5. Monetary Control

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Background Briefing Papers: No. 2

The "Monetary Control" Green Paper: A Response

Mid-April 1980

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GRIEVESON, GRANT & CO. ECONOMIC SERVICE

BACKGROUND BRIEFING PAPERS: NO. 2

THE "MONETARY CONTROL" GREEN PAPER: A RESPONSE

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THE "MONETARY CONTROL" GREEN PAPER: A RESPONSE

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INTRODUCTION

Anthony Harris recently chided monetary analysts for not replying to the authorities' request for a debate on the Monetary Control Green Paper. But as he rightly said it is reasonable to take a week or three to consider a reply. Although we have taken slightly more than the upper end of the Harris target range, we have at least been working on a response, and are in good company in exceeding the target. Moreover, like some of our competitors, we may pro duce further notes as the debate gets under way. These complicated issues, especially the Bank of England's "The Measurement of Liquidity" Paper take time to study. Furthermore, the Bank has indicated it will produce more consultative documents covering, for example, capital adequacy, foreign currency exposure, and cash.

Our first Briefing Note was designed to provide an introduction to this complex issue. In that Note Professor Morgan's section discussed the monetary base, reviewed the present system, and looked at some effects of changing to a monetary base system. He concluded that, if the change were made, and if it came up to the expectations of supporters,

- it would give more effective control over the rate of monetary expansion, and enhance the efficiency of financial markets;
- it might cause short-term interest rates to rise in some circumstances by more than they would under the present system, but it should reduce fluctuations in yields on medium and long-term stocks;
- it should also bring about a modest reduction in the average cost of financing a given borrowing requirement that is consistent with a given rate of monetary expansion; but
- it cannot provide an escape from the fact that more public borrowing implies higher interest rates and financing costs for the private sector and finally,
- it cannot alter the fact that a country's rate of monetary expansion relative to the rest of the world is a major influence on the exchange value of its currency, and that governments cannot, therefore, pursue independent monetary and exchange rate targets.

The authorities have apparently rejected the arguments in favour of a changeover to M.B.C. Professor Morgan and I are disappointed with the Green Paper's conclusion, though not particularly surprised. After all the Govenor had warned us in his Mais Lecture (Feb. 1978):

"We hope to be sensitive to new currents of thought; yet at the same time we must exercise our judgement and not be too ready to accept every change of intellectual fashion. Formulating a line of practical policy and trying to stick to it, while yet remaining appropriately flexible amid the uncertainties of day-to-day affairs, feels very different from devising ideal solutions in the seclusion of a study".

Moreover, the (signed, rather than unsigned — the latter representing the Bank ex cathedra) article on "Monetary Base Control" (Quarterly Bulletin, June 1979) concluded:

"One purpose of this article is to show that there are several variants of M.B.C. (an imprecise term) and to indicate reasons why *rigid* MBC would be unacceptable. More relaxed version of such a control system might be accompanied by changes in the functioning of debt markets .... and might provide the authorities with additional information to allow prompter and firmer countervailing action. Any such putative benefits would, however, have to be weighed against the costs of making structural changes in the system".

This in fact gives the clue to the Bank's present rejection of MBC schemes. A MBC system, either with or without a mandatory base requirement, would not produce the desired shortening of the period of control over money supply; and the reason lies in what the Bank calls "operational difficulties". These difficulties will reflect the institutional structure of Britain's money and gilt-edged markets — the role of discount houses, institutional investment, the building societies and the political power of mortgagees, and so on. This structure when taken together, comes into sharp conflict with the authorities' policy if that policy produces short and violent fluctuations in short term interest rates. Foreigners sometimes congratulate the UK on its range and diversity of financial institutions, but I suspect that range and diversity is a mixed blessing.

The Green Paper is very much in line with what might be called the Bank's traditional views. That does not imply a rigidity of position but rather one of historic continuity. Its threads can be traced back in to the inter-war period, with echoes of debates of the previous century still to be heard. A more recent landmark on the path of ideas can be found in the Radcliffe Report (1959), to which Professor Morgan alludes in his paper. The experts on the Radcliffe Committee saw monetary policy 'as acting on total demand mainly by affecting the ease of access to finance on what was more vaguely called the "liquidity of the economy". Changes in monetary policy took their effect through changes in interest rates: the latter altered the liquidity position of financial institutions, and this in turn affected the availability of funds to borrowers' (Mais Lecture). The Report itself said "This does not mean that the

supply of money is unimportant, but that its control is incidental to interest rate policy." It was also felt that changes in interest rates had little influence, although the Bank did not go all the way with that scepticism. The powerful developments in monetary theory in the ensuing decade or so led to a vigorous reappraisal, especially as inflation accelerated as the years passed. The Bank's 'New approach', as enshrined in Competition and Credit Control (CCC) (September 1971), was that there should be much less reliance on direct restrictive controls (eg ceilings on bank lending) with the corollary that market forces should play a predominant role. A DCE target had been imposed by the IMF in connection with Britain's post-devaluation loan (November 1967), but CCC did not encompass published monetary targets. Nevertheless, control of monetary aggregates was deemed important (this may now be thought odd in the light of the subsequent two-years' rapid expansion, but it is still an accurate reflection of the Bank's thinking) and was to be achieved by the market instrument of interest rates. By the end of 1973 CCC had broken down – partly as a result of the authorities' reluctance, especially in 1972, to see rates rise quickly and rapidly, no doubt for the reasons discussed above. This CCC experiment must be comparatively fresh in the Bank's mind, as indeed have been subsequent modifications to what has been called the post-CCC 'new, new approach'.

