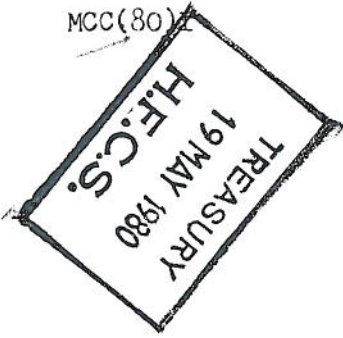


1. Monetary Control

Consultants

24 – 25 April 1980

MCC(80)



HER MAJESTY'S TREASURY
MONETARY CONTROL CONSULTATIONS

COMMENTS ON THE GREEN PAPER

Notes by the Secretaries

Mr Pickleford ✓ H.F.C.S.

*I hope from now
you will get copies
direct.*

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COPY NO.

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A number of comments have already been received on the Green Paper, and more can be expected. We propose to circulate all comments of substance to those concerned, and also those notes prepared in the Bank or the Treasury recording seminars, analysing comments and so on.

At annex A is attached a circulation list; if anyone has any amendments or additions, please can they let one of the secretaries know.

A number of comments (by Rose, Coglan, Bain, Sargent and Greenwells) on the Green Paper have been submitted to the Select Committee, and subsequently circulated as TR(Mon) papers; Treasury Central Unit (Mr Folger) will make sure that all TR(Mon) papers that discuss the Green Paper, or are otherwise relevant to the monetary control consultations, will be circulated to those on the MCC list (but they will not be given an additional MCC number). We do not envisage using the MCC list to circulate comments on the Bank's liquidity (or related) papers, but some overlap is probably unavoidable.

3942

If anyone receives comments or has other material thought worth circulating, please could they pass it directly to one of the secretaries.

M D K W FOOT

M L WILLIAMS

H M Treasury
24 April 1980

MONETARY CONTROL CONSULTATIONS: CIRCULATION LIST

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HER MAJESTY'S TREASURY
MONETARY CONTROL CONSULTATIONS

COMMENTS ON THE GREEN PAPER

Note by the Secretaries

Grenfell and Colegrave, Investment Research:
"Monetary Control and the Discount Market"
March 1980 is attached and circulated for
information.

M L WILLIAMS
M D K W FOOT

H M Treasury
25 April 1980

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March, 1980

Monetary Control and the Discount Market

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In earlier reviews of the discount houses we have reported the progress of the debate on monetary control. The Green Paper on this topic presented by H.M. Treasury and the Bank of England has now appeared. We set out our initial reactions.

The general stance of the paper reflects the preference of the authorities for a substantial element of discretionary control rather than a mechanistic approach which is seen as inappropriate to a sophisticated money market.

Some economists will challenge this position very vigorously in the comments which the paper invites. On the whole, significant institutional change is unlikely. Specifically the fears of the discount market have been removed. The changes proposed will have little impact on the valuation of discount house shares, and we see no reason to alter the views expressed in our recent review.

1. We discuss the background to the Green Paper, briefly outline the proposals and try to establish their impact upon the discount houses.
2. The worst fears of the houses have, as expected, been allayed. The lender of last resort facility remains, there will continue to be a fairly strictly defined range of assets which provide the banking system with primary liquidity and these assets remain those central to the discount market's trading.
3. The ending of the corset control mechanism could reduce the supply of commercial bills and therefore reduce the running margin available on them. This is unlikely to happen until the liquidity of the banking system improves.
4. The suggested indicator system could make interest rate movements more predictable.
5. It should be remembered that the debate may not be over and that the changes in market behaviour that ultimately stem from limited institutional changes cannot always be foreseen.

The Background to the Green Paper

The Government's determination to attack the UK's inflationary problem mainly by reducing the rate of growth of the money supply meant that the efficacy of the Bank of England's control of the level of bank deposits and of monetary aggregates would become a matter of intense debate.

Some "monetarist" economists have long advocated a more direct emphasis upon controlling the supply of money as a superior alternative to manipulating the level of interest rates in the hope of bringing the demand for money into balance with the authorities' target of the appropriate money stock. The position of these economists is evidently the modern equivalent of the "currency school" while the Bank of England can be seen as the modern exponents of the "banking school". The recent discussion can therefore be set in a very long term context of British monetary history, but we concentrate upon the immediate problems confronting the monetary authorities, even though we think that the outcome of the debate will be consistent with the position towards which the Bank's views have evolved over a very long period: that any attempt at controlling the volume of credit must permit sufficient flexibility to prevent liquidity crises and excessive volatility in short-term interest rates.

The central criticism of the existing arrangements has been that the reserve asset base upon which the pyramid of bank deposits is constructed is not subject to Bank of England control. Reserve assets have been so constituted that they are held by institutions other than the Bank of England and the clearing banks. Should the Bank attempt to constrain the growth of bank lending by operations designed to reduce the banks' reserve assets then they can replenish their holdings of such assets by bidding them away from other holders. Beyond this relatively narrow question of technical operation is that of the appropriate emphasis of monetary policy. The more rigid adherents of the monetarist approach advocate a determined attempt to control the money supply involving an acceptance of interest rate fluctuations and that this should be achieved by the replacement of the reserve asset base by a cash base method of control. The basis of the deposit pyramid would be cash and balances at the Bank of England — i.e. "high powered money" rather than the existing range of reserve assets, and the most rigorous versions of the "cash base" system envisage the ending to the Bank's lender of last resort role whereby money is always available to the discount houses against eligible security.

The months preceding the publication of the Green Paper have been notable for the difficulty encountered by the Bank in achieving the desired control of monetary aggregates and by disappointing results for counter inflationary policy. Although this might have been expected to have strengthened the case of the advocates of change the impression emerged that the proposed changes in institutional arrangements would be quite limited. The discussions started against the expectation that a fairly rigid money base control would be favoured, but that lender of last resort facilities would be retained. The theoretical advantages of such a system were aggressively presented, but the June number of the Bank of England Quarterly was decidedly cool and reflected the Bank's well known preference for acting directly upon interest rates as well as monetary aggregates, and for doing so through the discount market.

