9. Monetary Base IV
Part C

Comments on Green Paper

7/10/1980 – 22/10/1980

Lloyds Bank Limited

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In replying please address
THE ECONOMIC ADVISER

Peter E. Middleton, Esq.
Deputy Secretary,
Treasury,
Parliament Street,
London,
SW1P 3AG.

Your reference:
Our reference:

7th October, 1980.

Cc Mr Wallas 9/10

Dear Peter,

Congratulations on organising a most interesting conference at Church House. I am sure that it helped all of us to clarify our views, and I am only sorry that you and your colleagues did not feel able to say more, since I am sure that your comments would have been much more interesting than those from the private sector! (However I am gaining some fascinating insights into your thinking by catching up on my Minutes of Evidence to the Treasury Committee from last July.)

I thought you might like to have the full version of my rather disjointed comments to the Church House meeting, which I committed to paper afterwards. You may have seen the shorter version which appeared in the <u>Sunday Telegraph</u>. (I see that Brian Griffiths has put the opposite case in today's <u>Daily Telegraph</u>, so the honours are about even in the propaganda battle.) We are now all waiting with baited breath to see what you come out with, but it is a tribute to your discretion that nobody has even attempted to speculate as to what it will be.

With best wishes.

Yours sincerely,

Christopher Johnson
Economic Adviser

52/10

ONETARY CONTROLS - BACK TO BASE?

(An abridged version of this paper appeared in the Sunday Telegraph, 4th October 1980)

The Government's monetarist policy depends on the achievement of a series of descending targets for sterling M3, the broadly defined money supply. The target for 1980-81 was set at 7-11 per cent in the Budget, and backdated to February.

Up to August, the increase in sterling M3 since February was at an annual rate of 26 per cent. It was 8 per cent in the two months of July and August alone, partly as a result of the lifting of the 'corset' controls on the banks. Even if monetary policy has begun to get the rate of inflation down during the last three months, by means of an old-fashioned recession, judged against the targets it has failed.

The Government is therefore thinking of switching to a new, more effective form of monetary policy, known as monetary base control. This consists in regulating sterling M3 by controlling the banks' cash reserves at the Bank of England, and possibly also the issue of banknotes held by the banks and the public.

The Treasury and the Bank of England published a green paper about monetary base control in March, from which it appeared that neither institution was particularly enthusiastic. Until the terrible July and August monetary figures came out, it thus looked as if the system would survive the ending of the 'corset' without any very radical changes.

But Mrs. Thatcher herself has now become an enthusiast for monetary base control, partly as a result of a meeting in Switzerland with Professor Karl Brunner, the leading Swiss-American monetarist. Professor Brunner, who has advised the Swiss National Bank on their monetary base control system, was called to a meeting at the Bank of England last week with other foreign central bank advisers (September 30). The Treasury and the Bank of England are therefore having to re-examine the arguments for monetary base control, and a decision may be reached in a matter of weeks.

The case in favour is very simple. If the Bank of England can control the monetary base, and if there is a fixed relationship between monetary base and sterling M3, then the Bank of England can control sterling M3. This looks easier than the present roundabout method of controlling sterling M3 by changing interest rates. Some monetarists claim that monetary base control avoids the need to raise interest rates so high, but this is doubtful, and anyway not essential to their case.

The arguments against monetary base depend on exactly what system is proposed. The more rigorous the system, the stronger some of the objections become. The less objectionable the system is made, the less likely it is to be effective. The main objections to any such system are as follows:

1) Any monetary controls can be evaded, either by the use of close substitutes for money such as commercial bills, or by the use of money outside the definition of sterling M3, such as foreign currency inside the UK or 'euro' sterling outside the UK held by residents, or sterling held inside the UK by non-residents. The ending of exchange control last October, while desirable in its own right, has made monetary control far more difficult.

2) The Bank of England does not have complete control of monetary base at present. Monetary base consists of certain Bank of England liabilities. These change from day to day with intervention to steady the exchange rate, assistance to the London money markets to relieve cash shortages, and tax payments. Either the monetary base would in practice have to be allowed to fluctuate from day to day, or the Bank of England's policies with regard to financial markets would have to be fundamentally changed.