In the 'new, new approach' its explicit money supply target has been set (always sterling M3, and only one target – policies defended in the Green Paper); an aggressive policy in the gilt-edged market has been adopted based on the 'Duke of York' mechanism whereby "the authorities raise both long and short rates dramatically. They then (gradually) reduce short rates. This increases the demand for gilts and so generates sales and a rising market (falling rates)"; and the growth of bank lending to be controlled via the liabilities side of banks' balance sheets (the "corset"). In the last few years it has become evident that the authorities have been able to establish a considerable measure of control over the money supply on a twelve month or so basis via the traditional weapons of open market operations and gilt funding; the "corset" was less successful and with the relaxation of foreign exchange controls is now defunct. Two problems remain; the longer term control of bank lending and the control of money supply over the short tun – say three or four months. The key to longer run control of bank lending, which should be discussed in the light of the government's medium term strategy is something we shall consider in other publications. Brian Griffiths wrote (Monetary Review, October 1979) "Over the past few years this whole system of control has been called into serious question. Money supply growth has varied widely from quarter to quarter and interest rates have moved rapidly and by large amounts...... Such instability is undesirable not just because of the direct effect of unintended excess money supply growth rate has become an important indicator of the expected rate of inflation......"

It seems to me that the key question in the debate on MBC is should the authorities have better control over short run fluctuations in money supply growth, if so should that control be fully automatic. Those of us who answer Yes to both questions have to demonstrate convincingly the case for automaticity as the Bank's case for discretionary intervention is attractive. The Bank appears to have moved towards the "Yes" positions through their "trigger" proposals. The Bank may well have judged that what the money market and particularly the gilt-edged market wants is a commitment from the authorities to *act* when targets appear to be exceeded or undershot. By proposing the trigger scheme this market requirement can be met without creating insuperable "operational difficulties". Further discussion in this area and on the Liquidity Paper published by the Bank, is covered by Victor Morgan's following note.

In conclusion it appears at this stage that the Bank has rejected the case for a MBC system, but does welcome views on whether the difficulties can be surmounted in any way. Thus the door is not completely closed, but we think it unlikely that the authorities can be persuaded to open it. The difference in presentation between CCC and the Monetary Control Green Paper is quite startling. There was only minimal consultation between affected parties in 1971, and the tone of the CCC Paper was authorative to say the least. This time round the approach has been more open with virtually anyone free to make representation, whilst the authorities are, of course, seeking views from "interested organisations and people". Both the Bank and the Treasury are to be congratulated on their handling of the debate and decision making process.

Trevor Laugharne

MONETARY CONTROL – THE DISCUSSION PAPER

The recent "Green Paper" by the Bank and the Treasury was somewhat overshadowed by the budget. For the investor, the main interest of the paper is in the indications that it gives of the probability that various changes in the monetary control will occur, and in the effect of such changes on financial markets. However, the significance of the Paper in these respects has to be assessed partly on the basis of its general stance in relation to recent controversies.

This stance is very much astride the fence. The paper is "monetarist" in its statement of the relationship between money, nominal incomes and prices, but in several important respects the conclusions of recent monetary theory are either ignored or misrepresented, and in some ways the Paper is a "throwback" to the Radcliffe report of twenty years ago.

This note first considers the general arguments of the Green Paper. This is followed by a brief discussion of the relationship between money and interest rates leading to an analysis of the proposed changes, and of the rejected alternatives.

I SOME GENERAL PRINCIPLES

Money and Inflation

The paper begins with a strong assertion that the reduction in the rate of growth of the money stock is a necessary condition for the reduction of inflation. "The relationship between the rate of growth of the money stock and the growth of prices and incomes is complex. They can diverge in the short-run, but there are strong grounds for believing that they will not diverge significantly over a period of years" (Introduction, 3*). Civil servants employed by the present government could hardly say less, and some of the arguments that follow raise doubts as to how wholehearted is the conversion to monetarism.

* Figures refer to paragraph numbers in the Green Paper "Monetary Control" (Cmnd 7858) HMSO March 1980.

Money and Liquidity

First, the paper is ambivalent on what kind of money is to be controlled. "No single statistical measure of the money supply can be expected fully to encapsulate monetary conditions" (Introduction, 6). It is proposed that £M3 should continue to be the subject of published monetary targets, though it is envisaged that changes in circumstances may lead to re-definition or to a change of target in the future. Moreover, there are a number of references which suggest that "general liquidity" rather than any particular monetary magnitude is still regarded as central to monetary policy. For example, it is suggested that a move to monetary base control (MBC) might lead to an enlargement of holdings of short-term public debt outside the banking system. In that case, pressure on the base might be expected to raise the Treasury bill rate and lead to increased sales to non-bank holders. "But the resulting changes in the £M3 statistic would still be essentially cosmetic; the Treasury bill would be as liquid in the hands of its holder as a Certificate of Deposit, but the former would be excluded from £M3, while the latter would be included" (Annex B, 28).