There was also a wide recognition of the fact that much of the weakness of economic policy lay in the slackness of the Government's fiscal position. An excessive borrowing requirement would impose strains upon any system of monetary arrangements and equally any reasonable arrangements would work if fiscal policy were consistent with plausible monetary targets. In addition to this realisation of the limitations of the possible gains from changes in the technique of monetary management, the memory of the previous Conservative Government's experience with the move to "Competition and Credit Control" was perhaps a powerful argument for limited change. The political content of the discussion may prove decisive. In recent weeks the Government's determination that MLR should not be raised above 17% has obviously harmonised with the Bank's willingness to intervene on a massive scale to give temporary assistance during a period of severe liquidity shortages. Realisation that a rigid money base control might have pushed MLR to 20% may have curbed the Government's enthusiasm for change based upon theoretical argument.

The Green Paper

The green paper on "Monetary Control" is subtitled "A consultation paper by H.M. Treasury and the Bank of England". It therefore represents the monetary authorities' summary of the debate upon monetary control, their evaluation of the arguments and a tentative indication of the direction in which they might move in developing the techniques of monetary management. Its tone is notably similar to that of the article on "Monetary Base Control" in the June Bank of England Quarterly Review, in that the merits of the existing arrangements are recognised and it is clearly perceived that much of the action needed to restore controlled monetary growth lies in the field of fiscal policy. It perhaps tacitly recognises that the problems of moving from a permissive to a restrictive monetary stance are as much those of political will as of monetary technique.

An important theme in the argument of the Green Paper is that control techniques should avoid causing a significant incentive to disintermediation, and accordingly the corset's removal is suggested on the grounds that it has inhibited the development of business by the banks and diverted flows of lending into uncontrolled channels — most obviously the holding outside the banking system of a greatly increased volume of bank accepted commercial bills. Special deposits would remain as a method of removing surplus liquidity from the banking system.

The reserve assets ratio of 12½% "appears to be no longer necessary" and it is proposed that it should end. In fact it seems unlikely that the liquid assets of the banking system would be greatly changed, for the assets which should be held for prudential purposes to provide primary liquidity are "cash and those assets which the Bank of England is customarily prepared to buy in its open market operations, or which represent claims on institutions in the money market having access to lender of last resort facilities".

The Green Paper's scepticism extends to the usefulness of changing the methods of measuring monetary growth, so that sterling M3 is to remain the yardstick though other indicators are to be watched, and to the merits of potential systems of monetary base control. The theoretical basis of the Green Paper's position is the claimed absence of any stable relationship between a monetary base and present or future monetary growth, and doubt of the effectiveness of the interest rate changes resulting from operations on the base to influence monetary aggregates.

The direction in which the authorities appear to be prepared to move is towards an "indicator system" under which a departure by the control variable — probably sterling M3 — from its targeted path would automatically require a corrective interest rate movement. This would substantially remove the interpretive role of the authorities which "may be a bias towards delay" but even so the authorities would reserve the power to override automatic interest rate changes.

In theory such an automatic mechanism might be expected to make the timing and extent of interest rate changes rather more easy to predict, but the market might need to gain experience of its working, and of the circumstances in which it was overridden, before this could be established.

The Discount Market

The implications of the Green Paper for the working of the discount market appear to be quite limited. There is relief that the monetary authorities have come out in favour of a modest degree of evolutionary change rather than a dramatic alternation of the rules. However, it must be remembered that there is to be further discussion and pressure for a decisive move towards a form of money base control still exists. Moreover, quite important changes in the working of markets can ultimately follow from limited institutional change, often in ways that cannot be foreseen.

The immediate points are that the lending of last resort role is to remain so that the discount market remains the channel through which the Bank will normally supply additional liquidity to the financial system, the definitions of liquid assets are not greatly changed so that the assets dealt in by the discount market will be sources of primary liquidity as will loans made to the market. It has not been suggested that Treasury bills of longer maturity should be issued so that there is no new asset for the market to absorb.

The proposed withdrawal of the corset control could have an important implication for the market. If the banks have sufficient liquidity to expand their lending the great increase in the volume of commercial bills caused by earlier disintermediation could be reversed. It seems unlikely that this will happen quickly, given that attention will continue to focus upon the course of bank lending and sterling M3. Some of the recent growth of the use of bill finance may prove to be permanent for the advantages of bill finance have been well publicised, but over the medium term the margins available to the market on this paper must be expected to narrow.

The first impression of the green paper proposals must be that they contain little that is hostile to the discount market. The market's major problems remain those of the loss of resources caused by the November MLR increase, the difficulty of interpreting monetary developments in an increasingly open economy and the volatility of rates caused by the authorities' difficulty in gaining control of monetary growth.

HER MAJESTY'S TREASURY
MONETARY CONTROL CONSULTATIONS

COMMENTS ON THE GREEN PAPER

Note by the Secretaries

Sheppards and Chase: "Monetary Control and
the Monetary Base": 1 April 1980 is
attached and circulated for information.

M L WILLIAMS

M D K W FOOT

H M Treasury
25 April 1980

1st April, 1980

MONETARY CONTROL AND THE MONETARY BASE

1. Present Methods of Control

Since "Competition and Credit Control" in 1971, both the emphasis and the techniques of monetary control have changed several times, often substantially. The present explicit objective is to constrain the rate of growth of Sterling M3 (hereafter £M3) to a target bracket, but with the implicit objective of restricting the undefinable aggregate "money" as a whole. The essence of the mechanism of control is that the authorities set a level of short-term interest rates which they expect to be consistent with the £M3 target, and "enforce" it through gilt sales, open market operations in the money markets and periodic calls of special deposits. A further irregular element of control has been the so-called "corset", which seeks to limit directly the willingness of the banks to bid for and hence accumulate deposits.

Fiscal policy is another element of the monetary environment, but one which operates on a different, and notoriously longer, time-scale. That is not to say that variation in the fiscal environment cannot occur over a very short period, but this will be either heavily lagged, or largely involuntary. In the former category would come, for example, the current effects of last June's budget; in the latter, changes in fiscal drag resulting from unforeseen changes in the inflation rate and earnings.

2. Weakness of Present Methods

Chapters 1 and 2 of the green paper provide, with certain comments elsewhere, an excellent general critique of existing monetary controls. It is necessary only to draw attention to the most important aspects of this analysis and to add a very few remarks.

