

MONETARY BASE CONTROL

PART 15

15 November 1983 – 26 June
1985

5 August 1981

MONETARY CONTROL

1. The Chancellor of the Exchequer said in the Budget Speech that a number of improvements in monetary control would come into effect later in the financial year. The Bank of England has now completed its discussions with the financial institutions; the agreed detailed arrangements are set out in a note issued by the Bank today. They will come into effect on 20 August - the first day of banking September.

The Reserve Asset Ratio

2. Among the changes to come into effect on that day is the abolition of the requirement that the banks should maintain a minimum reserve asset ratio. The institutions to which it has been applied will discuss in advance with the Bank, as part of normal prudential supervision, any changes in their policies on liquidity management.

The Cash Requirement

3. The previous requirement on the London clearing banks to hold 1½% of their eligible liabilities with the Bank in non-interest bearing form will also be abolished. Instead there will be a uniform requirement on all banks and licensed deposit-takers to hold ½% of their eligible liabilities with the Bank. The fulcrum for the Bank's money market operations will in future be the balances - over and above the ½% requirement - which the clearing banks hold voluntarily with the Bank for clearing purposes.

Money Market Operations

4. Besides these changes, 20 August will mark a stage in a period of transition which we have been going through since last November. The Bank now relies mainly on open market operations - buying and selling bills - rather than on direct lending to the

... . Lending rates are no longer quoted; the Bank responds to bids and offers from the market, making public the rate at which it has done business. In future, the Bank will aim to keep interest rates at the very short end of the market within an undisclosed band which will be moved from time to time.

5. The new arrangements are intended to reduce the "bias to delay" in changing interest rates - in both directions - which was identified in the Green Paper on Monetary Control. And the market will have a greater role in determining the term structure of short interest rates. Market pressure will show itself mainly in movements in rates at the longer maturities which the Bank does not influence so directly - and this experience of market conditions will be one of the factors taken into account in deciding on the position of the interest rate band.

Minimum Lending Rate

6. The Bank will cease to post a continuous Minimum Lending Rate from 20 August, as this would be inconsistent with the objective of the new arrangements to give the market more influence over the structure of interest rates. The option will, however, be retained for use in some circumstances of announcing in advance the minimum rate which for a short period ahead the Bank would apply to any lending to the market.

Changes in the Interest Rate Band

7. The undisclosed interest rate band will be changed by the Bank with the agreement of the Chancellor of the Exchequer primarily in response to the requirements of the annual monetary target, taking account of a range of factors indicated in the Budget Speech.

Press Office
HM Treasury
Parliament Street
LONDON SW1P 3AG

Tel: 233 3415

117/81

The new monetary control arrangements announced today flow from work begun in 1980 with the publication of the Green Paper on Monetary Control (Cmd 7858).

In the months following publication of the Green Paper the Treasury and Bank of England received submissions from and consulted a wide range of commentators and market participants on the issues raised in the Paper. In his statement to the House on 24 November 1980 the Chancellor reported on the outcome of these consultations and outlined a number of improvements in monetary control which it was proposed to introduce. These included the ending of the Reserve Asset Ratio requirement, and changes in the Bank's money market operations to allow the market a greater role in the determination of the structure of short-term interest rates. The Bank issued a background note on "Methods of Monetary Control" on 24 November (published in the December 1980 Quarterly Bulletin).

In his Budget speech on 10 March the Chancellor described some of the changes that had already taken place and explained that the Bank would be discussing further changes with the financial institutions. He said that when these consultations were complete the Bank would aim to keep interest rates within an unpublished band, but without an announced Minimum Lending Rate. On 12 March the Bank issued two papers "Monetary Control: Next Steps" and "The Liquidity of Banks" (published in the March 1981 Quarterly Bulletin).

On 2 July the Chancellor told the House that the Bank had issued on 22 June the final draft of the detailed provisions and that discussions with the financial institutions were well advanced. On 31 July he said in answer to a question from Mr Newens that the full system would come into operation on 20 August, the first day of banking September.

Today's Treasury Press Notice explains the major changes and their rationale. At the same time, the Bank of England are issuing a paper entitled "Monetary Control: Provisions", which sets out the details of the new arrangements.



F.

H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-233 3000

Direct Dialling 01-233

Bi

15 November 1984

M Foot Esq
Bank of England
Threadneedle Street
London EC2R 8AH

Dear Michael,

MONETARY BASE CONTROL

As promised, I have dug up the latest stuff that went to Ministers on MBC. Both the attached pieces are in fact quite old - written about the time of the Election, and not intended to be any more than a summary of earlier arguments. Even so, I would be grateful if you could treat them as personal; for reasons which no doubt seemed good at the time they were never formally sent over to the Bank.

