MONETARY BASE CONTROL

PART 2

22 April 1981 – 21 July 1981

NOTES ON MONETARY BASE CONTROL

Replacement of the Cash Ratio

It seems that the negotiation about finding a form of income for the Bank, other than the income on the 1½% interest free deposits of the Clearing Bank at the Bank of England, is not proceeding very speedily. It is clear why the Bank is reluctant to give up this very secure form of income and is finding difficulty in replacing it with a similar form of income.

At present the Bank is doubly blessed. The deposits of the Clearing Banks expand at roughly the same rate as the money gross national product (probably the rate is slightly slower than the GNP but there is little in it). At least we can take it that they expand in line with the rate of inflation. In short the deposits themselves are indexed. But the rate of interest which the Bank will make by investing that 1½% of Clearing Bank deposits on the market also increases, and in fact of course massively increases, according to the rate of inflation. Market interest rates reflect these rates rather well.

One can see the effect on Bank income of inflation is in fact rather startling. The base, as we have argued above, is indexed. But also if the rate of inflation increases say from 9% to 18%, and interest rates follow those values, then the Bank's income, already indexed, will double over and above that indexing. (This is, of course, something like the experience of the economy over 1978-1980.)

The important point to note here is that the Bank's income is not simply indexed, nor indeed is it doubly indexed, the Bank's indexed income is raised according to the multiple of the inflation rate. Thus if inflation trebled the Bank's indexed income, that is to say the Bank's real income, would be trebled.

Let Ro be 1½% reserves of deposits of Clearing Banks at period 0.

Pt be price index (RPI) based on Po = 1.00 for period t.

Then if Rt = RoPt (that is to say the Clearing Bank deposits expand with the price level) and if the nominal interest rate is equal to the rate of inflation, the Bank's income is

$$(RoPt)\left(\frac{1}{Pt} \cdot \frac{dPt}{dt}\right)$$

which consists of the indexed income (RoPt) multiplied by the rate of inflation $\left(\frac{1}{Pt} \cdot \frac{dPt}{dt}\right)$ - note this is the rate of inflation and not the level of the price index.

Although the issue of the Bank's income was raised in association with the possibility of movement to monetary base control, there appear to be very strong grounds both in terms of efficiency in Government administration and spending, and in terms of equity for a radical change in the Bank's income. The Bank is one of the few public institutions that not only does not have cash limits but, during inflations, is absolutely showered with cash. This may explain the high salaries and fringe benefits paid to Bank staff.

It is also rather morally ambiguous that the Bank preaches on the one hand the need for stringent controls of Government spending, and on the other hand they ensure that no such limitations appear in their cash accounts. It seems remarkable that the press and media have not pounced on to this anomaly before.

22 April 1981

M.Lenyon
B4 Mr Shields

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Mr Burns
Sir K Couzens
Mr Ryrie
Mr Middleton
Mr Monck
Mr Unwin
Mr Turnbull
Mr Ridley
Mr A Walters) No.10
Mr T Lankester)

NOTE FOR THE RECORD

MONETARY BASE CONTROL

Mr Allan Walters called on the Chancellor this morning at 10.00 a.m. Mr Burns, Mr Middleton and Mr Ridley were also present.

2. Mr Walters said he felt that now the Budget was out of the way, the Government should take the decision to move to Monetary Base Control (MBC). He had no objection to the use of £M3 as an aggregate to be monitored, and he thought it appropriate that £M3 should be the focus of the MTFS. However, in the short run he thought the monetary base should be the control variable. His concern was to de-politicise decisions on interest rate movements; at present it appeared that MLR movements were very substantially affected by the requirements of the political situation. MBC by contrast would allow interest rates to be set by reference to an objective rule. In establishing such a rule, the move to MBC would fill a clear gap in the Government's current policy stance. There should be no particular difficulty about choosing numbers for a monetary base target, although a decision would be needed about the time period over which the authorities would aim to hit a target. Decisions would be needed about the future of the discount market, and perhaps also about the operation of building societies.