£M3

The first of these is that the choice of £M3 as the most appropriate indicator is an assumption of the introduction (pp iv and v), and is not considered in the body of the document proper. The arguments adduced in its favour (introduction, para. 10) are essentially the fact that it has been used for some time and that it may be presented easily in terms of either side of the banking system's balance sheet.

Each of these facts is important. The risks inherent in government being able and willing to change its main monetary indicator whenever it became convenient to do so are very plain. So are those of the indicator being even more difficult to understand by those who use it in the markets. From each point of view £M3 on the present definition has advantages, but they are not overwhelming.

The recent problems associated with £M3 have been of two kinds. The first, following from the operation of the corset (and disintermediation in the form of acceptances held outside the banking system etc.) would also have afflicted a wide variety of other measures, and is not likely to be a problem in future unless the authorities again come to believe, in the post-corset era, that disintermediation can be a small price to pay to "glamourise" the monetary statistics for a few months. The second type of problem is associated with a much wider spread of official policies, including those on PSBR, EMS, exchange control, and exchange rate management.

The fact that sterling deposits in the U.K. banking system from overseas are excluded from £M3 has been a cause of serious divergences in the course of recent months between the official indicator and those which we at least would regard as more representative. (This is, of course, a subjective judgement, but has some objective content since the professed aim of monetary policy is to achieve "a permanent reduction in inflation" (introduction, para. 2). The relevant measure must therefore be one which gauges the availability of money and/or liquidity and/or credit to the domestic economy). The table below shows recent movements of the basic measure and two amending series.

	£M3 (£bn)	Change ¹ (%)	Acceptances ² (£bn)	Change ¹ (%)	Overseas depos. ³ (£bn)	Change ¹ (%)	£M3+ ⁴ (£bn)	Change ¹ (%)
1978 Nov.	48.8	—	0.8	—	5.1	—	54.6	—
1979 Feb.	51.1	+4.7	0.7	-13	5.2	+2.4	56.9	+4.2
May	42.1	+2.0	0.8	+19	6.0	+15.1	58.9	+3.4
Aug.	53.7	+3.1	1.6	+101	6.6	+10.8	61.9	+5.1
Nov.	55.4	+3.3	1.9	+22	7.3	+9.9	64.6	+4.4
1980 Feb.	56.7	+2.5	2.0	+5	8.1	+11.4	66.8	+3.5

1. *over previous figure shown*
2. *held outside the U.K. banking system*
3. *in sterling with overseas banks*
4. *£M3 + acceptances + overseas deposits*

The difference in growth rate between £M3 and overseas sterling deposits is clearly sufficiently large to arouse interest. It is likely to remain substantial in the wake of the abolition of exchange control, as overseas sterling claims on the U.K. banking system grow as the counterpart of U.K. capital exports. Here again, the promised steady fall in PSBR may be expected to produce additional pressures, while any move to join the EMS could lead to further changes in European banking and financial habits.

This particular discussion will be a familiar one, being to a first approximation the same as that in the autumn of 1976 when a Labour government which had been relying on M3 as its indicator had DCE imposed upon it by the IMF to avoid the distortion caused by variations in sterling support and the current account balance.

The wording of the green paper does not exclude a re-definition of £M3, but certainly implies that no such amendment is now under active consideration. If other changes to the financial and monetary framework were made without some attempt to bring the main indicator more closely into line with changed circumstances we would regard this as an opportunity missed.

Quantitative Controls

The description of the weakness (1.12 to 1.17) of quantitative controls, in terms of their severe limitations and inevitable side effects, is excellent (see, for example, paragraphs 1.13 and 1.14). It is to be hoped that the detailed objection of paragraph 1.16 to the periodic switching off and on of controls will be borne in mind in relation to exchange controls. The problems of anticipation of reintroduction apply equally strongly, as we have been arguing since last autumn, and the case for repeal of the Exchange Control Act rather than its effective suspension is equally as strong as that for the permanent abolition of the corset.

The Corset

Our views on the corset are well-known, and we naturally welcome the news that it will be phased out. The last tranche of supplementary special deposits will be calculated on the April-June IBEL average, paid on July 14, and repaid on August 11.

Only one further point need be made on the subject of the supplementary special deposit scheme at this stage. A half-hearted defence of the scheme is attempted (1.17) on the grounds that the main form of disintermediation which it caused, namely the "bill leak" is easily measurable, and thus in principle containable. No mention is made of the possible leakage to the overseas sector, and the far less measurable consequences for euro-markets. Indeed, we do believe it to be a valid criticism of the green paper as a whole that it would be only too easy to gain from it the impression that ours is a closed economy.

The Reserve Asset Ratio and Liquidity

"Competition and Credit Control", in 1971, and the other documents which arose from that rethinking of monetary policy, were vague as to the precise function of the RAR. What is clear, however, is that the RAR was intended as an instrument of that policy, and not merely as a requirement of prudent banking. The implication is that the expectation had been that when market conditions and the RAR conflicted a bank would tend to react by restricting its eligible liabilities (i.e. reducing its deposits, or their growth). In fact the more immediate response at least has consistently been that a general shortage of reserve assets has been accompanied by more determined bidding for them, causing the normal, and perhaps liquidity-determined (see paragraph 3.7) difference between reserve asset and other yields to rise. As is generally the case, this distortion is followed by others.

The most positive aspect of the green paper was the conclusion that "the requirement to maintain the 12½% Reserve Assets Ratio appears to be no longer necessary either as a means through which interest rates are influenced or as a means of affecting the growth of banks' balance sheets. It is proposed that it should end".

This was linked with the Bank of England discussion paper entitled "The Measurement of Liquidity" which effectively suggested the replacement of the Reserve Assets Ratio by a system of Primary and Secondary liquid asset requirements.

The discussion paper re-iterates the four-fold need for liquidity outlined in the 1975 joint working party paper on capital and liquidity. These are:—

- i) The need to be able to meet overall increases in demand for advances and/or withdrawal of deposits or from timing differences in the maturity of assets and liabilities.
- ii) A shortfall in the anticipated inward cash flow usually as a result of the inability of a borrower to repay on the due date;
- iii) additional operating or capital expenditure;
- iv) losses.

