sold by the banks would ultimately be taken up in large part by the non-bank private sector which would draw down bank deposits to finance the securities purchases. In this way, the desired reduction in the money stock would be achieved but only through a process of disintermediation which left the overall state of liquidity of the financial system little changed. As we argued above, disintermediation flows, if they occurred on a significant scale, could undermine confidence not only in the short-term stability of the money stock growth path but also in the efficacy of a long-term deceleration in the money stock growth rate as a means of curbing inflationary pressures.

17. Although there might be circumstances where interest rate movements would be more volatile with a monetary base control system than under the present arrangements, so that interest rate adjustments to excessive money stock growth took place more rapidly, in certain conditions interest rates might be much less responsive to a divergence of the money stock from the desired growth path. This would typically be the case when the banks had ample scope for disintermediation in the manner described in the last paragraph. If the banks held relatively large amounts of short-term instruments (Treasury bills, etc.), as they normally do in the early stages of an economic recovery, it might be difficult for the authorities to control the state of liquidity in the economy. Relatively small upward movements in interest rates might then be sufficient to attract the spare liquidity of the non-bank private sector out of bank deposits into short-term non-banking instruments. Such disintermediation might smooth the money stock growth path in the short term but it would prevent the authorities from signalling to participants in the financial markets the desired degree of restraint.

Official Discretion

18. The present system of monetary control allows the authorities some discretion in regulating the credit counterparts of growth in the money stock and of choosing between a short run divergence in money stock growth and the imposition of a potentially-damaging straitjacket on each or all of the counterparts. The chief merit of sterling M3 as a monetary target variable is, in our view, the fairly simple relationship it bears to credit counterparts which are economically significant. For example, there is an easily intelligible relationship between the public sector borrowing requirement (PSBR) and growth in sterling M3 even if, in practice, the impact of an increase in the PSBR on sterling M3 may be complicated by the effects of such an increase on the other credit counterparts.

19. In the short run, it is not practicable to regulate the PSBR so as to achieve a smooth money stock growth path. The response of bank lending to the private sector to changes in interest rates is also unlikely to contribute to short term control of the money stock. What response there is from bank lending to interest rate changes may well take several months to appear.

20. However, the authorities may seek to offset the potentially destabilising effect on the money stock of anticipated temporary changes in the pressure of private bank loan demand by regulating sales of gilt-edged stock to the non-bank private sector. The incorporation of the partly-paid feature in issues of gilt-edged stock makes possible a nearer approach to the objective of smooth short-term money stock growth while accommodating sharp fluctuations in private demand for credit. The success of this approach, however, depends heavily on the extent to which the authorities are able to anticipate such fluctuations in credit demand. Any error in anticipating the course of credit demand may result in an erratic month-to-month or quarter-to-quarter movement in the money stock but this outcome may be less damaging overall than the imposition of a constraint on the availability of credit or toleration of a rise in interest rates which is not demanded by the need to achieve underlying restraint in money stock growth.

21. Under a monetary base system, the authorities might still have the option of selling gilt-edged stocks with partly-paid features, to anticipate the profile of public and private credit demands, but an error in forecasting this profile could not so easily be compensated by allowing a short-term divergence in the money stock from the desired long-term growth path. However, as we have argued in earlier paragraphs, the closer approximation of actual money stock growth to the desired growth path would be more than likely, in these circumstances, to be largely a consequence of disintermediation and it would not, therefore, necessarily enhance confidence in the authorities' resolve effectively to curb money growth.

22. In discussing the practical problems of monetary base control systems, we shall treat each of the systems described in the consultative paper in turn.

<u>Monetary Base Control</u>

23. A monetary base control system without a mandatory requirement would, we believe, face insurmountable difficulties relating to the probable instability of bank demand for base assets, however base assets were defined. Clearly, if base assets were defined to include those assets which are currently reserve assets for the banks, the authorities would have no effective control over the supply of the base since reserve assets include some liabilities of the private sector, for example, call money with the discount market, the supply of which is not under direct official control.