3. The Chancellor noted that Professor Griffiths, who had been an advocate of MBC, had recently produced a paper which argued for the retention of £M3 as the target variable. Given the extent of the Government's commitment to £M3, it would be very difficult to move away from this without a major change in the presentation

/of policy.

of policy. At the least it would seem sensible to wait until the next Budget; for the current year the £M3 target would have to remain. Although the movement of £M3 during the course of 1980 had given rise to serious problems, £M3 had proved a more reliable current policy in the circumstances of the earlier 1970s. There were reasons for thinking that last year's experience was likely to prove wholly exceptional; the 1979 switch from direct to indirect taxation, coupled with the removal of exchange, price and dividend controls could be seen as having resulted in a once-for-all shift in the demand for money. Mr Walters noted that the monetary base would in practice have given the right signals about interest rate movements in the latter part of 1980; while movements in £M3 gave no support to the interest rate reductions implemented by the authorities, the very slow growth of the monetary base would have provided a clear explanation for them.

4. In further discussion, Mr Burns and Mr Middleton said they thought the substance of the issue was how far the Government wanted to move now towards a situation in which the monetary base was the sole determinant of short-term interest rates. It was questionable how far it would be sensible at this stage to emphasise the monetary base to the exclusion of other factors. So far policy had been cautious and pragmatic, with the authorities seeking to learn from the market's response to each step towards a greater role for them in the determination of interest rates. Given the very slow growth of the monetary base and other narrow aggregates over the last eightee months, it was questionable how far the authorities should now limit the flexibility within which they would operate; it seemed likely that it would continue to be necessary to take some account of movements other aggregates and in the exchange rate.

5. Meanwhile it seemed undesirable for the authorities to commit themselves too deeply to the early introduction of MBC. Further

/work still needed to

work still needed to be done on the relationships between the monetary base and the various monetary aggregates. In these circumstances it would be better to concentrate for the time being on the further steps already outlined by the Chancellor for improving short-run monetary management: the introduction of the (unpublished) band within which interest rates would fluctuate, and the spension of MLR. While it now seemed likely that the cash ratio would have to remain, although transformed into a minimum applicable to all banks instead of an average applicable only to the clearers, the Bank had introduced a useful measure of flexibility into the reserve asset ratio. The best course seemed to be to work towards the successful implementation of these further changes, while at the same time paying close attention to movements in the monetary base and the narrower monetary aggregates. In this way the authorities might hope to learn more about controlling the base and M1 by regarding them as in a sense "shadow targets", without any commitment to a move away from £M3. It was noted that the monetary base seemed to have moved fairly closely in line with M1, and that operating by reference to a six month average of the monetary base might not be very different from using M1 as the target variable. As well as moves to enhance the role of the market and setting short-term interest rates, further attention should be given to possible funding initiatives in the fields of indexed debt and national savings.

6. It was agreed in the light of the discussion that it would be appropriate to stick to the programme of monetary control changes already outlined by the Chancellor. At Mr Walters' suggestion, Mr Middleton undertook to provide a note setting out a possible timetable for the work needed to reach the necessary further decisi in this field, which could then form the basis for a discussion wit the Bank. Mr Walters would thus be associated with the Treasury in keeping up the pressure on the Bank to ensure that they made the promised changes.

JW

A J WIGGINS
28 April 1981

Mr Oliver
NF

Chancellor of the Exchequer

cc Chief Secretary
Financial Secretary
Minister of State (L)
Minister of State (C)
Sir Douglas Wass
Mr Ryrie
Mr Burns
Sir Kenneth Couzens
Mr Hancock
Mr Britton
Mr Monck
Mr Kemp
Mrs Lomax
Mr Turnbull
Mr H Davies
Mr Lavelle
Mr Peretz
Mr Riley
Mr Grice
Mr Shields
Mr Bennett
Mr Ridley

MONETARY BASE CONTROL

1. At your meeting last week to discuss the papers for the Prime Minister's seminar, I said that we had prepared a separate note setting out the arguments for and against monetary base control. The note has been discussed with the Bank (who are in broad agreement with it), but not with Mr Walters. There seemed to be no point in raising potentially contentious issues with him when he had agreed that an immediate move to MBC, in any of the forms we discussed last autumn, was not a starter. For the same reason I would not recommend sending the note forward for the seminar.