At this stage the Bank does not recommend whether the new system of liquid assets should apply only to sterling business or should be applied to all business. If it applied to all business, secondary liquidity could be held in either sterling or foreign currency assets. In this context however although U.K. banks and the U.K. branches of overseas banks would be covered as to sterling business, the currency business of U.K. branches of foreign banks would not be subject to the new system of control.

The Bank considers that all banks should hold some primary liquid assets (defined later) "but that it is reasonable to look at this requirement being applied more stringently to banks nearer the centre". The Bank however would prefer to set the same requirement for all banks but licensed deposit takers would in addition be allowed to count as primary liquid assets claims on recognised banks maturing within 8 days. In this connection it should be mentioned that treating smaller banks the same as the major clearing banks is less than fair, as undoubtedly size must be an important stabilising factor. The clearing banks by now however must be used to this treatment.

The reserve asset ratio, established in 1971, took the form of a daily minimum requirement which "limits the utility of required reserve assets as liquid assets". The new system should be expressed as "norms" rather than compulsory minima as it is the purpose of such liquid assets to be utilised in times of difficulty.

The new methods proposed by the Bank distinguish between classes of liquid assets as follows:—

Primary liquid assets, defined as cash or those assets which are in all circumstances a ready source of cash, because the authorities stand ready to either purchase them or accept them as collateral for last resort lending;

secondary liquid assets, which are near-cash or readily marketable.

The list of such assets is shown below:—

Primary liquid assets:

- Cash
- Balances with the Bank of England (excluding special deposits)
- Call money with the London Discount Market Association
- U.K. and Northern Ireland Treasury Bills
- Local authority bills and bank bills eligible for re-discount at the Bank of England
- British Government Stocks with less than one year to maturity.

Secondary liquid assets

- Market loans to banks up to one month
- Secured money at call with recognised Stock Exchange money brokers and gilt-edged jobbers
- Loans to Local Authorities up to one month
- Non-eligible bills with less than three months to maturity
- Certificates of Deposit and certain marketable promissory notes with less than three months to maturity.
- British Government Stocks with between one and five years to maturity
- Northern Ireland Government Stocks with less than five years to maturity
- Local Authority and public corporation marketable securities with less than five years to maturity
- Gold
- Irrevocable undrawn standby facilities from other banks (possibly identified by payment of a fee).

The primary liquid asset total is very similar to reserve assets but with cash in tills included and loans to money brokers excluded. Of the expected liquid asset cover 40% should take the form of primary liquid assets.

The requirements for various forms of business are divided between maturity uncertain liabilities for which 25% of the gross total needs to be provided in the form of liquid assets and maturity certain business where varying proportions of net liabilities are needed according to the length of maturity. These are shown below:—

	Expected liquid asset cover
Gross market deposits from banks up to one month	100%
Irrevocable undrawn standbys given to banks	100%
Net liabilities on maturity-certain business	
Up to 8 days	90%
8 days to 1 month	75%
1 to 3 months	50%
3 to 6 "	25%
6 to 12 "	15%
over 1 year	5%

There are a number of potential problem areas here.

- i) The first recognised in the Bank of England paper is that illusory liquidity could be created from the proposed treatment of Certificates of Deposit — which would need to be monitored. It is difficult, however, to see what the Bank of England at this stage would use as a "norm" with the very drastic contraction of the CD market in the last eighteen months or so and the parallel growth of acceptances.
- ii) The second problem is created by the substantial steepness of the fall between the less than three months and over 6 months net liability positions. This reflects the Bank's view that the need for liquidity on maturity certain net liabilities of less than three months rises very sharply and drops away sharply after six months. The difference in requirement gives scope for ingenuity in by-passing the spirit of the proposed new system.
- iii) The problem of currency business and overseas banks could be a further area of weakness. Even in sterling terms, there could be a move to the use of euro-sterling if the proposals were felt to be unduly onerous by certain banks. Furthermore the currency business of overseas banks could easily be moved from London, if foreign currency business was included in the scheme. In this context the Bank of England proposes to issue a paper on Foreign Exchange in the near future.

There has been no real clarification provided as to how the implementation of the proposals would affect the various classes of bank, or the banking system as a whole. No doubt introduction of the scheme would be on relatively easy transition terms, with perhaps any possible slack being taken up by special deposits.

Although one of the criticism of the existing system was that in the banking system as a whole there was too little primary liquidity, it seems unlikely that there would be any shortage within the clearing banks of primary liquid assets. At present the banks have to provide 12½%, as a daily minimum of reserve assets, and this is 12½% of sterling deposits with an original maturity of up to two years (with interbank deposits netted off).

The calculation of the likely parent bank requirements (leave alone the group) is difficult. Typically a clearing bank will have:—

- (a) 70—75% maturity uncertain deposits, i.e. current account and ordinary seven day deposits.
- (b) 25—30% made up from branch deposits, street money, C.D.'s etc.

For the sake of illustration we will assume a 75%—25% split. Against the 75% maturity uncertain content, the bank will have to provide 25% in liquid assets of which latter total 40% (or 10% of the maturity uncertain liabilities total) should be primary liquid assets. Of the 25% maturity certain, some unknown proportion — depending on the net mismatch position — will need to be provided. This could well be below the 25% gross figure for maturity uncertain liabilities. In the example given in the B. of E. paper there is considerable mismatch and substantial use of short interbank and short maturity certain (up to one month) liabilities and accordingly out of £1,630,000 some £529,000 is needed as liquid assets i.e. just over 32%. The liquid asset requirement in total sterling deposits in the example is 26.3% of sterling liabilities.

On the basis of our assumed 75%—25% split between maturity uncertain and maturity certain sterling liabilities, we show the requirement for total liquid assets and for primary liquid assets in the table below:—

Liquid and primary liquid asset requirements

Maturity certain liquidity co-efficient	Total liquidity without (liquid asset requirement)	Primary liquid asset requirement
0	18.75	7.5
25	25	10.0
50	31.25	12.5
75	37.5	15.0
100	43.75	17.5

At the present time, the reserve asset ratio of the London Clearing Banks is 12.8%, if cash in the tills is added in, this would bring the ratio up to around 15%. Excluding loans to money brokers from primary liquid assets, though being undoubtedly iniquitous and unreasonable, will make little difference to the totals.