24. If the authorities defined base assets to include only public sector liabilities, there would be no prudential reason why banks should hold these public sector liabilities rather than the short term private liabilities which would not be included within base assets, as long as the authorities maintained the Bank of England's lender of last resort role towards the discount market. Banks might then switch between short-term public sector and short-term private sector instruments without loss of liquidity, thereby increasing or reducing their holdings of base assets independently of the growth in their own deposit liabilities.

25. The Bank of England's 'lender of last resort' facility might be abandoned, which would effectively leave banks' balances with the Bank of England as their only source of primary liquidity. However, we fully concur with the consultative paper's conclusion that, if this were done, the definition of a monetary base, the supply of which was under the authorities' control, would involve a significant impairment of the efficiency of the discount market and of the financial system.

26. Furthermore, although a definition of monetary base which included only the liabilities of the Bank of England would allow the authorities to regulate the supply of base assets to the banks, it is very unlikely that the banks' demand for base assets, even narrowly defined in this way, would bear a stable relationship to the amount of their deposits. The consultative paper somewhat optimistically indicates that it might require several years' operation of such a monetary base system before a stable relationship became discernible. In practice, unless balances with the Bank of England yielded returns comparable with those to be obtained from other uses of banks' funds, there would probably be a strong incentive for banks to economise in their holdings of base assets, which would be reflected in a tendency for the proportion of base assets to deposits to follow a declining trend. There might also be a cyclical pattern in base asset holdings superimposed on this trend, with banks being less reluctant to hold base assets when interest rates were low and other demands on banks' funds were weak. This pattern would make the authorities' operating problems in supplying base to achieve a desired money stock outcome almost impossibly difficult and might also encourage banks to accept undue prudential risks through their tendency to minimise holdings of primary liquid assets.

27. The Swiss National Bank's operations are often quoted as an example of a successful monetary base control system without a mandatory requirement. However, while the Swiss National Bank had succeeded, to the end of 1978 when it abandoned its base control operations, in achieving restrained growth in the money stock over the long run, it did not eliminate sharp short term fluctuations in the money stock as the table below illustrates.

TABLE : SWISS MONEY STOCK (M1) GROWTH

% Change		M1 Seasonally Adjusted (annual rate)
1977	I	-0.1
	II	5.4
	III	1.2
	IV	-4.1
1978	I	50.1
	II	3.9
	III	8.2
	IV	10.3

28. The problem which the consultative paper addressed is that of achieving a smoother short-term growth path for the money stock. The Swiss experience does not, we believe, provide encouragement for the view that a monetary base control system without a mandatory requirement would result in a smoother growth path for the money stock, even if a solution could be found for the practical problems described above.

29. Monetary base control systems with mandatory requirements may be divided into two classes, those where the requirement to hold base assets determines the permissible future level of bank deposits and those where the requirement is a function of actual past or present bank deposit levels.

30. Systems of the former type would probably, as the consultative paper suggests, provide some incentive for banks to hold excess base assets so as to accommodate increases in deposits required to finance unforeseen increases in loan demand. Since the variability of demand for excess base assets might be large relative to required base asset holdings it would be very difficult for the authorities to judge the appropriate volume of base assets to be supplied in order to achieve the desired level of the money stock. The authorities might seek to penalise banks' excess holdings of base assets as well as shortfalls in holdings from the required level but this would probably encourage disintermediation and re-intermediation on a large scale as banks sought to avoid the penalties.

In any event, disintermediation might well be seen by banks as a more attractive solution than the holding of excess base assets to the problem of conforming their recorded deposit liabilities to the penalty-free level predetermined by their base asset holdings.

31. Monetary base control systems where there is a mandatory requirement to hold base assets related to past or present bank deposit levels would also run the risk of achieving a smooth growth path for the money stock at the cost of significant disintermediation. It is unlikely that financial markets would be impressed by a regular series of moderate monthly money stock increases if it were widely recognised that the regularity was largely a consequence of disintermediation processes. In the short term, there would probably be little scope for banks to respond to a shortage of base assets by reducing the rate of growth in their advances, which would be determined by previously-agreed lending commitments. Nor would the tendency for interest rates to rise, which would probably be evident as long as the base asset shortage persisted, provide a favourable background for the authorities to sell gilt-edged stock. Consequently, the only means available to the banks in the short term to make the adjustments in their balance sheets needed to conform with the base requirement would be disintermediation.