2. The note, which has been prepared by Mrs Lomax, will however serve as briefing for the seminar. And it has been drafted in such a way that it could be tabled if absolutely necessary.

3. If I may summarise the key points:

a. A <u>mandatory</u> monetary base system, involving a new compulsory cash ratio and close week by week (or month by month) control of the supply of base money to the banks is not an immediate option:

i. It cannot be used to control £M3 without causing disintermediation overseas. The new M2 series, which may reduce this risk, is not yet ready and it will be a long time before we can tell whether it is a suitable target aggregate.

ii. Even then it will be difficult to ensure that such a scheme did not operate to a large extent by diverting financial flows into other channels.

b. Non mandatory MBC, in the sense of a quantity rule for the Bank's money market operations, to achieve close short term control of the narrow base (bankers' balances at the Bank of England) would be possible, but:

i. we have no reason to suppose there is a close link between the narrow base and the wide monetary aggregates. So we would probably have to abandon the annual target for £M3.

ii. There is no guarantee that our control over monetary conditions in general would be improved. There is little we can tell about the demand for narrow base from past experience. The base might be very unstable, in which case it would be a very poor fulcrum for influencing monetary conditions.

iii. It could involve very volatile short term interest rates which could destabilise the exchange rate and have far reaching implications for financial institutions.

c. More generally, controlling the monetary base as the sole means of controlling inflation would be regarded as a very narrow approach. It has not many supporters. A move to a fully fledged regime would inevitably be regarded as an extreme move, and a step away from the position you took in the Budget which was designed to widen the range of factors taken into account.

d. The argument has therefore become one about whether to control the wide base (including notes and coins held by the public) over a longish period of 6-9 months, using broadly the same money market techniques as we now use to control £M3 -

ie with discretionary changes in interest rates.

e. There would be no need for changes in institutions or techniques if we did this.

f. But it is tantamount to treating the monetary base as another target aggregate, probably as an alternative to £M3, at least over periods as short as a year.

g. Work summarised in the paper on the narrow aggregates for the Prime Minister's seminar suggests that the base has some serious drawbacks when looked at from this point of view:

i. It is in many ways inferior to other narrow aggregates such as M1. Only the currency component of the base appears to show any systematic relationship to money incomes, or prices, but since this is entirely demand determined, it provides no firm evidence of a causal link.

ii. The relationship of the wide base to interest rates is not well determined and looks to be pretty unstable; the greater the instability of the interest rate response the more far reaching the implications for base rates and mortgage rates.

iii. It is certainly not possible to control £M3 or any other wide aggregate simply by acting on the wide base.

h. This certainly does not rule out taking the base into account among the other factors which determine interest rates.

4. Whatever Zjilstra may have said, MBC in any of its many guises, is definitely not a way of combining quantitative control over cash with discretionary control over interest rates. The two are quite incompatible.

5. I have more sympathy than most with monetary base control. But there are great risks in making the change. We could perhaps have taken these risks two years ago; but I do not see how it could be wise for the Government to take them now. The pain -

- if there is to be any - in terms of unpredictable interest rate movements, would be immediate and the benefits distant. If we get into another monetary crisis, the balance of argument might change, but otherwise the risks seem disproportionate to the rewards.

pp E A Clark

P E MIDDLETON
21 July 1981

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MONETARY BASE CONTROL AND THE NEW ARRANGEMENTS

Introduction

The papers prepared for the PM's Seminar last autumn identified a number of problems with the system of monetary control, as it then was. Since then, a number of innovations have been announced which have been publicly justified both as "desirable in their own right" and as contributing to a possible eventual move to some system of monetary base control. The paper on "The New Arrangements" describes these changes, how they will function, and what they are seeking to achieve. This paper looks at where we now stand on the question of MBC. Part 1 reviews the current state of the debate about MBC, and tries to narrow down the serious options, in the light of the internal discussions that have taken place since the Autumn. Part II discusses how far the recently announced changes in monetary control techniques are consistent with an eventual move to MBC, and how much we can expect to learn about the feasibility of such a move from the operation of the new system. The main conclusions are summarised in the final section.