On the basis of existing statistical tables it is not possible to calculate secondary liquid assets. While a number of items, e.g. Government Stocks with more than one year to maturity are available, certain others (such as loans to local authorities) are not divided up in the necessary way.

Lessons of "Competition and Credit Control"

The publication of "Competition and Credit Control" in 1971 coincided with the beginning of the most disruptive phase of British monetary policy since Winston Churchill's decision to return to the gold standard at an unrealistic parity. There has, not unreasonably, been some debate as to precisely how far the changes made following and as the result of that publication were responsible for inflation which followed.

It is our belief that the problems of 1971/74 especially flowed from the fact that the policy officially adopted in 1971 was one of controlling the money stock rather than interest rates, but that the reality of official policy was very different. Whereas interest rates were to be used as the lever to regulate money, they were in fact used for totally different purposes. From 1971/73 there was a quite deliberate policy of accelerating rather than controlling inflation, succeeded very soon (and most obviously in 1977) by one of controlling the exchange rate.

The weaknesses which caused or assisted these deviations from announced policy were several, and to be found in more than one place. The institutional changes in the monetary system were embarked upon before all the concepts were properly formed, which made it too easy for the authorities to make up rules as they went along. The market signals (and notably long-term interest rates) which should have discouraged the excesses of 1971/74 were delayed

and muted partly because of a political desire to believe in the new government, and partly because of inexperience in the conceptual framework of monetary economics among many city institutions. (This latter was typified by the cry, popular in early 1972, that faster monetary growth must be good for gilts because more money meant more demand).

Thus far, the experience of the last decade may not seem to have very much to tell us about the present exercise, but it is important to note that divergences between actual and stated policy may most easily be disguised where there are no rules of behaviour laid down, and all action is purely discretionary. This may be the most important lesson of 1971.

3. Monetary Base Control

The most important section of the green paper is that on possible changes in the monetary system. These are divided into two chapters (4 and 5) on control of the monetary base, and control of money using a monetary aggregate as an indicator, respectively. The tone of the green paper is antagonistic to both of these changes, but we understand that the press briefing which accompanied the release of the paper suggested that the latter ("indicator systems") should not be ruled out.

Before considering the paper's detailed discussion of MBC we should perhaps expand and justify some of the points made in our recent (March 5th) note.

Just as there is no single logical or generally accepted definition of what is money, so there is room for debate on the operational definition of the monetary base. For the present, it is sufficient to describe the monetary base as the "high-powered" money which consists in essence of the balance sheet liabilities of the monetary authorities. The monetary base is therefore approximately definable as notes and coin with the public, notes and coin with the banks ("vault cash") and bankers' balances at the Bank of England. These liabilities have their counterpart, of course, in the assets of lending by the monetary authorities to the private, public, and overseas sectors, principally in the form of money market advances, government securities, and the counterpart of the foreign exchange reserves. This alternative presentation of the monetary base makes the mechanism of variations in it a little clearer. Now, as our previous note showed,

If	M	is	the money stock
	C		notes and coin with the public
	D		the deposit liabilities of the banks
	H		the high-powered money base
	R		the banks' reserves (say vault cash plus bankers' balances)

$$M = H \frac{1 + \frac{C}{D}}{\frac{R}{D} + \frac{C}{D}}$$

So far, this is simply a definitional identity. Thus assumptions are normally made as to the actual behaviour of individuals and banks to give this identity any operational value. If the banks hold a constant proportion of their deposits in the form of vault cash and bankers' balances, and if the public maintains a constant ratio of notes and coins to bank deposits, then the ratios C/D and R/D in the identity above are constants and it can be rewritten as

$$M = kH$$

where k is now a constant. Given the rather restrictive assumptions, if the authorities can control H they can control M, for any change in H produces a proportionately identical change in M. In absolute terms, of course, the change in M will be greater than that in H by a factor of a multiplier which is the constant k.

Unfortunately, a substantial part of the argument on monetary base control has been directed to the question of whether the ratios C/D and R/D really are constant or not. Those who claim "excessive" variability in the ratios generally believe that they have discredited monetary base control, but this is in fact not so.

To understand why not, consider two separate cases in which 1) at any instant M would be precisely proportional to H, but the constant of proportionately k varies with time, and 2) k is not actually a constant, but varies with H in a manner independent of time.

In the latter case it is at least possible in principle that some combination of experience, theory, and statistical analysis could enable the authorities and the market to determine for every possible H what the resulting M would be. Except in very exceptional cases, this would clearly be quite sufficient for monetary control through MBC to be possible. The exceptions would be if the multiplier k (H) (to denote that k is now a function of H) were either to become very large (so that tiny changes in H might give excessive changes of M) or to change very much over a small range of M (so that uncertainties of H might give excessive uncertainties in M). These exceptions apart, to achieve a given target for M, all the authorities would have to do would be to move towards a given target for MBC.

In the former case the authorities' action will be very similar. Using any combination of theoretical and empirical knowledge they will attempt to predict the value which k will take up, and will adjust their MBC target accordingly. Again, unless k varies erratically or suddenly in time, there will be no very particular difficulty in controlling M through the base.

Note that the validity of the above depends not on Bank of England imposed ratios but simply upon a known (or assumed) behavioural pattern. Nothing of the above implies that the authorities should seek to dictate a ratio of banking deposits to the banks' holdings of the base, or the way in which the base should be distributed between the public and the banking system. As the model now stands, the cash:deposit and reserve:deposit ratios' behaviour being consistent with MBC is a behavioural hypothesis subject to empirical test. To make it axiomatic by imposing ratios raises substantial complications.

We therefore move to considering this empirical evidence.

Empirical Analysis

The data for this analysis were provided by Bank of England statistics from 1963 I to 1979 II, adjusted for breaks where possible. Some series, such as £M3 itself, are seasonally adjusted (although the recent discussions of CTD's illustrates the fact that this adjustment may not be complete) but many are not. We have therefore made some adjustment ourselves to two series, those for bankers' deposits and vault cash. The precise form of adjustment has been deliberately crude (a simple constant of proportionality applied to each quarter) for three reasons.

Calculation is eased, as is recalculation if another method is preferred, and it does not imply any great predictive ability on the part of the authorities.