Another way in which this type of thinking is revealed is the frequent references to £M3, and also to the amount of the monetary base, as "indicators of monetary conditions." Nowhere in the Paper is there any recognition of a logical distinction between the ultimate means of payment ("high-powered money") and other forms of money and credit.

The Control Instruments

Though the Paper lists a number of policy instruments, it states firmly that, "the main instruments must continue to be fiscal policy and interests rates" (Introduction, 5). The emphasis on these two instruments raises several problems.

First, there is a risk of confusion between the proper spheres of fiscal management and monetary management. There is no doubt that fiscal and debt management policies impinge on the monetary sector, and no doubt (at least in the mind of the present writer) of the desirability of reducing government expenditure and government borrowing. But, with appropriate monetary management it is possible to accomodate variations in government borrowing within a given monetary target, and the PSBR should not be unduly influenced by purely monetary considerations. There would be no virtue, for example, in forcing nationalised industries to raise their charges in order to cover more of their capital requirements than is normal in private industry merely as a monetary measure.

Secondly, there is the nature of the relationship between interest rates and the money stock. Experience leaves no doubt that they are closely connected but do changes in the money stock cause changes in interest rates or vice versa? The Green Paper envisages a fiercely one-way relationship with

interest rates as the prime mover. This is discussed further in the next sector.

Finally, the Paper declares that "the government is satisfied" that fiscal policy and interest rates, "provide the means to achieve its medium-term objectives" (Introduction, 5). Short-term fluctuations in the demand for credit from both public and private sectors are so large that a completely smooth month to month growth of £M3 could be achieved, if at all, only by "massive swings in interest rates" (1.10). Nevertheless, the paper argues, short-term fluctuations in monetary growth may damage confidence in the government's intentions about medium-term and create harmful effects or expectations, so it is desirable to moderate them so far as possible. The various schemes of MBC are considered purely in relation to these short-term smoothing operations. Most advocates of base control would claim that it was far more important in the medium-term than in the very short-term, and would certainly not share the authorities "satisfaction" with the medium-term effectiveness of present techniques.

Assets or Liabilities?

Monetary base control operates on the liabilities side of the banks' balance sheets. Provided that there is a stable ratio between the amount of "base" assets held by the banks and the amount of their deposits, control over the base controls the total deposits of the system. The Green Paper states that it is "sometimes helpful" to consider how a particular control will affect the assets side of the balance sheet (1.2) and then goes on to concentrate almost wholly on that side.

This goes back to a long-standing academic argument whether the money stock is or should be "endogenous" (i.e. determined by forces within the economic system) or "exogenous" (fixed by some outside authority). A long line of economists from the "Banking School" in the nineteenth century to the Radcliffe Committee and those neo-Keynesians who contend that money does not matter, believe that the money stock is endogenous and neither can nor should be anything else. Monetarists would not deny that money can be endogenous if the central bank adopts a passive role but believe that it can be made exogenous and that this must be done if inflation is to be kept under control.

The attitude of the Green Paper is in line with the Bank of England's monetary model. In practical terms the underlying reasoning can be summarised as follows. Individual banks are so bound by obligations to their customers that they cannot, at least in the short run, restrain their lending to match constraints imposed on their liabilities. For reasons discussed below, market forces will not operate so as to bring about the necessary restraint of lending in the system as a whole. Hence, controls operating on the liabilities side are ineffective, and the authorities must either operate directly on the demand for bank credit from the public sector, or engineer interest rate changes that will affect demand from the private sector.

Market failure

Advocates of base control would expect market forces to bring about changes in assets to match changes in controlled liabilities. A shortage of base assets would raise interest rates in the money market and this would work through both to the general level and the relative structure of rates in the whole system. The view of the Green Paper is that freely operating markets will not, by themselves, bring about changes in interest rates of the right size or even the right direction. They appear to base this view on three reasons:—

i Banks do not raise their lending rates to market clearing levels, at which demand is reduced to match a (restricted) supply.

ii Banks engage in "liability management", bidding for deposits, and hence reserve assets, in the wholesale money markets.

iii Markets are strongly influenced by expectations. This very complex subject is not pursued in detail but an example is given of the effect of expectations of future movements in MLR on the discount market (Annex A, 4).

Disintermediation

This ugly jargon word occurs very often in the paper. It is used to cover both the transfer of lending from banks to non-bank institutions and the switching of assets (e.g. bills) from banks to non-bank holders. These processes are regarded as unequivocally bad and, "the authorities consider that any new technique must avoid providing any significant incentive to disintermediation" (1.19). Reasons for this attitude seem to be:—

i Disintermediation renders monetary control ineffective. Since bills in the hands of the public are virtually as liquid as deposits, there is no change in "general liquidity".

ii It detracts from the value of £M3, or any other money stock statistic as an indicator of monetary conditions.

iii It may be harmful on prudential grounds, and

iv It is detrimental to the growth of the banking system.