I MBC: CURRENT STATE OF THE DEBATE

(i) Monetary base control: as a technique of control

2. The debate that followed the publication of the Green Paper was dominated by the value of monetary base control as a technique of control. In the absence of direct controls on credit, the main way in which the Bank has sought to influence monetary conditions is through its operations in short term money markets* - ie. by supplying cash to or withdrawing cash from the banking system through open market operations with a

*It also operates in other financial markets, notably the foreign exchange market and the gilt edged market. While it now uses a quantitative rule to determine its operations in foreign exchange (ie no net intervention) it has traditionally acted as a price taker in the gilt edged market, without formulating precise quantitative objectives.

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safety valve, which may be used to a greater or lesser extent, in the form of discount window lending.

Traditionally, money market operations have been directed towards securing the Bank's objectives for short term interest rates. Monetary base control was seen, above all, as providing an alternative quantitative basis for these operations, according to which the Bank would focus on the amount of cash supplied rather than on its price.

3. The technical case for MBC is that it would provide a more appropriate and reliable means of controlling the targeted monetary aggregate than the alternative technique of manipulating interest rates to influence the demand (and supply) of money. Discretionary control of interest rates was said to have the following disadvantages:-

(i) if the authorities fix interest rates, errors and unexpected shocks will show up in the target variable - money. There is a risk of giving misleading signals to the market. Policy may, unwittingly, be given an inflationary bias, as inflationary shocks are accommodated and prove hard to reverse;

(ii) the authorities can only directly influence short rates but broad money depends on <u>relative</u> interest rates. The link between the level of short rates and broad money (and possibly other aggregates) is tenuous and poorly understood;

(iii) interest rates are too political an instrument to use flexibly (there will be a "bias to delay" at least in the case of upward movements).

4. How far is MBC an effective answer to these problems? Whether (i) is a serious problem at all depends on the nature of the shocks to which the demand for money is most frequently subject. In some cases it may be desirable to allow

the money supply to respond to unforeseen events. Failure to accommodate unexpected changes in the demand for money, relative to nominal incomes, will involve unnecessary changes in interest rates which will destabilise the real economy. On the other hand, the appropriate response to unforeseen movements in nominal incomes will typically be an offsetting movement in interest rates. Whether interest rates or the monetary base provide a better operating guide is therefore an empirical issue.

5. It is sometimes argued that choice of a money supply target establishes some presumption in favour of the base as an operational rule. It is true that similar questions arise in choosing between the monetary aggregates and interest rates as intermediate targets; and that one implication of setting money supply targets is that unpredictable shifts in velocity are, in practice less of a problem than unforeseen movements in nominal incomes. But separate issues are involved in adopting some form of MBC. Choice of a money supply target assumes only that velocity is relatively stable. Choice of MBC requires the additional assumption that the relationship between the monetary base and the money supply (the money multiplier) is fairly stable, at least compared with the link between interest rates and the demand for money. In principle, there is nothing inconsistent in opting for a money supply target, and attempting to achieve it by manipulating interest rates.

6. Nor is MBC necessarily the best answer to (ii). An alternative solution would be to target one of the narrow aggregates which has a better defined relationship with short term interest rates. Even if this is not possible, the case for MBC depends not just on the empirical weakness of the link between interest rates and the demand for money, but on the demonstrable superiority of the relationship between base money and the target money supply. In pratice, however, institutional arrangements have made it impossible to judge this point in the UK.

7. Whether MBC is a solution to (iii) is more open. On the one hand, it can be argued that the mere fact that interest rates are so highly political makes it impractical to relinquish control over them, as implied by MBC. On the other hand, similar arguments apply to exchange rates, and the Government has had some success in convincing sections of opinion that; given the monetary target, the exchange rate cannot be regarded as a policy instrument and directly controlled by the authorities.

8. Before leaving techniques of control, it is worth noting another group of problems which we identified last autumn which have an indirect bearing on the case for MBC - the shortage of effective monetary policy instruments. The authorities have no direct control over long term interest rates - though whether this is self-imposed or an inevitable corollary of the Government's domination of UK long term capital markets has been hotly debated. The range of available debt instruments is limited (though it is being extended). The scale of the distortions revealed by the removal of the SSD scheme has, for the time being, seriously discredited direct controls, while the abolition of exchange controls has severely limited their potential usefulness in the future.