3) The relationship between monetary base and sterling M3 is unpredictable, and may vary considerably. The banks would probably try to keep some flexibility by holding excess reserves of monetary base, so that they could still expand deposits and credit without running short. There is little past experience to go on, since the present 1½ per cent of their liabilities which the banks have to keep in Bank of England balances has not been used up to now as a method of control.

4) It is not clear what would happen if the banks ran short of monetary base. The Bank of England would have to impose penalties, either by making enough monetary base available at a high cost, or in some other way. The history of the 'corset' suggests that penalties for infringing monetary control may not be an effective deterrent. Banks incurred 'corset' penalties, sometimes unintentionally, and sometimes deliberately, in order to maintain their share of the market.

5) Monetary base control could mean the end of the overdraft system in its present form. The undrawn portion of overdraft facilities, particularly for large companies, can be seen either as a source of uncontrollable increase in the money supply, or as a flexible insurance policy against rapidly changing financial requirements. Either banks would have to charge commitment fees for undrawn facilities, or borrowers would have to draw down the whole of a loan and redeposit it - thus paradoxically increasing sterling M3 as a result of monetary base control.

6) Interest rates would vary much more with monetary base control, as they have in the US since it adopted this kind of system last October. The long-run average level of interest rates might not be higher. But the uncertainty about future interest rates might affect long-term financial markets, and the difficulty of selling gilt-edged or company debentures would then be increased. The effect would be that the government and industry would have to borrow more from the banks, and less from the capital markets, thus once again raising the money supply.

7) Even if a monetary base system might eventually be made to work in the UK, the transition period could be difficult and prolonged, and monetary control might for a time become even less effective than it is at present. A good example of the perils of running in a new system is the monetary expansion which followed the introduction of the Competition and Credit Control policy in 1971. The onus of proof should thus be on the proponents of radical reform.

The defenders of monetary base would reply that the existing system of control has been so ineffective that the onus of proof is on those who wish to retain it. A number of amendments would make the present system more effective, and easier to defend.

1) Since the main objective of the government's monetary policy is to reduce inflation, its main targets should be a series of ranges for the retail price index. Instead of saying as now, that it wants sterling M3 to be rising by 4-8 per cent by 1983-84, it should make this its target for prices by then. It should try to achieve this objective not by putting all the strain on monetary policy, but by also using taxation, public expenditure, nationalised industry and, if necessary, incomes policies.

2) The sterling M3 targets appropriate to the inflation target should be fixed every year, as a rate of increase on the previous year. Sterling M3 would thus be measured in the same way as the inflation rate, and month-to-month fluctuations such as inevitably occur would be seen in the context of a whole year. The next target is due to be announced in October, and the present figure of 7 - 11 per cent is about right, starting from the higher base level that has now been reached.

3) Sterling deposits of overseas residents, and foreign currency deposits of British residents held in the UK should be included in M3, as the latter were until 1976, when the term 'sterling M3' was coined. Targets should also be set for the Bank of England's new wider measure of private sector liquidity, PSL2, so as to include building society deposits and other substitutes for money within the system of controls. Savings deposits of two years and longer, which banks are now encouraging, should be excluded from M3, as they already are from PSL2, because they do not provide liquid [illegible] and are thus not 'money'.

4) The authorities can make the present system as tight or as loose as monetary base control or any other system. It depends on how aggressively they are prepared to buy or sell bills and gilt-edged in open market operations, and call for special deposits from the banks. Although the present $12\frac{1}{2}$ per cent ratio of reserve assets to banks' liabilities is to be ended, the reserve assets will all continue to be held in roughly the same quantities as at present under the new name 'primary liquid assets', and it is on these that the Bank of England will be able to operate. If the government wants money to be controlled, however, it must give the Bank of England more freedom than it has done so far to vary interest rates up and down - though not as much as would be required under monetary base control.

5) Monetary policy must be flexible enough to allow some limit to the variation of the exchange rate. The Bank of England has intervened in recent months to prevent the exchange rate moving even higher than it has already done, and would doubtless also want to prevent any fall getting out of hand. Britain might be well advised to join the relatively fixed exchange rate mechanism of the European Monetary System next year, at a lower exchange rate than now. The monetary targets would then have to become even more flexible. As long as the main aim of reducing inflation is achieved, this need not matter.