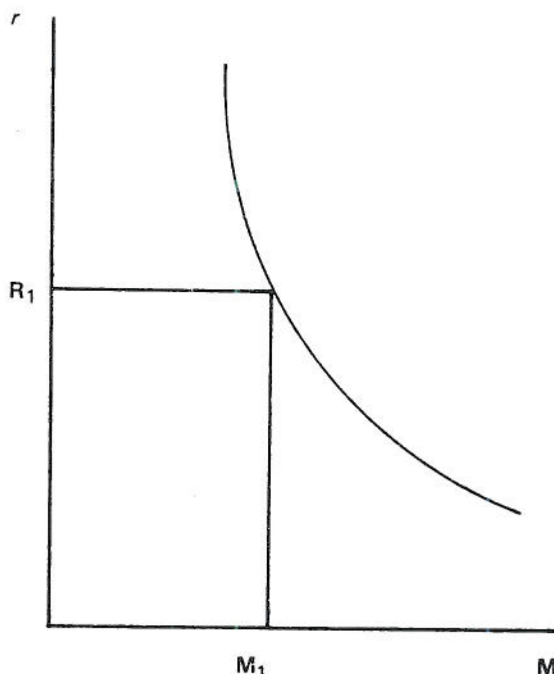
Again the authors of the Green Paper seem closer to the Radcliffe Committee than to the advocates of monetary base control. "Disintermediation" has been familiar to generations of monetary economists but they described it in such phases as, "mobilisation of idle balances" or "an increase in the velocity of circulation". Everyone would expect that a restriction in the supply of money relative to demand would produce a short-run increase in velocity. The Radcliffe Committee believed that an indefinitely large increase could happen together with very small changes in interest rates. Modern monetarists believe that the potential increase is limited and would occur only in response to large changes in interest rates. The authors of the Green Paper believe that substantial changes in interest rates are necessary to produce significant effects on the rate of growth of £M3, but their fear of "disintermediation" suggests a strong Radcliffe influence.

II MONEY AND INTEREST RATES

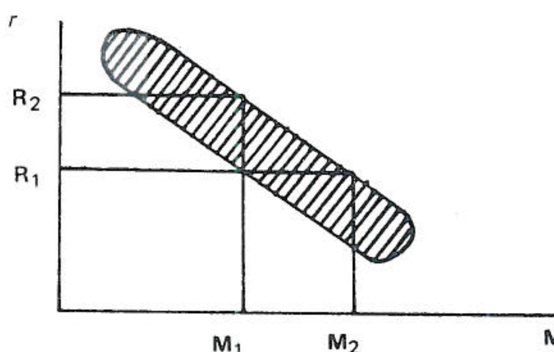
The relationship between money and interest rates on different kinds of financial assets, and the way in which these relationships are brought about by market forces are central questions for any debate on monetary control. This section attempts a simple analysis of a very complex problem.

We start from the assumption that there is a unique relationship between the rate of growth of one particular measure of the growth money stock (M) and the level of one particular interest rate (r), such as can be shown in a demand curve like those in ele mentary economics texts.

In that case the authorities could choose either the relevant interest rate or the money stock, but not both, if they chose to maintain a rate of growth of the money stocks such as M1, they would have to accept the interest rate R1 and vice versa. In that case the choice between a money stock target and an interest rate target would be purely a matter of convenience and there would be a strong case for choosing a monetary base, since this is the thing most directly under the control of a central bank.

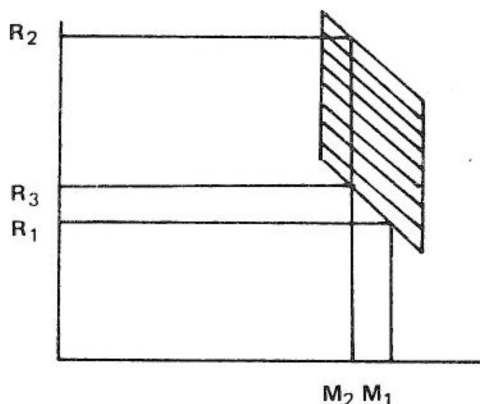


It is possible, however, that a particular value of one of our variables may be associated not with a single value but a range of values of the other. This is illustrated by the shaded area in the diagram. A rate of growth of the money stock M1 would be consistent with an interest rate in the range R1 to R2; and an interest rate R1 would be consistent with a rate of growth of the money stock in the range M1 and M2. The most likely reason for such a situation actually arising in the real world would be if different actions by the monetary authorities, designed to produce the same end, had different effects on expectations.



(*) Both money and interest rates are measured in nominal rather than real terms.

For example, let us assume that action by the Bank to reduce M (e.g. by open-market operations) produces a strong expectation that interest rates will rise sharply and remain at the higher level for some time, while a small rise in MLR induces little or no expectations of a further rise. The shaded area in our previous diagram would become diamond shaped as shown below.



