

## 18. Monetary Control Consultations

15 November 1980  
continued

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  $1\frac{1}{2}\%$  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  $12\frac{1}{2}\%$ :-

- (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

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.

## 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  
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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.

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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

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.

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.



D. G. Champion  
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 unforeseeable 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.

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.  
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