Christopher Johnson
Economic Adviser, Lloyds Bank Limited

MCC(80)46 COPY NO.

10 October 1980

HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

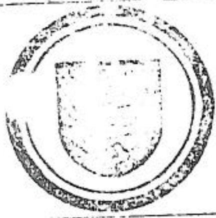
LETTER FROM G C POWELL

Note by the Secretaries

The attached letter from Mr Powell is circulated for information.

M D K W FOOT
M L WILLIAMS

H M Treasury



States of Jersey

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Our Ref: 1/10/GCP/KLeM

Your Ref:

Mr. P. E. Middleton,
H.M. Treasury,
Parliament Street,
LONDON,
SW1 P3HE

7th October, 1980.

Cc to Mr Williams 7/10

Dear Mr. Middleton,

I should like to express my appreciation for your inviting me to join in the most interesting seminar on monetary control held at Church House last week.

From the standpoint of Jersey, there were two aspects of the seminar which I found of particular interest. Firstly, I was struck by the considerable uncertainty attaching to the expected outcome of any change in the system of monetary control. The differences of opinion expressed on such subjects as the interest rate level and volatility likely to flow from the adoption of monetary base control appeared to my mind to add considerable weight to the arguments put forward by those questioning the need for revolutionary, as opposed to evolutionary, change.

The other thought related very much to the comments in the article by Tim Congdon, published in the London Times on the day of the seminar, in which he raised the issue of the likely encouragement of off-shore banking that would follow from the adoption of a system of monetary control that placed undue burden on the U.K. banking community.

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Mr. P. E. Middleton,
H.M. Treasury.

6th October, 1980.

Our experience with the response of banks to the actions of other monetary authorities would certainly lend weight to this point of view.

I shall look forward with interest to seeing the way that the United Kingdom Government's Monetary policy unfolds, with obvious particular concern for the implications of that policy for the Channel Islands.

Yours sincerely,

G. C. Powell.

FEU. 2/6/03F

MCC(80)47 COPY NO.

HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

PAPER BY THE NATIONAL ASSOCIATION OF PENSION FUNDS

Note by the Secretaries

The Association's paper on the Green Paper on Monetary Control is attached for information.

H J DAVIES
M D K W FOOT

H M TREASURY
22 October 1980

The National Association of Pension Funds

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Nigel Lawson Esq., M.P.
Financial Secretary to the Treasury,
Treasury Chambers,
Parliament Street,
London SW1P 3AG.

17th October 1980

Dear Mr. Lawson,

Green Paper on Monetary Control

Some time ago you invited the Association to comment on the Green Paper "Monetary Control" (Cmnd 7858) and our Chairman, Mr. Pilch, indicated that we would be happy to do so.

I regret to say that it has taken longer than expected to produce suitable comments but we understand that your discussions are not yet complete and our paper may therefore be of some value to you.

I have pleasure in enclosing a paper detailing our observations.

Yours sincerely,

B.W. Lofthouse
IPC Secretary

779/10

THE GREEN PAPER ON MONETARY CONTROL

Introduction

This paper comments on the principal issues raised by the Green Paper on Monetary Control, particularly where these have implications for the Pension Funds. Section 1 examines the limited firm proposals for change put forward by the Green Paper. Section 2 considers the general problems associated with the use of monetary targets in order to provide a basis for assessing the potential significance of the introduction of monetary base control. Section 3 comments on the feasibility and desirability of the adoption of such a system.

Section 1: The Proposed Changes

The firm proposals for change in the Green Paper appear to be intended to improve the efficiency of the financial system. The termination of the corset controls will help ensure that in future the official indicators provide a more reliable guide to the underlying rate of monetary growth but none of the proposed changes is likely to make a major direct contribution to monetary control.

(a) Termination of Corset Arrangements:

The sharp increase in the money supply in July and August was significantly greater than most analysts had anticipated. It is not possible to isolate the precise extent to which the increase was the result of the unwinding of the distortions associated with the corset and it is difficult to see any alternative to the rebasing of the targets later in the autumn. The increases also clearly dictated the postponement of the widely anticipated further reductions in Minimum Lending Rate in order to preserve the credibility of the current strategy. Despite the extent of the evasion of the controls it is likely that the corset resulted in some additional growth in the uncontrolled sector. The termination of the controls may result in extended competitive pressure on this sector as the principal banks bid for the business which the corset made unprofitable.