9. There are a number of implications for the MBC debate. First, the shortage of alternatives underlines the need to conduct money market operations as effectively as possible. Second, if MBC could increase the range of monetary policy that would be an important advantage. It is sometimes argued for example, that MBC would be a way of putting pressure on the banks to modify their behaviour in ways that would be helpful to monetary control (eg. by encouraging their customers to limit their reliance on short term borrowing, and raise more medium term finance) rather than, as at present, responding passively to the demands of their customers. Attractive as this argument is, however it has been treated with considerable scepticism by almost eveyone who has ever had anything to do with practical banking - and while that is scarcely conclusive, there is no evidence to the contrary either. .

10. Thirdly, the objections to direct controls extend to some forms of MBC as well. We concluded last autumn that the abolition of exchange controls made it impractical to attempt to control £M3 (or any other broad money aggregate) by mandatory MBC.* The reasons were spelt out at length in the TCSC Report on Monetary Policy. While in principle it might be possible to use MBC to control a narrower aggregate, like M2, there would still be scope for domestic distortions and leakages from the control aggregate, especially if building society deposits were excluded from the definition of M2. The value of so doing, despite these problems, also depends, of course, on whether the narrower aggregate was thought to be sufficiently well related to final objectives to be suitable as a target.

(ii) Monetary base: as an intermediate target

11. The debate about control techniques took it for granted that the intermediate objectives of monetary policy would be defined by a target for the money supply. But subsequent discussions have ranged more widely. The unexpectedly rapid growth of £M3, at a time when other indicators were suggesting that policy was very tight, raised fundamental questions about the way in which monetary policy objectives were defined. Was £M3 a suitable target? Was it sensible to rely only on one measure of the money supply? Was it even right to define monetary policy exclusively in terms of a money supply target and ignore other indicators of monetary stance like real interest rates and the exchange rate? Monetary base control

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*Or by a negotiable entitlements scheme.

as defined above (a rule for determining the basis on which open market operations are conducted) has a place in this wider debate, since what should be controlled turns, at least in part, on what can be controlled. But the monetary base was also considered not as a short term operating target, but as a longer term intermediate target - a proposal which does not necessarily involve radical changes in techniques of control (though it might).

12. The case for the monetary base as an intermediate target is that it is at least as well related to final objectives as other monetary aggregates, and that it has the advantage of being more directly controllable. Both propositions are debateable.* It is only the currency component of the base that appears to be systematically related to GNP or prices: but since currency has been entirely demand determined it is difficult to see this as evidence of a causal link from the base to nominal incomes. In the short term at least, it would be surprising if the relationship between the base and nominal incomes were as good as that between broader measures of money and GNP, since (as noted in para 5 above) the base/GNP relationship will be disturbed by shifts in the money multiplier as well as by the shifts in velocity which upset the link between broad money and GNP.

13. There is reason to believe that the wide base could be more difficult to control that M1. True, there is daily information about the base. But 85% of the base consists of the public's holdings of notes and coin. The enormous disparity between the banks' holding of cash and the public's means that a simple policy of offsetting movements in one against the other would not be practical. Control of the wide base would not be different in principle from control of M1 or £M3, whether the Bank's operating rules were formulated in terms of prices or

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*See "The Role of the Narrow Aggregates" for a summary of the evidence bearing on paras 12 and 13.

quantities. A surge in the public's demand for notes and coin would require the Bank either to squeeze the supply of cash to the banks (or equivalently, to drive up interest rates), until the banks bid notes and coin away from the non-banks (or, what amounts to the same thing, the public's demand for notes and coins is reduced to the required extent). The problem is that the relationship between the wide base and interest rates seems to be considerably weaker, less stable and more poorly determined than that between M1 and interest rates. Control of the base would probably be <u>less</u> certain, and require wider swings in short term interest rates, than control of M1.

(iii) <u>Narrowing the options on MBC</u>

14. We see severe problems with at least two versions of MBC:-

(i) MBC as a technique for controlling broad money (£M3 and the PSL's) certainly in mandatory form;

(ii) targeting the monetary base as an alternative to the money supply proper (M1 or £M3).