Regression analysis with M as the dependent and H the independent variables, and with the departure (on the reasoning of section 2 above) of adding overseas sterling deposits to £M3 as our definition of money, gives a reasonably satisfactory fit. To be more precise, the relationship found is:

$$1) \quad M = -5271 + 6.12H$$

$$R^2 = 0.98$$

Although we have explained above that it may, at least, be unimportant why M and H correlate well, it may be of interest that:

$$2) \quad D = -2149 + 6.02C \quad R^2 = 0.97$$

$$3) \quad D = -19734 + 38.17R \quad R^2 = 0.87$$

The correlation between R and D is therefore not particularly strong, a point of some practical importance as we shall see.

The most instructive measure of the behaviour of the general public (i.e. the non-banking private sector) is given by the relationship:

$$4) \quad C/GDP = .345 - 1.7 \cdot 10^{-3}t - 2.27 \cdot 10^{-4}i \quad R^2 = 0.92$$

where t is the number of the quarter in which the ratio is measured (from 1 in 1963 I to 66 in 1979 II) and i is MLR or Bank Rate. This relationship demonstrates the two effects which one would expect, of the public's cash requirement falling with time (and therefore with "increasing technology") and with interest rates. As we pointed out in our preliminary note, however, and as regression equation 4 makes plain, the interest rate factor is very small. From the present level of 17%, MLR would have to rise to 25% simply to anticipate the "natural" fall which is in any case to be expected over the next three months at least on the basis of the experience of rates from 5—15%.

Returning to the regression equation relating M and H (equation 1 above), it may be used to compute "expected" values of M for any value of H, and this is done in the table below. The final column of this table compares the observed and calculated values of M. The first point to be noted is that there is no clear secular trend, the "error" being of the same order at the start and end of the fifteen year period. Nonetheless, there is a clear pattern, with M growing much faster than the equation would suggest from 1971 II throughout the remainder of the Heath-Barber monetary explosion, before starting to subside again after 1974 I to reach the more normal relationship by 1977.

It is, we may hope, reasonable to treat the gross monetary mismanagement of 1971/74 as a non-recurrent problem, but even without making any special provision for the figures of those three years, it is noticeable that the O—C (observed minus calculated) figure is in general remarkably stable from quarter to quarter. (In fact, the 1971/74 episode is largely a matter of the round-tripping which the money and interest rate policies of the day promoted. The O—C figures for that period may indeed be interpreted as giving a measure of the amount by which recorded monetary growth exceeded the actual underlying rate). A form of monetary targeting which was based on the O—C of the previous quarter would have been more than 2% in error in only one case in three in the last 15 years, and it must be stressed once more that this is using a very simple predictive equation. In more than one case in 4 the error would have been less than 1%. This should be compared with recent targets which allow a deviation from the central target rate of 2% p.a..

Unfortunately, there are severe limitations to the extent to which the above data can strictly be regarded as testing the hypothesis of MBC. These limitations arise primarily from the forms of control applied in the past. To the extent that the clearing banks are required to hold 1½% of eligible liabilities in the form of bankers' deposits at the Bank, it would be unsurprising if a close relationship were found between the two, or even between base and money, of which latter pair the former pair form a large part. Nonetheless, the apparent basic stability of the relationship under these separate monetary regimes (1963/71, 1971/73 and 1974/date) is at least interesting and we believe persuasive.

YEAR	QUARTER	BASE ¹	MONEY 1 ²	MONEY 2 ³	O-C ⁴
1963.0	1.0	2945.6	12374.0	12752.3	-3.1
1963.0	2.0	2995.3	12631.0	13056.9	-3.4
1963.0	3.0	3009.7	12984.0	13144.9	-1.2
1963.0	4.0	3079.4	13258.0	13571.3	-2.4
1964.0	1.0	3163.1	13522.0	14083.2	-4.2
1964.0	2.0	3197.6	13711.0	14294.7	-4.3
1964.0	3.0	3203.7	14008.0	14331.8	-2.3
1964.0	4.0	3263.7	13933.0	14698.9	-5.5
1965.0	1.0	3304.0	14075.0	14945.4	-6.2
1965.0	2.0	3394.0	14383.0	15496.6	-7.7
1965.0	3.0	3381.4	14673.0	15419.1	-5.1
1965.0	4.0	3439.7	14843.0	15776.0	-6.3
1966.0	1.0	3501.9	15437.0	16156.7	-4.7
1966.0	2.0	3573.5	15402.0	16594.6	-7.7
1966.0	3.0	3533.7	15251.0	16351.3	-7.2
1966.0	4.0	3575.0	15169.0	16603.6	-9.5
1967.0	1.0	3625.3	15650.0	16711.5	-8.1
1967.0	2.0	3632.4	15928.0	16955.4	-6.3
1967.0	3.0	3665.8	16230.0	17159.6	-5.7
1967.0	4.0	3770.2	16373.0	17798.3	-8.7
1968.0	1.0	3776.6	16599.0	17837.2	-7.3
1968.0	2.0	3874.4	16931.0	18436.1	-8.9
1968.0	3.0	3850.3	17302.0	18288.7	-5.7
1968.0	4.0	3931.0	17414.0	18782.1	-7.9
1969.0	1.0	4018.4	17628.0	19317.3	-9.6
1969.0	2.0	4008.8	17407.0	19258.3	-10.6
1969.0	3.0	3959.6	17461.0	18957.1	-8.6
1969.0	4.0	4049.1	17764.0	19505.1	-9.8
1970.0	1.0	4126.3	18028.0	19977.5	-10.8
1970.0	2.0	4125.4	18611.0	19971.8	-7.3
1970.0	3.0	4204.9	19086.0	20459.2	-7.2
1970.0	4.0	4246.2	19600.0	20711.2	-5.7
1971.0	1.0	4593.1	20371.0	22833.5	-12.1
1971.0	2.0	4466.6	20718.0	22059.7	-6.5
1971.0	3.0	4424.7	21458.0	21803.4	-1.6
1971.0	4.0	4521.9	22824.0	22398.0	1.9
1972.0	1.0	4644.5	24154.0	23148.4	4.2
1972.0	2.0	4805.2	25433.0	24131.7	5.1
1972.0	3.0	4804.3	26083.0	24126.0	7.5
1972.0	4.0	5146.6	27393.0	26220.8	4.3
1973.0	1.0	5113.0	29193.0	26015.1	10.0
1973.0	2.0	5338.1	30781.0	27392.1	11.0
1973.0	3.0	5363.5	32537.0	27547.9	15.3
1973.0	4.0	5655.7	34495.0	29335.7	15.0
1974.0	1.0	5682.1	35478.0	29497.2	16.9
1974.0	2.0	5826.7	36114.0	30382.5	15.9
1974.0	3.0	6145.1	37153.0	32330.5	13.0
1974.0	4.0	6573.2	38452.0	34950.3	9.1
1975.0	1.0	6734.5	38816.0	35937.0	7.4
1975.0	2.0	6785.0	39427.0	36246.0	8.1
1975.0	3.0	6934.9	40623.0	37163.4	8.5
1975.0	4.0	7246.1	40804.0	39189.8	4.0
1976.0	1.0	7313.9	41675.0	39482.4	5.3
1976.0	2.0	7689.8	42411.0	41782.7	1.5
1976.0	3.0	7950.5	44268.0	43377.8	2.0
1976.0	4.0	8079.2	44246.0	44165.4	0.2
1977.0	1.0	8301.4	44980.0	45524.9	-1.2
1977.0	2.0	8657.0	46478.0	47701.2	-2.6
1977.0	3.0	8836.7	47637.0	48800.7	-2.4
1977.0	4.0	9331.9	49955.0	51830.8	-3.8
1978.0	1.0	9523.3	52371.0	53002.2	-1.2
1978.0	2.0	9969.9	53346.0	55734.8	-4.5
1978.0	3.0	10224.0	54730.0	57289.6	-4.7
1978.0	4.0	10610.7	56556.0	59655.9	-5.5
1979.0	1.0	10957.0	58235.0	61774.9	-6.1
1979.0	2.0	11200.9	60842.0	63267.3	-4.0