The experience of the last two months is inevitably resulting in disillusionment with specific controls such as the corset. However, it would be inappropriate to discard this type of approach entirely and the recent difficulties only reinforce previous experience. Specific controls can work well for a period and they may offer a valuable approach to short term crises. If they are used over a long period, however, the adaptability of the financial system means that they increasingly distort the distribution of deposits between institutions and the allocation of credit whilst having a decreasing impact on the actual level of both.

(b) Abolition of the 12½% Reserve Asset Ratio and the Introduction of New Prudential Liquidity Requirements:

The main effects of this changeover will depend on the extent to which it alters the total primary liquidity requirements of the banking system and the extent to which it alters the relative demand for, and therefore yield of, different types of reserve asset. This is difficult to assess, not least because the difficulties which the consultative paper on liquidity requirements published by the Bank of England has encountered in

discussions with the banking community may result in substantial revisions to the proposals. It has been suggested that the proposed requirements are inequitable and could damage the standing of London as a financial centre. The proposals would adversely affect the competitive position of the UK branches of overseas banks which were previously outside the ambit of UK controls. They would also tend to improve the competitive position of the clearing banks in particular since this group has relatively high cash requirements for their normal business and cash is included once more in the proposed new requirements.

The authorities are clearly concerned about the possible growth of business which relies for liquidity on assets created by inter-bank lending rather than primary assets, both because this creates potential instability and because of the associated weakening of monetary controls. However, it is unclear whether the proposed requirements would result in an overall increase in the total primary liquidity requirements of the banking system. An increase would tend to act as a contractionary monetary influence - in effect there would be a higher reserve asset ratio, even if it were not called this - and the yields on reserve assets would be depressed as a result of the expansion in demand.

There had been some speculation that the authorities would like to see the development of a wider market for Treasury Bills and that the new arrangements might provide an opportunity to encourage this. This now seems unlikely since the proposed list of primary liquid assets is similar to the list of reserve assets and the central role of Treasury Bills as reserve assets is widely believed to depress their yield. However, one potentially significant exclusion from the new list is money at call with Stock Exchange money brokers and gilt-edge jobbers. This may affect the terms on which they can borrow and thus the extent of their operations.

(c) Extension of the Requirement to Hold Balances at the Bank of England:

This extension seems largely intended to further equalise the competitive position of all parts of the banking system and it will clearly add to the possible pressure on institutions which are outside the ambit of existing controls. It is being resisted since the Clearing Banks require these balances in part to cover clearing operations, whereas for the other institutions they would simply amount to a tax. The extension is unlikely to make any direct contribution to monetary control, although in principle it would provide a means of extending the impact of the Bank of England's money market operations.

Section 2: Monetary Targets and Fluctuations in the Rate of Monetary Growth

The Green Paper is primarily concerned with the scope for the control of short-term fluctuations in the rate of growth of the money supply. It is argued that medium term control is already exercised effectively through interest rates and the restriction of the Public Sector Borrowing Requirement.

Since there is no evidence that month to month fluctuations in the rate of monetary growth are directly reflected in future rates of inflation, the desirability of eradicating these fluctuations rests on the view that they may undermine confidence in the government's ability to meet its medium-term targets and thus adversely affect inflationary expectations.

The value of the type of rolling monetary targets used in the UK in

recent years is of course disputed. The targets basically preclude an active counter-cyclical demand management policy and, indeed, the tendency of the PSBR to rise during recessions means that a rigid monetary policy may require pro-cyclical fiscal measures at some times. The advocates of published targets tend to emphasise their impact on the inflationary expectations of wage bargainers. In effect, a restrictive monetary policy will have a less deflationary impact on the real economy the more rapidly inflationary expectations are reduced. Although it may be premature to judge the effects of current policies, there appears to be little evidence so far that the announcement of the targets has significantly influenced bargaining attitudes. The announcement of targets may also affect the problems of funding a given PSBR although their effect will be complex. If the targets favourably influence the inflationary expectations of institutional investors, they are likely to be more willing to acquire long term gilts. Conversely, however, the targets may contribute to short-term funding crises by visibly limiting the authorities' freedom of manoeuvre which may in turn contribute to instability in the gilt purchasing policies of the institutions.