Suppose that we start with a rate of growth of the money stock M1 and an interest rate R1 at the bottom of the range. If the authorities now decided to move to M2 direct action would raise the interest rate to R2 (at the top of the range because high rates are expected to continue) while the necessary rise brought about by a change in MLR would be only to R3.

It seems possible that a view of expectations rather like this may underlie the authorities' frequent assertion that monetary base control would produce greater volatility in interest rates than does the present system. Unfortunately, however, this is only one of an indefinite number of assumptions that might be made about the nature of expectations. It seems no more plausible than many others, and we have virtually no information of how expectations are actually formed.

Expectations also have an important influence on relative interest rates on shorter and longer term obligations. If we assume, as experience suggests, that investors have some "liquidity preference" a normal yield curve would be upward sloping.

However, if there is a widespread belief that the general time level of rates will fall in the future, many investors will want to "go long", and the pressure to sell short-dated assets and buy longer ones can produce a downward sloping curve. A reduction in the rate of growth of the money supply is likely in the short-run to lead to a general rise in interest rates but also, through the expectations effect, to a change in the shape of the yield curve. Moreover, the expectations effect may be re-inforced if a lower M is generally expected to reduce the rate of inflation.

The Green Paper makes a number of references to expectations, at least two of which seem important. In discussing the present position, it refers to expectations in the money and discount markets, pointing out that penal borrowing one day may have little effect in raising rates for bills of one to three months to maturity if there is a strong expectation of an early cut in MLR. Hence, "the Bank's money market operations are, at times, intended to influence expectations in a much broader way, rather than simply to influence the cost of money to the discount market" (Annex A4).

This statement invites two comments. First, the authors admit that the authorities know virtually nothing about how expectations are formed. For example, in discussing MBC the paper refers to movements of short-term securities into and out of banks, "depending haphazardly on the distribution of expectations within and outside the banking system". Since the authorities can have no firm knowledge of how any particular action on their part will affect expectations, there must be a strong element of "haphazardness" in the present system.

Secondly, this type of expectations effect is *stabilising* with respect to fluctuations that are known (or generally believed) to be temporary. For example, if there were a temporary shortage of funds in the money market due to an abnormal inflow to the Exchequer, this would be expected to be short-lived and expectations would damp down the rise in interest rates. It is thus difficult to reconcile this view of expectations either with the "massive swings" in rates alleged to be necessary to ensure a smooth growth of £M3, or with the volatility of rates that is a supposed consequence of base control.

In discussing MBC the Green Paper attributes to its advocates the argument that, if the base were observed to be growing too fast, banks and discount houses would expect a rise in interest rates and would sell Treasury bills and other short-term securities.

This would raise the yields on these assets relatively to bank deposits and so cause "disintermediation". In reply, the paper argues that, "what actually happened could be very different". Both banks and non-bank holders could expect a rise in interest rates and be sellers of short-term securities, while banks could bid up deposit rates in the wholesale markets, so that all short-term rates would go up with little change in relativities. (Annex B, 30). What the paper ignores is that, even if this were to happen, expectations would probably raise short-term rates relatively to longer-term ones with an associated switch in demand from bank deposits to longer-term assets.

III THE NEW MEASURES

The Green Paper announces four changes in the present system:—

i "The corset" will not be retained after June, and will not, apparently, be reimposed.

ii The present 12½% reserve assets ratio (RAR) will also be abandoned.

iii There will be a new "prudential" liquidity requirement, which will not be used as an instrument for influencing interest rates or the money stock.

iv The requirement to keep balances with the Bank of England, which at present applies only to the Clearing Banks, will be extended.

The monetary target will still be set in terms of £M3, though the authorities will "take account" of the growth of other aggregates; the main control instruments will continue to be fiscal policy and interest rates; and special deposits (as distinct from supplementary special deposits) will be retained, "to guard against the possible effects of excess liquidity in the banking system as a whole" (6.3).

The end of "the corset"

The effects of the corset on relative interest rates and on the growth of £M3 are well known, and are admitted in the Green Paper. Its abandonment is likely to cause rates in the wholesale money market to be somewhat higher than they would otherwise have been. This will diminish the scope for early reductions in MLR and somewhat increase the pressure on other institutions using short-term funds, notably the building societies. There will probably also be some re-absorption by the banks of credit recently supplied from outside through the "bill leak". The resulting rise in £M3 means that the 7–11% target for the current financial year, though numerically the same as last year, implies more additional restriction. By the same token the reduction in the target between 1980/1 and 1981/2 will be rather less restrictive than is implied in the numbers. However the amounts involved will probably be only one or two percentage points – well within the 4% range of the targets.

The abolition of the RAR

The Green Paper admits that the reserve assets ratio was originally regarded as, "an element in the control of short-term interest rates" (3.6) and, occasionally, as a means of inducing banks to part with non-reserve assets. The paper implies, without making a positive statement, that the ratio has not been used for these purposes in the recent past and that its abandonment will have no significant impact on the techniques or effectiveness of monetary policy. This is almost certainly right.