That leaves mandatory MBC as a means of controlling narrow measures of money; and non-mandatory control of bank holdings of cash (ie bankers' balances and, possibly, till money). Memories of the corset make all forms of mandatory MBC fairly unattractive. But the main problem is the lack of a suitable target aggregate. Disintermediation would almost certainly be a severe problem with M1. Figures for M2 will be available later this year, but it will be a matter of years before we can tell whether it will be a suitable target aggregate. For practical purposes, therefore, we can probably rule out an early move to <u>any</u> form of mandatory monetary base control.

15. The main problem with non-mandatory control of banks' holdings of cash is that there is no guarantee that it would lead to improved monetary control. That would depend on the stability of the money multiplier.* While we can infer something about the money multiplier by observing the stability of the relationship between the public's holdings of notes and coins and total deposits, recent institutional arrangements mean that the banks have not had a well determined demand for bankers' balances: their demand for cash has been dominated by their precautionary holdings of till money. There is every reason to expect changes in the terms on which cash is supplied to produce changes in the nature of the bank's total demand for cash. In our present state of knowledge we are in no position to judge whether or not the money multiplier is likely to be more stable than the relationship betwen short term interest rates and the relevant measure of the money supply.

16. Non-mandatory MBC might also raise the question of the appropriate monetary target. The narrow base might turn out to be well related to M1 or M2, but not to £M3. But the value of such a link with narrow money would depend on the significance attached to targeting these aggregates.

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* The money multiplier m, is defined as $\frac{M}{B}$, where M is broad money, and B is the monetary base. It can be expressed as:

(i) $$m = \frac{1 + c}{r + c}$$

Where c is the ratio of the non-bank private sector's holdings of currency (Cp) to total bank deposits (D), and r is the ratio of bank holdings of base money (in the form of currency C_B and deposits at the Bank of England R) to total deposits D.

((i) is obtained by manipulating the identities:-

$M = Cp + D$ and

$B = Cp + C_B + R$)

17. A key issue is the extent to which monetary policy objectives are defined in terms of money supply targets. MBC presupposes a fairly clear commitment to using targets for the monetary aggregates as the basis for setting interest rates. The Budget marked a re-affirmation of broad money targets as a basis for setting <u>fiscal</u> policy instruments: but the decision to take a wider range of factors into account in determining interest rates seemed to imply a shift in emphasis away from money supply targets as the basis for determining <u>monetary</u> policy instruments (ie. interest rates). There is an obvious tension between making interest rate decisions more discretionary (as is involved in widening the range of relevant criteria) and making them more endogenous to decisions about quantities (as implied by MBC).

II RECENT CHANGES IN MONETARY CONTROL TECHNIQUES

(i) <u>Consistency with an eventual move to MBC</u>

18. Whether the UK finally adopts some form of MBC and if so, when, and in what form, remains an open issue. At a technical level, many features of the new arrangements are likely to be helpful if and when we decide to adopt MBC, in the sense of a quantity based approach to money market operations:-

(a) the abolition of the reserve asset ratio. This is the most important: a primary liquidity requirement is quite incompatible with any form of MBC as it encourages the banks to treat certain short term liquid assets as very close substitutes for cash.

(b) Steps to broaden the bill markets, by widening the range of eligible bills. By improving the flexibility of the Bank's open market operations, this should make it easier to control the supply of base money in the face of large, and often unpredictable, swings in the CGBR.

(c) Reduced reliance on discount window lending. This is a necessary step if interest rates are ever to be fully market determined, given the target for the base. As long as discount window operations are a regular feature, the rate at which the Bank are prepared to lend to the market will tend to put a ceiling on short term rates.

(d) The proposal to let interest rates fluctuate within a band (2% in the first instance). This should familiarise market operators with more day to day volatility in short term interest rates and could cause them to differentiate more sharply between cash and other liquid assets. If the position of the band is changed relatively more frequently, the private sector might be prompted to make more far-reaching changes eg. to the terms on which loans are extended - though this would be more likely if there were a clear declaration of intent to move to MBC on an announced timetable. Of course unless interest rate bands are somehow related to quantitative targets (eg. for the base) they will mark a very partial move in the direction of MBC.