I am also enclosing two recent pieces by me on Pepper's thoughts on the July base rate rise. They reflect conversations with Tony and Charles, but I don't think I sent them copies. Nothing very sensitive about them, and I would be interested in any comments you have. I send them not because they are particularly deep, but to bring you up to date on the sort of stuff we have been sending the Chancellor.

I seem to remember promising you a contribution to your paper, if needed. Perhaps we could have a word some time about what - if anything - you want.

*Yours
Rachel*

Rachel Lomax

12/285

FROM: P N SEDGWICK
DATE: 14 JUNE 1985

MR CASSELL

*cc Mr O'Donnell
Mr Wood*

cc Sir T Burns
Mr Lavelle
Mr Lankester
Mr Peretz

MONETARY CONTROL IN A LIBERAL FINANCIAL SYSTEM

Introduction

One issue that has exercised us for some time in discussion of monetary strategy and control is that the very large build up in private sector holdings of liquid assets gives the private sector the ability to increase expenditure sharply should it wish to do so. Many - including most recently Alan Walters and Gordon Pepper - believe that policy should be operated to make such an increase in expenditure - which would add to inflationary pressures - impossible.

2. My own view is that the interaction of financial liberalisation and innovation have rendered inappropriate many of the existing or suggested techniques to prevent any such increase in expenditure and that we need to consider different methods of control. This note, in which I briefly set out my initial views, is to initiate an internal debate on feasible methods of control.

The problem

3. Financial liberalisation appears to be underway in a large number of developed economies, including some rather surprising ones, eg New Zealand under a Labour government. In the UK we had the removal of exchange controls - the key initial move that has helped to make others inevitable - and the removal of the corset. These removed controls that in one form or other

had been in place for decades.

4. Those who think that the disturbances following the liberalisation of 1979 and 1980 will soon die down and that a period of calm is imminent are deluding themselves. There are "in the pipeline" important changes to the rules governing building society behaviour and a major upheaval in the market for securities. I would not be surprised to see the latter followed by major developments in retail markets for securities so that all private investors would be able to switch between liquid capital-certain financial assets (bank, building society, and national savings accounts) and securities as easily as they can now switch between bank accounts. For the next year or so at least a fairly massive privatisation programme - to a great extent targeted at individual investors - will produce a series of "shocks", some of which - like the sale of BGC - will be massive. Finally these changes as a result of policy will be accompanied by various financial innovations. Many of these developments - such as the current increase in use of swaps - seem almost to be tailor-made to distort the monetary indicators.

5. One reaction to the changes so far in the UK is that the private sector has increased significantly its stocks of gross debt and liquid assets relative to income. Presumably the new ratios of these stocks to income are preferred levels not previously attainable under credit rationing. One of the supposed dangers of this adjustment is that individuals in the private sector could in principle suddenly raise their expenditure simultaneously and thereby increase inflationary pressures.

6. Before assessing how to cope with this potential threat it is worth pointing out that there is probably no way of preventing the rise in the ratios of gross debt and liquid assets to income unless the policy of liberalisation is put into reverse. In particular it would probably be essential to reimpose fairly drastic exchange controls as a first step.* I see no obvious

*If it were possible to manipulate the yield curve in a drastic way it might be possible to induce the private sector to switch its gross financial assets into less liquid forms without reversing liberalisation. I do not discuss here the feasibility of this approach, which I regard as low.

alternative way to induce the private sector voluntarily to choose lower ratios. Given private sector preferences any crude attempt to constrain the growth in broad liquidity and credit to low levels in order to control or even reduce the "overhang" of liquidity will either fail or, more seriously, produce a lower growth in nominal demand than is desired. Targets for broad money and liquidity &/or for credit are therefore unlikely to be an appropriate or effective way to deal with the potential problem of a liquidity "overhang". Given the evolution of techniques of payment, targeting narrow monetary aggregates - such as MO or NIBML - need not provide a foolproof way of detecting at an early stage any significant attempt to spend liquid balances, though it is conceivable that these will continue to have a stable relationship with income.

Historical experience with liberal financial systems

7. Financial innovations - such as the development of international markets for wholesale money - and technical change have rendered current conditions and problems very different from those in the period before exchange and credit controls began to distort financial systems during the last war. Nevertheless it is of some interest to see how the authorities in earlier years exerted monetary control in very liberal systems. There was for instance a very highly developed international bond market in the years before 1914, and there were no direct controls to prevent a UK resident increasing his domestic expenditure or purchasing foreign bonds.

8. It is worth remembering that the monetary authorities in the UK at least had a rather better record in preventing peacetime inflation in this earlier liberal era. There was admittedly a tendency for the price level to fall, but there were not the large changes in the inflation rate that have been experienced recently. Furthermore they achieved this result without having data on the monetary aggregates let alone targeting them!