32. Since monetary base control systems, with or without mandatory requirements, appear to us to present the serious difficulties outlined in the preceding paragraphs, we are unwilling to recommend the adoption of any of the systems suggested in the consultative paper.

<u>Indicator Systems</u>

33. The consultative paper describes a system whereby the Bank of England's present method of operating in the money market would be broadly preserved but where the Bank of England's lending rate would be set in accordance with a formula which would establish a link between the lending rate and the performance of the monetary aggregates in relation to the objectives of monetary policy. We agree with the consultative paper's conclusion that, if such a system were to be introduced, the lending rate would be more appropriately linked with movements in the money stock than with changes in the monetary base. However, there appear to be two major difficulties attending the system as it is described in the conslutative paper.

34. First, there would, as the consultative paper conceded, be a very serious problem for the authorities in judging whether and by how much the actual money stock was diverging from the level implied by the desired smooth short-term growth path. The paper accepts that there would be difficulties in collating the seasonally adjusted weekly money stock data but, even under the present arrangements, it is a matter of very fine judgement whether a money stock figure reported for a particular month is or is not in line with the desired growth path for the money stock. It is reasonable to make allowance, in judging the figures, for temporary factors which are known to be operating. If the authorities exercised similar judgement in relation to the proposed weekly money supply data, occasions might frequently arise when the authorities would rightly conclude that the formula should be overriden. This might create confusion in the financial markets, however, with use of the 'override' impairing confidence in the authorities' monetary resolve more than publication of the formula would sustain that confidence.

35. Secondly, a published scale for determining the Bank of England's lending rate could greatly increase the instability of investors' demand for gilt-edged stock. A deviation in the money stock from the desired growth path, although insufficient to trigger a change in the lending rate, might well create an expectation in the gilt-edged market that the next movement in interest rates would be in the direction indicated by the deviation in the money stock. Investors would probably act on this expectation and, thereby, amplify the deviation in the money stock until the expected interest rate change had been triggered. The authorities' ability to use gilt-edged funding tactics to counter short term deviations in the money stock might thereby be lost. We believe that this would be a serious disadvantage of any indicator system.

36. For these reasons, we believe that there would be little advantage in adopting an automatic link between the Bank of England lending rate and the short term behaviour of the money stock. Indeed, such a link could increase the instability of expectations in the financial markets and, whenever the formula were overriden, there would be wide scope for market participants to midunderstand the authorities' intentions.

Reform of the Guideline

37. The consultative paper takes as its starting-point the desirability of minimising short term deviations in the money stock from the growth path. Such deviations are potentially damaging to the authorities' monetary aims because they create uncertainty regarding the Government's resolve to restrain the monetary aggregates. The financial markets' perception of the Government's resolve is indeed probably dependent in large part on the extent to which the annualised rate of growth of the £M3 money stock from the guideline's base date deviates from a straight-line projection of the guideline range from that base date. However, there may be occasions when the Government draw up the guideline but fully anticipate factors which may cause divergences in the money stock from a straight line path, within the period for which the guideline is current. If the factors are such as would exert upward pressure on the money stock in the early stages of a guideline's currency they may present especially difficult problems of monetary management for the authorities.

38. We strongly believe that those difficulties would be reduced if the terms in which the guideline is presented were amended. If the Government were to present their money stock guideline in terms of an annual average rate of growth instead of a point-to-point growth range, the financial market's sensitivity to erratic or fully anticipated divergences in the money stock in the early months of a guideline period would probably be greatly reduced. The need to introduce major changes to the financial structure, risking uncertain and potentially undesirable consequences for credit flows, to deal with the problem of short run money stock deviations would thereby be avoided. We therefore recommend the adoption of average annual guidelines for £M3 money stock growth.

S.J. Lewis
PHILLIPS & DREW

5th June, 1980