(e) The proposal to abolish MLR as a posted rate. This is essential if the interest rate bands are to be, as intended, unpublished, (at least so long as MLR continues to have some operational significance): and, *a fortiori*, if the authorities were to operate without any interest rate bands at all (in a fully fledged MBC system).

19. The proposal not to publish the interest rate bands has been attacked by several commentators as irrelevant to MBC and as creating uncertainty for its own sake. But uncertainty about interest rates *is* a likely

consequence of introducing MBC, though it is not the purpose of doing so. Moreover, greater uncertainty about the terms on which cash will be available may be required to give cash the special status vis-a-vis other liquid assets which is implicit in the MBC approach to monetary control. But the critics have a point. A failure to couple the announcement about unpublished interest rate bands with some statement about the new (possibly quantity based) rules by which the authorities will be operating in future could lay the Government open to the charge of gratuitously increasing uncertainty.

20. The feature of the new arrangement which is least obviously consistent with a move to MBC is the undertaking which eligible banks* will have to give to place an average agreed level of funds with the discount houses. The objective is to ensure that the ending of the RAR does not cause a sharp decline in call money, which would undermine the discount houses ability to discharge their present role as market makers in bills. While a well functioning bill market would make it easier to move to MBC, it is not clear that the discount houses themselves would be able to survive a move to MBC (or at least some forms of MBC).

21. During the monetary control consultations, it was widely accepted, not least by the Discount Houses Association, that using MBC as a control technique would probably mean the end of the discount market in its present form. The special position of the discount houses stems from their priviledged access to cash. If discount window facilities are granted less freely, and on less predictable and favourable terms, while the terms on which other assets can be turned into cash become more uncertain as the by-product of operating an MBC system,the discount houses may find it impossible to make a profit from accepting money at call. But we cannot be certain that the discount houses would fail to adapt to the changed circumstances under MBC. It appears that the Discount Houses

*ie. banks whose bills are eligible for discount at the Bank of England, under the new arrangements.

themselves now take a more sanguine view of their ability to survive a move towards MBC, though what has caused them to change their original assessment is less clear. The new arrangements for securing a high volume of call money are not in our view a significant obstacle to an eventual move to MBC;but arguably they are not a significant step in that direction either.

(ii) New Evidence on MBC

22. We cannot expect to deduce from the operation of the new system how well a fully fledged system of MBC would work. We will only learn that by making the switch. But, on a less ambitious plane, there are a number of things we may hope to learn in the next few years. First, we shall start collecting figures for M2. That will tell us whether there is a narrow aggregate which is suitable as the denominator of a compulsory cash ratio in a mandatory MBC system. Second, we should be able to see how responsive the banks demand for cash is to changes in the way the Bank conducts its money market operations. At present we do not know if there is likely to be a stable money multiplier at all. Even though the value of the multiplier would certainly shift as we moved closer to MBC, observation of the behaviour of of the base under the new system may help us to decide whether there is likely to be a reasonable behavioural link between bank cash and deposits. The existence of such a link is important information, even if the parameters cannot be determined in advance of a full move to MBC.

23. We may also learn something about how the system responds to more flexible, and possibly more volatile, short term interest rates. That includes the effect on financial institutions - discount houses, banks, building societies - and possibly on companies. It could also include the Government. We may also be able to observe the effect on other economic variables - notably the exchange rate. Even if there is no visible response to a 2% interest band,

that will be information of a sort - at present we have very little idea what degree of interest rate volatility would provoke significant changes in economic behaviour.

24. More ambitiously, we might discover more about the significance to be attached to different monetary aggregates. The divergent behaviour of the broad and narrow aggregates in 1979 and 1980 is not entirely unprecedented, but it was very striking. It will be interesting to see whether the lessons commonly drawn from the 1972/5 period receive any confirmation. If they do, then our relative neglect of the narrow aggregates in setting monetary policy instruments may be vindicated. Since the case for MBC (in both mandatory or non-mandatory forms) depends in large part on the relevance of the narrow aggregates to monetary control, that is in many ways the most important issue to be decided before passing a final verdict on MBC.