1. \$m
 2. M3 plus overseas sterling deposits
 3. (base times 8.11907) - 8271.77
 4. percentage of money 1 by which money 2 exceeds it.

MBC and the Green Paper

The green paper quite properly divides the various forms of direct MBC into the two classes of those which do and do not require mandatory regulation of a bank's holding of monetary base.

The treatment of the latter is initially (paragraph 4.6) thoroughly unsatisfactory, tending to mislead by confusing the position of an individual bank and the banking system of a whole. It is suggested that the relationship between demand for base and liabilities will be unstable as a bank's demand for cash will depend more on its transaction level and type of business than on the size of its balance sheet.

This is plainly true of an individual bank, but the case is very different for the banking system as a whole. The assertion that the type of business done by the U.K. banking system as a whole may be liable to change within the time-scale of the money planning horizon should not be accepted uncritically. As for the transaction level problem, this is identical to that of the maturity structure of deposits and loans to which we referred in our previous note. By an obvious identity,

$$\text{average maturity (days)} = \text{balance sheet size/turnover per day,}$$

whether for a bank or for the banks taken together. Again, it is not clear that a competitive banking system can necessarily, of its own volition, do very much to change the maturity structure of its deposits. One individual bank might try to discourage current account banking, or to insist on full notice of withdrawal of deposits nominally on seven days notice, but the conservative nature of the banks' customers in the short-term could make this an expensive exercise in terms of lost business.

In short, although the clearing banks' holdings of base would clearly be very large relative to those of the rest of the banking sector this need not in any way be disruptive of control, and the maturity problem would be unlikely to impose large, sudden (and therefore disruptive) changes on the relationship shown in the table.

Paragraph 4.7 is equally unsatisfactory. It observes that the liquidity requirement of the banking system might (as we have seen it does) change, and gives a specific example of the uncertainty which this would produce in money supply. Here again, the vital missing factors are predictability and timescale. The above table suggests rather strongly that even in the presence of the large-scale round-tripping which (thanks to the money and interest rate policies of the time) distorted the monetary statistics in the early 1970's, variation in the need for liquidity are slow.

Given these doubts about the arguments used by the authorities, we believe the case for MBC without a mandatory ratio to be impressive, and certainly far more so than is implied by paragraph 4.9.

The case for schemes carrying a mandatory requirement is, we believe, fundamentally weaker. If the requirement is significantly different from that of prudent banking, it will tend to risk artificial transactions, disintermediation, and loss of business overseas. If not, it is hard to see its value. It may also seem perverse to try to impose a fixed ratio on that element of the system (viz the ratio of D to R, in the above) which has the greatest "natural" variability, as signified by the lower value of R^2 cited above. Although this variability may be a feature of the existing cash controls on the clearing banks, this seems inherently unlikely. Furthermore, although all the relationships tested gave adequate or good straight-line fits, none of these passed through the origin. In other words, although the relationship appears to be linear, the ratios do change with time. Any imposed ratio, however reasonable today, will therefore be wrong tomorrow, increasing the dangers of the "bill leak", disintermediation through the euromarkets, and all the other horrors to which the authorities are belatedly alert.

The forms of such a scheme involving what the paper calls "lead accounting" (i.e. today's base puts a limit on tomorrow's deposits), are most obviously open to such risks. The time lag would serve very little purpose other than to allow the bank in question time to arrange its window-dressing. It would also tend to discourage competition, in that a high-growth bank could expect more trouble with its deposit ceiling.

The alternatives are to match the base and deposits of the same period, or to require tomorrow's base to conform to today's deposits — the techniques of "current" or "lagged" accounting respectively. These, too, have their difficulties. In the former case, there is the basic disadvantage that by the time the bank is in a position to know with any great precision what its base (or deposit) requirement is, it will be too late to do anything about it, at least through normal market channels. In both cases, there is the additional question of what the authorities response should be if the figures for the monetary base arrived at separately from the banking system's deposits and from the official target do not coincide. This matter is discussed at length in paragraphs 15 to 24 of Appendix B.

It is, we believe, impossible to avoid the green paper's conclusion that the Bank would have to supply whatever base assets were required to allow the banking system to meet its mandatory ratios, and that this raises fresh questions about the appropriate level of interest, and the setting of day-to-day targets. Again, it is difficult to dispute the paper's conclusion that the simultaneous problems of determining what the base should be and what it actually is could very easily lead to larger, and perhaps disruptively large, fluctuations in short-term rates. The impossibility of setting a suitable scale of interest penalties perhaps belongs more properly in the discussion of indicator systems.