The Green Paper argues for the continued use of £M3 as the main target variable, although the well-documented problems of this and other single measures are to some extent recognised. Any definition of money is to some extent arbitrary in that it involves establishing a cut-off point along an effectively continuous spectrum of liquid assets. Further, traditional measures take no account of the availability of under-utilised overdraft facilities and credit cards which may influence expenditure decisions in much the same way as bank deposits. The abolition of exchange controls creates particular problems for the £M3 measure. Additionally, the selection of any single measure as the target variable creates a danger that the policies adopted to secure the target may mean that the indicator ceases to be an accurate guide to overall monetary growth - the problems revealed by the termination of the corset are only an extreme example of this.

Although the rapid apparent monetary growth in recent months has obviously undermined confidence in the restrictiveness of current monetary policies, there is clearly an opportunity to restore this within the timescale which would be required to introduce the more radical forms of monetary base control. The evidence of monetary stability over an extended period would substantially reduce the risk of short-term fluctuations undermining confidence in the targets and therefore the need for radical changes would be less clear. In view of this and the other uncertainties noted above, even if the use of monetary targets is accepted to be an effective and efficient policy, it appears that major changes ought to be contemplated only if the benefits go considerably beyond the smoothing of short-term fluctuations and/or the associated costs and risks are minimal. It is argued below that these risks are significant and that alternative stabilisation measures offer a superior solution.

Section 3: Monetary Base Control

Monetary base control has had a number of advocates in city and academic circles for some time. The Green Paper considers two broad approaches:-

- the central bank could seek to control the quantity of base money in existence (cash, balances with the central bank, etc.) and thus the total growth in the money supply.

- the bank could use divergences of the base figure from target to trigger corrective interest rate changes.

The first approach depends on the banks holding a predictable proportion of their assets in base money through custom, prudence or legislative requirements. The second approach requires that changes in interest rates have a stable, predictable impact on the rate of monetary growth.

The Green Paper contains little real discussion of the fundamental merits and demerits of the first approach. It concentrates on the formidable operational difficulties associated with a variety of possible schemes and invites submissions on ways in which these problems could be surmounted. The approach of the paper suggests there is little prospect of the introduction of such a scheme. The complexity of the issues involved is illustrated by the delay in the submission of responses and the conflicting views which have been expressed.

The first approach would necessitate the removal of lender of last resort facilities and would also presumably require a revision of the arrangements for the Treasury Bill tender. Interest rates would be left to take the whole burden of adjustment to shocks to the monetary system. Rates would inevitably fluctuate sharply because the variables which would need to adjust are relatively insensitive to short-term rates - this is amply illustrated by the current buoyancy of bank lending to the corporate sector despite record interest rates. The resultant increase in uncertainty in the financial markets would be detrimental to investors and would create difficulties for those companies which rely on short-term borrowing for their working capital requirements. This type of system would require considerable time to plan and introduce and there would be a particular risk of disruption and uncertainty over the transition period.

The second type of system appears to be receiving more sympathetic official consideration. The Green Paper argues that it would be preferable to base adjustments to the official lending rate on movements in £M3 itself rather than on movements in the monetary base. The rate would be adjusted according to a predetermined scale on the basis of the divergences of £M3 from target indicated by the money supply figures of the previous period(s). Lender of last resort facilities would be retained and open market operations would be used to ensure that the adjustments in the lending rate had a general influence on short-term rates. The system would require the rapid production of reliable weekly money supply figures and the Green Paper recognises that this may create problems.

The system would again entail frequent substantial adjustments in short-term interest rates. It would however have the possible attraction of reducing the political profile of official rate adjustments. In view of the insensitivity of bank lending to interest rates, the impact on the money supply of these adjustments depends largely on their effect on the demand for gilts. Since this demand depends on the expected future changes in rates as well as their current level, the relationship is not likely

to be stable [1]. It is therefore unlikely that any mechanistic system of adjustments will permit precise 'tuning'.