(iii) Further Steps to MBC

25. The most important single development needed to transform the new system of control into a proper MBC regime would be for the authorities to formulate objectives for some measure of the monetary base, and to allow interest rates to respond more closely to divergences of the base from the target. That would mean both widening the bands and setting them with movements in the base in mind. Ultimately operating instructions might be couched entirely in terms of quantities (targets for the supply of cash to the banks) - rather than prices (short term interest rates). These changes would not require institutional changes in the system of monetary control, though they might provoke institutional changes in the private sector.

26. There are two possible changes to the existing framework that might be needed depending on the form of MBC adopted. The first concernes the cash ratio. Under the new arrangements, the cash ratio has no monetary control function. It could remain as it is, if we adopted non-mandatory MBC, but a mandatory system would have to be based on a new, appropriately defined cash requirement (eg. as in the illustrative scheme outlined in the papers for the autumn seminar)

The second concerns the way in which the Bank organises its interventions in the money markets. If changes in the terms on which cash is supplied caused a sharp contraction in the discount market, the Bank would have to deal directly with the banking system. At present they see real difficulties with this, because the interbank market is dominated by the clearers, who (like the Bank) are net suppliers of cash to the rest of the system. With such a market structure, the Bank have argued, it is unrealistic to look for interest rates which are, in any meaningful sense, market determined.

27. It is not clear what the answer to this problem is, or even if it is a real problem since the discount houses might survive a move to MBC. One possible solution would be for the Bank to influence the base by operating in a short term asset market which is less dominated by the oligopolistic clearers. An obvious candidate is the foreign exchange market, since the base can be influenced by sales and purchases of foreign exchange, as well as by open market operations in bills. One immediate objection to this course is the effect on the exchange rate which, unless domestic and foreign assets are perfect substitutes, would be more affected by operations in the foreign exchange market than in the domestic short term money markets. No doubt there are other problems. But the idea might be worth exploring further, if the problems of operating in the interbank market looked like posing a major obstacle to further movement towards MBC.

III <u>CONCLUSIONS</u>

28. A move to MBC is sometimes presented as the logical operational consequence of adopting money supply targets. The corollary certainly holds - the case for MBC presupposes a clear commitment to formulating monetary objectives in terms of monetary aggregates rather than prices - interest rates or exchange rates. Monetary base control has little to offer a if the authorities want a wide range of factors to have a bearing on movements on short term interest rates. There is room for discretion in operating an MBC system

of course, but if a move in that direction is to mean anything , it must mean a switch of emphasis away from interest rates, as important instruments of policy, towards quantities (some measure of the base).

29. The analogy with the foreign exchange market is illuminating. Between the extremes of pure floating and totally fixed exchange rate regimes there is a wide range of "dirty floating" options. The opposite ends of the spectrum are however clearly defined. Similarly, MBC is, in principle, at the opposite end of the spectrum from a purely discretionary interest rate regime.

30. It is not obvious what MBC could offer, as long as the authorities continue to define their monetary objectives primarily in terms of £M3. MBC is unlikely to be an effective instrument for controlling broad money. Moving to MBC would involve adopting a target for a narrow aggregate, possibly one for which we do not yet have figures. The merits of such a target would need examining in its own terms.

31. We may now be in a position to narrow down the options on MBC. Targeting the wide base has no clear advantage over targeting M1, and some disadvantages. Mandatory MBC in any form is not an immediate option, because there is no suitable aggregate against which reserve requirements might be set. Even if there were, the risk of creating unnecessary distortions make it fairly unattractive. That leaves (non-mandatory) control over the narrow base. The only serious objection is that we cannot tell whether moving in this direction would improve monetary control or not.

32. Compared with these issues, the technical questions raised by a further move to MBC are relatively minor. As far as we can tell a move to non-mandatory MBC would not require further major change to the framework of monetary control. The main practical question is how rapidly it is sensible to move along the spectrum - from thinking in terms of interest rates, to thinking in terms of quantities. That is something which we may be better able to judge when the financial system has had a chance to digest the changes we are currently in the process of making.

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