The "Prudential" requirement

The new prudential liquidity requirements are set out in a separate paper by the Bank of England. They involve a number of changes of which the most important are:—

i The new arrangements will apply to all licensed deposit-taking institutions, and not only to "recognised banks" under the 1979 Act.

ii They will apply to both sterling and foreign currency business, though banks will not be required to match liabilities in one currency with liquid assets in the same currency.

iii Liquidity requirements are related both to the maturity composition of liabilities and to the extent of "matching" in a bank's portfolio.

iv Requirements will be expressed as a norm rather than mandatory minima on a day-to-day basis.

v Banks will be required to hold 40% of their total liquidity needs in "primary liquidity".

vi "Primary" liquid assets are the same as the old "reserve assets" with two exceptions. Notes and coin are included in primary liquidity and so are all commercial bills eligible for discount at the Bank (whereas these only qualify as reserve assets up to 2% of E.L.s).

It is not possible at this stage to estimate e total liquid asset requirements of the system as a ıole, but it seems that holdings of "primary" assets ll not be very different from those of present serve assets. Individual banks will have to make justments, but there is not likely to be much effect ı the relative yields of present reserve assets and her short-term securities.

The authorities do not intend to operate on the ock of primary assets as an instrument of monetary licy, but "prudential" requirements cannot be mpletely isolated from more general policy nsiderations. A shortage or a glut of "primary" uidity, however it came about, will affect both the vel and the structure of interest rates.

Balances with the Bank of England

The Paper says of the present obligation on the ondon Clearing Banks to keep 1½% of eligible bilities in balances with the Bank, "This cash quirement, rather than the RAR, is effectively the lcrum on which the Bank of England works when it eks to affect short-term interest rates through its oney market operations" (3.10). The extension of e requirement (details of which will be contained in separate paper) is defended on grounds of equity ther than effectiveness. It could be argued that this a form of monetary base control under another ıme, but there are two major differences between it d the programmes usually associated with MBC. rst the Banks' operations are purely discretionary; ere is no published target rate of growth for nkers' balances with the Bank, nor is there parently even a target for internal use. Secondly, e operation of the "base" by open market erations is used as a means of influencing interest tes rather than as an end in itself. In the current onomic jargon interest rates are the instrument and e level of bankers' balances is an indicator rather an the other way round.

THE ALTERNATIVES

The Green Paper considers four alternative rsions of monetary base control:—

Base control without a mandatory ratio
Base control with a mandatory ratio.
"Negotiable Entitlements" and Trigger schemes.

By implication, they are all rejected, though the Bank and the Treasury, "invite views" on some of them.

Discussion of these schemes is brief and in some respects cursory. For example, the composition of the base is not discussed at all, it is simply stated in a footnote that, "base money includes bankers deposits at the Central Bank and may also include notes and coin held by either or both the banks and the public" (4.1).

Base control without a mandatory requirement

This is fairly rejected on the grounds that banks acting voluntarily would keep only very small balances with the Bank of England and their desired ratio of such balances to deposits would not be stable enough to make control effective. The main reasons given for this are the large amount of "primary liquidity created by London's short-term financial markets, and the availability of lender of last resort facilities from the Bank".

Base control with a mandatory ratio

The discussion of this version of MBC covers several variants. The one most generally favoured by advocates of the system would require the banks to hold a minimum proportion of their liabilities in "base" assets either on a daily basis or on average over a number of days. The Bank would, "in principal" keep the base on target by open-market operations and, "any additional requirements of the banking system for reserve assets would be provided through lender of last resort facilities on a penal scale of interest rates related to the extent of relief provided by this means" (Annex A, 20). Against such a scheme it is argued that:—

i The desired level of the base could not be established precisely from day to day for seasonal and other reasons.

ii It would not be possible to hit a desired level on any particular day.

iii "The inherent fluctuations in the various elements affecting the cash base" would enhance the volatility of interest rates (Annex A, 24).

iv This volatility might, "erode the value of liquid assets and so affect, both the functioning of these markets and the liquidity of the banking system" (Annex B, 25).

These arguments appear to depend on a very rigid system, and are not very convincing. In practice, as the Paper admits, both the target rate of growth of the base and the required ratio could be related to a moving average over a period rather than to a single day. The target could also be set as a range rather than a precise figure, and banks and/or discount houses would probably keep some excess reserves that would act as a cushion against both random and seasonal variations. Moreover, as shown earlier, fluctuations in interest rates associated with the temporary pressure on the base would be moderated by expectations. However, it is the views actually held by the authorities, not their rightness, that is important in the present context, and there is no doubt that they are strongly against this version of MBC.

Negotiable Entitlements (NEs)

These would be a new base asset, which would be supplied by the Bank and allowed to grow at a rate in line with the desired growth of deposits. Banks would be required to hold a mandatory proportion of deposits in this form; they would trade in the existing stock, and bid for new supplies as the Bank made them available. The scheme is rejected after a brief discussion on the grounds that the rise in the cost of NES in periods of monetary restraint, "would effectively be to tax the banks covered by the scheme," (Annex A, 35) and so would discriminate between such banks and other financial institutions. It is hard to see why the scheme should be worse than other forms of MBC in this way, but it is also hard to see any positive advantages in it.