The interest rate adjustments under this type of system will often reflect the impact of possibly erratic influences on the previous period's money supply figures rather than the underlying market trend or expected future money market flows. There is therefore a marked difference from the situation in the early 1970s when MLR was allowed to follow market rates. Although the authorities envisage a provision for the overriding of the automatic adjustment formula, the value of the system depends on this only being used infrequently.

It is difficult to gauge the extent of the impact on the gilt market, although this will obviously be damped particularly for longer dated stocks. It is possible that the more frequent and automatic variation of the official lending rate will weaken its impact on expectations since it will provide less of a guide to underlying monetary conditions and the authorities longer-term intentions. The system may assist in smoothing the irregularity of gilt sales which follows when a consensus of expectations amongst buyers emerges about future interest rate changes because of a view that inevitable official action is being delayed. These irregularities are an important source of fluctuations in the money supply. Against this, to the extent that the new system of lending rates does affect gilts, it will tend to introduce greater day to day uncertainty into the market and reduce the extent to which asset prices will discount expected trends in official rates.

It is difficult to draw any general conclusions about the impact of either type of system on the availability of different types of debt instrument, although this is obviously a key issue for pension funds. It appears that any changeover would primarily affect short term assets but the actual effect would differ dependent on the precise operational form of the system. For example, the indicator system discussed in the Appendix to the Green Paper envisages an extension of the maturity range of Treasury Bills but this is not necessarily inherent in other approaches.

It appears that both of the approaches put forward by the Green Paper would involve substantial costs. The fluctuations in interest rates associated with the second approach might be less serious but this would be largely because rates would not necessarily adjust to the market clearing levels consistent with the monetary targets. The benefits of smoothing short-term fluctuations in the rate of monetary growth would be very limited and could be obtained more readily through other approaches.

The first alternative which is not considered by the Green Paper is greater attention to the smoothing of fluctuations in the PSBR itself. The pattern of the PSBR this year, although rather atypical, is only a

1 *Recent experience indicates that the impact of interest rates on bank lending may even be perverse at some times, with high rates leading to an increase in short-term borrowing as companies are unwilling to view medium and long-term debt when rates are high.*

more skewed form of the distribution in previous years. A more regular monthly borrowing pattern could be obtained through measures to smooth the pattern of tax receipts, including Petroleum Revenue Tax, and this would reduce the strains on the financial markets. The second alternative is more direct measures to smooth the sales of gilts. A number of possible approaches were put forward by the Bank of England last year and the Wilson Committee recommended the introduction of arrangements for an underwritten tender.

ECO/GB/VC
15 October 1980

MCC(80)48

COPY NO.

HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

LETTER FROM THE AMERICAN BANKS ASSOCIATION OF LONDON

Note by the Secretaries

The attached letter on Monetary Control is circulated to the Committee for information.

Would copy recipients please note the change of Committee Secretary.

H J DAVIES
M D K W FOOT

H M TREASURY
22 October 1980

MCC

whole list

AMERICAN BANKS ASSOCIATION
OF LONDON

C/O THE CHASE MANHATTAN BANK, N.A.,
WOOLGATE HOUSE, COLEMAN STREET, LONDON EC2P 2HD

TELEPHONE 01-600 6141

9th October, 1980.

Recd 10 OCT 1980

Copies to The Deputy Governor
Mr Fforde
Mr Dow
Mr Page
Mr Loehnis
Mr George
Mr Coleby
Mr Goodhart
Mr Cooke
Mr Gill
Mr Walker
Mr Willetts
Mr Somerset
Mr Quinn
Mr Foot

Mr. Gordon Richardson,
Governor,
Bank of England,
Threadneedle Street,
London, EC2R 8AH.

Dear Governor,

Monetary Control

In reply to your letter of 5th June, 1980, the American Banks of London are pleased to have the opportunity to comment on the Green Paper dated March 1980, entitled Monetary Control.

The ABAL's position is that the U.S. banks, as a group, will be able to maintain the same competitive position after the institution of cash requirements as existed during the time of the 12½% Reserve Asset ratio. We appreciate this is a transition period during which the Bank of England is quantifying its prudential requirements. We understand that the cash requirement which at present applies only to the London Clearing Banks may well apply to all banks, but that it may not necessarily be as high as the current 1½%. In order to maintain their competitive stance, it is the sincere hope of the American Banks that interest will be paid on such monetary cash reserves, and that balances currently maintained with the London Clearing Banks will be subtracted from whatever percentage is finally determined.