9. The pre-1914 gold standard, which was operated with a

minute gold reserve, was essentially a fixed exchange rate system. It was viable providing the authorities were prepared to adjust interest rates quickly and by whatever amount was necessary to prevent pressures on the gold reserve. The system was clearly inappropriate by the early 1930's when for domestic reasons the authorities did not want to raise interest rates by the necessary amount and furthermore the world's largest economy, the US (which was less significant before 1914), was operating monetary policy in a way that led to a very sharp fall in the US price level for several years running.

Liberal financial systems in the 1980's

10. One obvious option in the 1980's for small or medium size liberal economies is to have a fixed exchange rate regime.* Provided world price inflation is fairly low and stable - a condition which I discuss below - the domestic monetary authorities can in principle by pass the difficulties associated with monetary targeting in a liberal system - and steer policy by reference to the exchange rate. This need not of course imply a rigid fixed rate system, but would rule out the accommodation of major changes in the exchange rate. It could well turn out to be easier to decide at budget time in the next few years what is the appropriate exchange rate for the year ahead than to guess the appropriate growth rate of broad money, broad liquidity, or credit given the "shocks" that we are about to inflict on the system.

11. As far as the liquidity "overhang" problem is concerned there probably would be fairly significant and swift ex ante pressure on the exchange rate if the private sector began to spend its stock of broad liquidity. This pressure could be swamped for a time by capital flows so that the exchange rate might not at first register this effect, but it would not be too long before pressures on the exchange rate occurred. As argued above there is no reason why increased domestic expenditure should necessarily lead to similar warning signals being recorded by narrow monetary aggregates, though in many countries such

*This is the McKinnon prescription for economies as diverse as Singapore and the UK.

aggregates have had a fairly stable relationship with nominal demand during periods of major financial upheaval, eg MO in the UK during both the CCC and post-1979 periods.

12. The viability of steering by means of the exchange rate does, however, in the 1980's presuppose stable and responsible behaviour on the part of the US. Given its record in recent years this may not be a realistic assumption. In any case steering by means of the exchange rate is not a feasible policy for the world economy as a whole or its dominant economy. What would be the best policy for the US if it decided to indulge in a massive round of financial liberalisation that severely impaired the usefulness of existing monetary indicators? It is difficult to see a clear answer. The US, and maybe other large economies, would probably be driven to use inflation or money GDP as operational targets in the day to day operation of policy - a role for which they are not suited.

P.N.S

P N SEDGWICK

FROM: P N SEDGWICK
DATE: 19 JUNE 1985

MR CASSELL

cc Sir P Middleton
Sir T Burns
Mr Lavelle
Mr Lankester
Mr Peretz
Mr Lewis
Mr Dolphin

WOULD RESERVE ASSET RATIOS DRIVE MUCH BANKING BUSINESS OFFSHORE?

At his meeting on Monday the Chancellor mentioned the possibility of imposing reserve asset ratios. In other economies, such as Germany, this does seem to have helped to secure a closer relationship between the behaviour of broad monetary aggregates and of the monetary base. We have argued that such regulations would drive banking business offshore.

2. It is not possible to provide estimates for the loss of business that would occur if we imposed reserve asset ratios. (Presumably the reserve asset ratios would only need to be on sterling deposits of residents if the purpose was to control £M3. There would be no purpose in imposing them on ^{liabilities to} non-residents' and thereby driving this business elsewhere.) The attached tables do, however, give some idea of the scale on which London has gained business in other currencies and from other financial centres, and the extent to which it has retained most of the sterling business.

3. The Euro-sterling market has not grown significantly in relation to the domestic market (Table 2). On the other hand non-resident sterling deposits in the UK have risen sharply in recent years in relation to domestic deposits.

4. What is perhaps of greater significance is the enormous growth in the UK of the ratio of liabilities (in all currencies) ^{to} non-residents to the liabilities ^{of} residents (Table 1). Most of the growth in non-resident foreign currency liabilities will have been in the main international currencies - above all in \$'s, but in DM as well. The growth of offshore deposits in \$ and DM appears to have been at a markedly higher rate than

in onshore deposits^{in these countries}. The imposition of reserve asset ratios on domestic residents sterling liabilities would lead to a similar, and most undesirable, large flight offshore. I cannot see such a development enhancing our ability to control monetary conditions, particularly if we continue to attach significance to the behaviour of the exchange rate.