4. Indicator Systems

The basic concept of an indicator system is as simple as that of MBC proper, and indeed the two do tend to overlap at the margin. Instead of attempting control of the base the authorities merely watch it or EM3 itself, responding to any divergence between the actual total and the desired (or target) total by moving interest rates. Such a scheme is also not necessarily very different from that operated at present, but the specific systems considered go further by assuming a more or less rigid scale of MLR responses to given discrepancies between the target and the actual base or money supply.

It is in the automaticity of response, rather than in the attention paid to the monetary base or EM3 as the indicator, that advantages are sought. Both of the tendencies already remarked upon above, to delay necessary changes and preach monetary control while actually pursuing contradictory objectives, could be controlled by any such system of automatic response, whether based upon the monetary base, M1, EM3 , or a wider based aggregate such as the one we have used above. The paper suggests that it would be more sensible to use EM3 as the appropriate measure since that is the target variable. Those who feel strongly that the monetary base or M1 is a lead indicator for EM3 will prefer to use one of these, but M1 is seriously flawed as an indicator, and our findings appear to show that there is little practical difference between using the base and EM3 .

Of course, if the government of the day is determined to pursue a policy of inflation through excessive monetary growth it is unlikely to be discouraged by any institutional framework, but this fact makes it even more important that such a policy should be made manifest as quickly as possible. In more concrete terms, if excessive monetary growth is contemplated the sooner the market can signal the consequences (in higher borrowing rates for industry and house-buyers, for example) the better.

Unfortunately, the disadvantages of any possible scheme now contemplated seem overwhelming. They are of three kinds, two arising from the separate problems of estimating a reference level for the monetary measure with which the actual level can be compared, and arriving at a suitable scale by which to convert a movement in the rate of growth of the measure into a movement in interest rates. The third, to which the paper does not refer, is one more familiar in physical than economic systems, that of "feedback".

Prof. Milton Friedman, in a well-known paper which has influenced the thinking of the present Treasury ministers, has suggested that any form of Keynesian fine-tuning of the economy is, as a matter of simple mathematics, more likely to be destabilising than smoothing. In this case, the risk is that with money supply held firmly to a desired path there will be violent swings in interest rates, or that if interest rates are held steady the money supply will be unstable. None of this depends strictly on the official response to monetary fluctuations being automatic, but such a system would seem intuitively more likely to lead to instability.

Of the other objections to an indicator system, that relating to the difficulty of selecting the appropriate path for the monetary indicator seems less convincing. The paper naturally stresses the alleged importance of the authorities' discretionary powers in overriding the signals given by erratic fluctuations in money (see, for example, paragraph 5.1), an apologia for recent intervention in the money markets) but there is little reason to believe that the authorities are any better at distinguishing temporary problems from fundamental imbalance in money than they were at discharging an indential obligation in international trade under the terms of the Bretton Woods agreement. An automatic system does not therefore seem to involve any extreme or new risks of response to purely transient deviations.

The selection of a scale of appropriate response is a very different matter, as the paper acknowledges (paragraph 5.9). The extremes, of the response being permanently too little too late, or altogether excessive, could perhaps be avoided by reference to past experience, but the last eighteen months have shown, past experience may not always be a perfect guide.

5. Summary and Conclusions

The proposed ending of the corset and the effective replacement of the Reserve Asset Ratio by the system of primary and second liquid assets are the most positive aspects of the green paper and the associated Bank of England discussion paper on the Measurement of Liquidity. The ending of the corset entails the problems of reintermediation and the accommodating of acceptances etc. within the EM3 target figures. The idea of a "norm" rather than a daily minimum R.A.R. seems sensible, and also will probably be welcomed by the banks: Certainly as far as the clearing banks are concerned, there will be no shortage of primary liquid assets, although measure of the secondary liquid asset position is not possible. There are various problems including the potential Certificates of Deposit Leak (where monitoring is rendered difficult and with the existing situation distorted by the acceptances/CD distortion induced by the corset). Also the steepness of the proposed requirements between the less than 3 month and the more than 6 month area and the currency business problem could both be areas of difficulty.

The indirect control of money through interest rates propounded by "Competition and Credit Control" in 1971 has not always been attempted, and where attempted has not always worked as well as might have been hoped. There are inevitably many reasons for this: society has gone some way towards an accommodation with inflation, so that behaviour patterns have changed; the swings in government policy have been both large and rapid, so that simple extrapolation has not always been a good pointer to the effects of the public sector on the economy; changing circumstances have meant that no single monetary aggregate has been a consistently good guide to policy. In short, the information and analytical tools available to the

Treasury and the central bank have not been adequate for the task of determining what rate of short-term interest, applied when, will produce a given rate of monetary growth. That these technical problems have not been helped by the use of monetary policy to create inflation (1971/74), to preserve an unrealistic sterling parity (1977), or as a main element of election strategy (1978), goes without saying.

The advantages claimed for Monetary Base Control would go some way towards dealing with both of these basic sets of difficulties. By relying on a more mechanistic process of control, the authorities would risk signalling any fundamental change of policy clearly and more quickly to the markets. Any weakening of resolve to control the stock of money does, given current market attitudes, tend to involve considerable costs to government (through higher interest rates), and therefore a mechanism which would signal such a relaxation to the market quickly would act as a powerful deterrent. Equally, a mechanism through which money is controlled directly, with interest rates finding their own level, relieves the central bank of the need to play an elaborate and difficult guessing game.

One must not necessarily expect to have the support of the monetary authorities for any change which reduces their present absolute discretion. Like any part of the civil service, they have a job to do, and we must not be surprised if they have convinced themselves at least that it is one which is indispensable. The green paper contains ample evidence for this attitude, together with more overtly political attempts to justify the actions of the immediate past.

We would therefore recommend that the objections raised in the green paper to any far-reaching monetary reform be treated with a degree of scepticism. Even where they are, in themselves, valid (and we are not convinced that all come into this category), it should be remembered that the search should be not for a perfect, but for a better, system.

E. & O.E.

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