Trigger schemes

The essence of such schemes is to provide a formal link between the growth of a monetary aggregate and the Banks' lending rate. It is suggested that the scheme would be better applied directly to £M3 rather than to a base. The version discussed would involve the weekly publication of MLR as at present, but also the establishment of an "operational rate" on a scale from three percentage points below to three percentage points above MLR, the scale being related by a published formula to the previous weeks' growth of £M3 (or a moving average over four or five weeks). The Bank would continue to set MLR on a discretionary basis but the relationship between MLR and the operational rate would be determined automatically. Last resort lending would be at the "operational rate".

It is claimed that such a scheme could help to eliminate a "bias towards delay" in changing administered rates. The paper raises some statistical problems in relation to weekly money stock figures but the general attitude is much less hostile than to the other alternatives.

V CONCLUSIONS

The Green Paper suggests that there are still important differences of opinion both within the Bank and the Treasury, and between officials and ministers. In particular, there is a strong contrast between the monetarist stance of Treasury ministers and the "Radcliffian" emphasis on interest rates and general liquidity that pervades large sections of the Paper.

It does little to undermine the strong intellectual case that has been built-up by advocates of MBC, but it shows marked hostility to any formal base target and to any change that would displace interest rates as the major policy weapon.

It seems most unlikely, therefore, that we shall move to any formal version of MBC in the near future. There could be a 'de facto' move in that direction by the authorities placing rather more emphasis on open-market operations following the extension of the requirement to hold balances at the Bank. It also seems likely that there will be earlier and more vigorous use of changes in MLR to combat deviations from target in the growth rate of £M3, and that this will lead to rather greater volatility of interest rates. Another possibility is the introduction of a trigger system on the lines discussed in the Paper, indeed the contrast in tone between this and other sections suggests that such a scheme may be a defensive position prepared by the Bank against political pressure to adopt more distasteful innovations.

The changes already announced, and those that seem reasonably likely, will have no more than a marginal effect on control techniques. Given our experience in the period since monetary targets were first announced in 1976, the Paper does not enhance confidence that the new medium-term targets will actually be met.

E. Victor Morgan
28.4.80

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12 May 1980

COPY NO.

HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULATIONS

I G WARBURG & CO LTD

Note by the Secretaries

The attached paper "Monetary Controls" by Andrew Smithers of Warburgs is circulated for information.

M D K W FOOT
M L WILLIAMS

H M Treasury

MONETARY CONTROL

The Consultation Paper ("The Paper") issued by H.M. Treasury and the Bank of England in March 1980 concluded by welcoming views on whether the difficulties arising from a system of monetary base control outlined in The Paper could be surmounted and if so, whether there would be advantage in a change to such a system.

In this memorandum I set out reasons why I believe that the difficulties put forward in The Paper are not real ones but arise from misunderstandings as to how a monetary base system should work. In addition, I set out the great advantages that would flow from a change to such a system.

The objections put forward in The Paper are effectively three:-

(a) That the authorities cannot estimate accurately what level of monetary base would be consistent with the money supply target.

(b) That the control of the base would be beset with practical difficulties if the relationship between the base and deposits were expressed either on lagged, current or leading basis.

(c) Practical problems in the financial system would follow.

Difficulty (a) only arises if the objective of monetary policy is to control the monetary aggregates over the short to medium term (say, 1 to 6 months) rather than over the medium to long term (over 6 months). In the shorter term the level of the monetary aggregates is determined by the demand for credit. It is not within the control of the authorities. The correct objective of monetary policy, according to advocates of a monetary base policy, is a steady and controlled growth of the monetary base. The maximum growth of the monetary aggregates over the longer term will be determined by the growth in the monetary base. In the shorter term the level of the monetary aggregates cannot be controlled by the authorities and they should not attempt to do so. The demand for credit is not price elastic in the short term. As with any commodity which is short term price inelastic the market can only clear if either supply is accommodated to demand or there are surplus stocks available to meet short term fluctuations in demand. If supply is accommodated to demand no form of money supply policy is workable. It is therefore essential that there should be the equivalent of surplus stocks of money available to meet short term fluctuations in demand. Under a monetary base policy these

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are represented by the difference between the current ratio between the aggregates and the base (e.g. M_3/M_0) and the maximum ratio permitted by the system.

If the growth in the monetary aggregates is faster than the growth in the base then the ratio M_3/M_0 is rising, interest rates will rise and the price effect will have time to operate. Interest rates will rise until the ratio peaks and will remain a restriction on economic activity until the normal ratio is re-established. No interference by the authorities will be needed to achieve this as it will happen as a result of normal market forces. The market will be paid for holding excess "base reserves" in the same way as holders of copper stocks are rewarded for their activities in running down stocks in times of excess demand and building them up in times of low demand.