P.N.S

P N SEDGWICK

TABLE 1: LONDON AS AN INTERNATIONAL BANKING CENTRE

billion per year	LIABILITIES TO RESIDENTS			LIABILITIES TO NON RESIDENTS			RATIO OF NON RESIDENT/ RESIDENT BUSINESS (%) (6) ÷ (3)	RATIO OF NON RESIDENT STERLING/RESIDENT STERLING BUSINESS (%) (4) ÷ (1)
	(1) STERLING	(2) FOREIGN CURRENCY	(3) TOTAL	(4) STERLING	(5) FOREIGN CURRENCY	(6) TOTAL		
1963	31	0.3	31.3	4.9	3.6	8.5	27.2	15.8
1964	33	0.3	33.3	4.9	5.0	9.9	29.7	14.8
1965	35	0.3	35.3	5.3	5.9	11.2	31.7	15.1
1966	36	0.4	36.4	5.4	8.4	13.8	37.9	15.0
1967	34	0.6	34.6	4.5	10.5	15.0	43.4	13.2
1968	37	0.8	37.8	4.2	17.2	21.4	56.6	11.4
1969	38	1.1	39.1	4.4	28.6	33.0	84.4	11.6
1970	41	1.2	42.2	5.3	36.1	41.4	98.1	12.9
1971	50	1.1	51.1	8.0	44.3	52.3	102.3	16.0
1972	58	1.9	59.9	7.2	59.3	66.5	111.0	12.4
1973	73	3.3	76.3	7.7	90.1	97.8	128.2	10.5
1974	81	5.6	86.6	9.5	112.4	121.9	140.8	11.7
1975	74	5.9	79.9	9.2	128.2	137.4	172.0	12.4
1976	68	6.6	74.6	7.1	148.6	155.7	208.7	10.4
1977	84	8.0	92	11.1	171.4	182.5	198.4	13.2
1978	103	10.2	113.2	11.9	213.4	225.3	199.0	11.6
1979	127	11.2	138.2	19.2	282.8	302.0	218.5	15.1
1980	162	14.3	176.3	27.7	347.6	375.3	212.9	17.1
1981	162	19.1	181.1	27.9	420.6	448.5	247.7	17.2
1982	149	21.1	170.1	30.8	455.9	486.7	286.1	20.7
1983	148	23.2	171.2	34.2	480.8	515.0	300.8	23.1
1984	130	24.4	154.4	35.2	496.3	531.5	344.2	27.1

The table shows the total liabilities of banks ^{operating} in the UK to residents and non-residents, with a breakdown between sterling and foreign currency deposits. (For convenience all are expressed in billions of dollars.)

TABLE 2: RELATIVE SIZE OF THE ONSHORE/OFFSHORE STERLING MARKETS

\$ billion End-year	(1) ONSHORE STERLING LIABILITIES	(2) OFFSHORE STERLING LIABILITIES	(3) RATIO (2)/(1) o/o
1976	75.1	6.6 ⁽¹⁾	8.8
1977	95.1	10.4 ⁽²⁾	10.9
1978	114.9	11.4	9.9
1979	146.2	17.1	11.7
1980	189.7	27.0	14.2
1981	189.9	23.5	12.4
1982	179.8	19.4	10.8
1983	182.2	17.4	9.5
1984	165.2	19.0	11.5

NB. Data supplied by Bank of England, except (1) Morgan Guarantee, (2) BIS press release.

Since 1976 the total size of the Eurosterling market expressed as a percentage of total onshore sterling liabilities has fluctuated within a 9-14% band, with little evidence of any overall trend. The sharp rise over 1978-1980 and subsequent decline is consistent with the corset controls having driven sterling funds offshore while they existed. UK residents eurosterling holdings remained flat over 1980-83 but did rise in 1984 (mainly interbank). By far the greater part of non-resident eurosterling liabilities are interbank (about 80% in 1984).

(B1.)

147 2/100

MR SEDGWICK

Joan
Can you retrieve a copy of X?
AWP

FROM: MR CASSELL

DATE: 26 June 1985.

cc Sir P Middleton
 Sir T Burns
 Mr Lavelle
 Mr Lankester
 Mr Peretz
 Mr Lewis
 Mr Dolphin

WOULD RESERVE ASSET RATIOS DRIVE MUCH BANKING BUSINESS OFFSHORE?

X/ Thank you for your interesting - and timely - minute of June 19th.

On one point, however, I am not sure I agree with you. You say that there would be no purpose in imposing reserve asset ratios on (sterling) liabilities to non-residents, if the purpose was to control £M3. That is no doubt true if we are simply talking of £M3 as a number. But since for big, internationally trading, companies the line between resident and non-resident deposits is a very fine one it could look pretty pointless to make the distinction. And if the real concern were not so much £M3 as such but the banks' ability to lend we would need to try to control the whole of their sterling deposit base.



F CASSELL