There are really two topics when discussing Monetary Control, one is the theory and the purpose, and the other, the techniques of the execution of Monetary Control. The current paper starts from the point of the techniques, and puts less emphasis on the theory, and in view of the general acceptance in the U.K. that Monetary Control is proper, and an appropriate means to influence the economy, we, like the paper, will be concentrating on the technique, as opposed to the theory, realising that one could spend a great deal of time discussing the pros and the cons of the theory.

/Contd.......

AMERICAN BANKS ASSOCIATION
OF LONDON

C/O THE CHASE MANHATTAN BANK, N.A.,
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With regard to the technique of the application of Monetary Control, the green paper, in essence, gives a choice between:

(A) relying on a supposed relationship between the rate of interest and the demand for sterling M3.

O R

(B) relying on a supposed relationship between the monetary base (MB)(Bankers balances at the Bank of England) and the supply of sterling M3.

With system (A) the Bank of England sets a desired path for MB consistent with desired path of £M3; divergences from this path lead to changes in the rate of interest (MLR) aimed at reducing or increasing bank demand for MB. Such changes can be made (a) according to a rule i.e., a scale relating an MLR change to a given excess or deficiency of MB with respect to the target or (b) according to a rule, but with an over-ride or (c) at the Bank of England's own discretion. The change in MLR must lead to consequential changes in bank deposit rates, loan rates and interest rates on public sector debt, if MB and £M3 are to be influenced.

If the 'ultimate' policy variable is £M3 and the relationship between £M3 and MB is not stable or predictable, why not set target for £M3 directly?

Note: The system we have today is very broadly equivalent to (a) (c) above, i.e., the Bank of England sets targets for £M3: aims at determining demand for £M3 through funding operations (in which the yield on gilts is the important instrument): and follows a discretionary policy with respect to MB and MLR.

With system (B), a target for MB is set and adhered to; LLRF are withdrawn or available only in 'crises' and/or within a fixed limit; the Bank of England has no discretion with respect to MLR which becomes fully market determined, as do other rates of interest. The only possible slippage is in the relationship between £M3 and MB, but it is argued, with usage this relationship will become more stable: moreover the reserve ratio should initially or eventually be left to the bank's own discretion and not be mandatory.

The case for system B is that once the targets for MB (and implicitly £M3) are determined by the Chancellor (or Parliament?) the Bank of England has no discretion, so that there is no doubt that the targets will be met or at any rate closely

AMERICAN BANKS ASSOCIATION
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met. On the other hand, interest rates (particularly short rates) are likely to become much more unstable than with the present system or with system A; banks will be forced to hold excess reserves, leading to higher costs of intermediation; and there may well be a diminution in overdraft and other flexible short term credit facilities provided to industry.

A theoretical and possibly practical argument for a more discretionary approach is that the Bank of England could meet shifts in demand for £M3 (and MB) which arise from shifts in liquidity preference rather than from changes in incomes and prices. If such shifts were not accommodated, the real economy could be subject to severe shocks.

The Green Paper seems to favour system A incorporating an indicator for determining required changes in MLR but with over-ride, and focusing more attention on £M3 than MB.

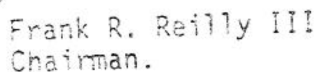
The U.S. banks would not favour system B which involves complete or virtually complete withdrawal of LLRF since:

(a) this would involve radical structural changes in the system for uncertain benefits.

(b) it would lead, at least initially and perhaps for some time, to substantial interest rate instability in money markets which, given their (the American banks) reliance on money market funds, would be to their disadvantage.

However, U.S. banks believe that short term control of £M3 should be improved within a general system of type A i.e., although retaining some discretion, the Bank of England should give more weight to controlling MB, allowing interest rates to take more of the strain.

But, recognising that in the short run the demand for bank loans tends to be very interest rate inelastic, so that control of £M3 depends principally on influencing the distribution of public sector debt between banks and non-banks, they believe that procedures for disposing of public sector debt to non-banks should be improved and widened. In particular, thought should be given to financing more of public sector borrowing through short term debt instruments, without reserve-asset status, thus improving access of corporations to long-term debt market with consequentially less dependence on bank credit.



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