The growth in the monetary aggregates need not be as fast as the growth in the monetary base. A persistent shortfall should be met, not by a change in monetary policy, but by fiscal stimulus to the economy.

Difficulties (b) and (c) also disappear if it is accepted that the objective of monetary policy should be a steady expansion of the monetary base and that the maximum permitted ratio M_3/M_0 will never be reached.

"Base reserves" should be offered each week to the banking system by tender. Interest may be positive or negative so that the market will always clear and the allocation taken up. The balance between public sector revenue and debt will in a small part be met by the increase in "base reserves" when the public sector is in deficit. The remainder will be met by issues of notes and coins, treasury bills, gilts or even borrowing from the banking system. The difficulties referred to in The Paper of predicting the short term financial requirements of the public sector need not therefore have any impact on the level of "base reserves". In the medium term the Bank of England would be wise to ensure that its total liabilities did not grow at a materially different rate from the growth in "base reserves" as this could encourage disintermediation of the banking system. Equally, funding between treasury bills and gilts should probably be balanced over time but there need be no short term concern over fluctuations in the relative amounts in issue.

Banks should therefore be required to be within the maximum permitted ratio of M_3/M_0 at all times on a current basis.

The Bank of England would not have to decide on an appropriate level of penalty rates to be applied to borrowings

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of "base reserves" as the market would itself operate such a system. When the ratio M_3/M_0 is rising individual banks will be increasingly driven to purchase or borrow "base reserves" from other holders and the price will rise. It would probably be desirable to encourage the development of a forward market for "base reserves" so that banks could be assured of having sufficient reserves to cover forward lending commitments.

The advantages that would flow from a system of monetary base control would be:-

(a) That confidence in financial markets would rise and expectations increased that the Government would achieve its medium term monetary objectives.

(b) That the authorities' operations in the gilt-edged market would give rise to fewer problems.

(c) That interest and exchange rate movements would be less volatile.

(d) That the Government would have a greatly improved guide to the appropriate fiscal policy.

A monetary base system acts automatically. No judgement would be required as to the amount of funding. At present when the monetary target is the growth of the aggregates rather than the base the Bank of England has to decide whether or not a sudden increase in the aggregates represents a temporary fluctuation or a trend. Such judgements are bound, periodically, to be proved wrong by events. With an automatic system financial markets will be assured that such errors will not occur, the burden of judging the importance of fluctuations, including seasonal ones, will be borne by the private sector. Market forces should ensure the rapid emergence of efficient judgement by the private sector.

The Bank of England will be able to use the bill issue as a method of monetary control and will not need to rely so heavily on the gilt-edged market. The decision to lengthen or shorten the average maturity of the government's debt can then be taken at times which suit the Bank of England which will not be forced to issue gilts to an unreceptive market.

If the monetary base is the target for money supply control rather than the monetary aggregates fluctuations in exchange rates and interests should, ceteris paribus, be less severe. If it were to prove possible to dampen down fluctuations in the monetary aggregates the monetary base would have to fluctuate in a contrary direction to the monetary aggregates. Thus, for example, when the aggregates tend to rise at above the trend rate and interest rates are rising, market forces will tend also to push up the value of sterling. Attempts by the authorities to dampen such movements in the aggregates will act to accentuate both the rise in sterling and the rise in interest rates.

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The argument that monetary base control would cause less volatile movements in interest rates than attempts to control the monetary aggregates is contrary to many statements that have been made on this subject and should therefore be amplified. In the past the authorities have often sought to pursue conflicting policies, namely, to dampen down interest rate fluctuations and to dampen down fluctuations in the money supply. Attempts to dampen short term interest rate movements can be effective but, as we have seen post-war, they result in an accommodating monetary policy followed by large rises in interest rates over the longer term. A monetary base policy will have the same impact in producing stability of interest rates over the longer term as a policy aimed at controlling the monetary aggregates. It will, however, cause less short term fluctuations in interest rates. This is not to say, however, that it will not give rise to greater short term fluctuations than have occurred in the past when the policies actually being pursued have been to dampen fluctuations in short term interest rates, rather than to control the monetary aggregates. A monetary base policy will, however, cause less fluctuations in interest and exchange rates than a policy based on a direct attempt to control the aggregates. The former policy is, in this and other respects, less extreme than the latter and more likely to be successful.

One of the less happy features of the post-war economic debate has, I believe, been the tendency for different schools of economists to argue in favour of a reliance on either fiscal or monetary policy rather than to advocate the use of the appropriate policy for different circumstances. Should the monetary aggregates persistently rise more slowly than the monetary base the efficiency of attempts to stimulate the economy by monetary means alone must be in doubt, and if attempted could produce an alarming decline in the international value of sterling, to the point where the subsequent growth in the monetary aggregates reflects a rise in price inflation rather than a rise in output. "Pushing on a string" may prove ineffective. The guide to fiscal policy provided by the relative growth of the base and the aggregates is likely to be more soundly based than arguments based on abstract calculations about the correct level of the Public Sector or Central Government borrowing requirements, which give rise to serious problems of accounting definitions.

30th April, 1980

A.R.W.S.