File FEA/0000000099, Part B – Monetary Base Control

Original reference FEA\C\650\1440\02 B

PART 11

15/4/1981 – 30/6/1981

Pages 191-210

(vi) Reserve asset ratio, prudential norms.

24. The reserve asset ratio will be abolished on the starting date for the new arrangements. While discussions on developments in supervision are continuing, the banks have given assurances that they will discuss in advance any changes in their policies for the management of their liquidity. Meanwhile the Bank [will shortly be] resuming discussions with the banks on a new prudential regime. This will not be characterised by a universal norm for all banks like the RAR but will seek to establish with individual banks what are the liquidity characteristics which are appropriate given the type of business they conduct.

25. These liquidity policies will not be operated as norms to be observed either constantly or on make up days. It is intended that there should be a substantial degree of variability around the liquidity pattern agreed so as to accommodate pressures on bank liquidity, for example during periods of high tax payments. This will permit liquidity to be used when it is most needed, something which the RAR tended to obstruct. These new arrangements should therefore help in avoiding local crises of shortage of liquid assets and should therefore conflict less with the operation of monetary policy. It would be an exaggeration, however, to claim that the norms set for individual banks would not have any monetary effect. The new arrangements cannot help solve a potential secular shortage of bank liquidity caused by a tendency for bank lending to grow faster than deposits. If liquidity has been

seriously eroded, there is likely to be pressure on the money supply as banks seek deposits in order to increase their holdings of liquid assets. While the liquidity norms can accommodate seasonal variations, it will not be appropriate to relax general prudential standards to accommodate a chronic problem of monetary policy.

(vii) Minimum Lending Rate

26. It was announced in the Budget that the Government's intention was "in due course to suspend altogether the practice of having an announced MLR, which would by then have lost its operational significance". Retention of an MLR would be inconsistent with the new arrangements as it would present a clear signal of the authorities' views about interest rates which would prevent the expression of a market view. It would also retain the high political profile of administered changes.

27. However, there may be a case for not abolishing MLR simultaneously with the start of the rest of the new arrangements. There are two arguments for delay. The first sees some advantage in a phased transition. Market participants might find it easier to adapt to the new arrangements with less uncertainty if MLR were retained for a time. The second argument is that a possible use for MLR has been identified when the Civil Service dispute is being unwound. This will tend to create upward pressures on interest rates which for

monetary policy reasons the Government might consider inappropriate. Although operations within the interest rate band could give a signal about the authorities' views, having MLR available would enable this to be done more clearly. These considerations point to delaying the final demise of MLR until the autumn though it is possible that it could have become redundant by then if in the interim a rise in interest rates were sought.

28. As a way of comparing the different implications of using MLR or operations in bill markets, it is interesting to assess how the authorities could react if a rise in interest rates were decided upon to arrest a slide in the exchange rate. Among the relevant factors would be :

(a) the size and speed of the upward move in interest rates wanted;

(b) the degree of confidence that movement in that scale will suffice if done in a way that has a clear announcement effect;

(c) whether the authorities would be leading the market or confirming and enlarging a movement already in process;

29. If we were reasonably confident that a rise of (probably) 2 per cent would suffice, wanted this rise to be quick and

and to have an announcement effect and if we were having to lead the market, there would be a strong case for doing it by raising MLR. It might be necessary to supplement that by some intervention in the foreign exchange market, though when the Germans announced a sharp increase in interest rates in February, they needed rather less intervention afterwards than they had done, without success, before the announcement. This would however be a step back from the process of draining MLR of authority which has made some progress in recent weeks.

30. If on the other hand there was a serious risk that a 2 per cent increase in MLR, despite its demonstration effect, would not suffice, the Bank could withdraw cash from the money market by selling bills sufficiently to get a 2 per cent rise, though it might take 2 or 3 days to achieve that if the money markets started from a "balanced" position. But the Bank seem less doubtful about their ability to achieve an upward movement through money market operations than they do about leading the market downwards (hence their wish to keep MLR while the effects of the Civil Service strike are unwinding).

31. The main disadvantages of retaining MLR are that it further delays progress in depolicitising interest rate changes and might prevent the new arrangements from operating freely. There will be a tendency for much public discussion to remain focussed on MLR, though some expert commentators may

be beginning to appreciate its reduced status. Rentention of MLR is likely therefore to delay the presentational benefits which the new system is intended to bring.

(viii) Presentation

32. The new arrangements are intended to:

(i) reduce the high political profile and scale down the degree of direct Ministerial responsibility. If this can be done it should help to:

(ii) reduce the so-called bias for delay. Interest rates will be adjusted more promptly and there will no longer be the presumption that the direction of a change will not be reversible within a matter of weeks.

33. In principle control of quantity - money - should imply freedom for the price - interest rates - to vary. In practice, however, it will be difficult to achieve public acceptance of this proposition. Although the monetary target is a quantity rule, the links between money and interest rates are not very direct or precise nor have we committed ourselves to being guided only by one monetary aggregate. What we do not have is a quantity rule at the point at which monetary policy is operated i.e. in the money markets. This contrasts with the position on the exchange rate where the objective

of achieving no net intervention rule is directly operational or with monetary policy in the US where the Fed sets a path for the supply of non-borrowed reserves. Only if we were operating a policy of controlling the supply of monetary base month by month (targetting the wide base over 6 months would be little different from targetting other aggregates) would there be a sufficiently precise quantity rule.

34. Although the task will not be easy, there are ways in which the arguments can be presented and which emphasise interest rates as the product of policy rather than their objective.

(i) It should be stressed that control of a quantity, money, implies that interest rates cannot be controlled. Though the Government has some discretion this is very much circumscribed. The authorities can influence the timing of interest rate changes and can choose the speed with which deviations from the monetary target are corrected. They cannot control the general level of interest rates.

(ii) There will eventually be no MLR which is pivotal to the whole structure of interest rates, and thus a single rate to which banks can link a base rate. It is to be expected that base rates will both be less important in pricing loans and be moved more often.

35. A change will be needed in the way briefing is prepared and in the way Ministers refer to interest rates. Above all it will be necessary to cease talking about "setting", "cutting" or "raising" interest rates. Instead the emphasis must be on creating conditions which produce or permit lower rates, or if rates have to go higher, on the need for higher rates. Ministers statements will have to be symmetrical, refraining from taking credit when they have "cut" rates. Ministers will also have to refrain from commenting on interest rate changes by banks and building societies and still more from attempting to exert moral suasion on them.

36. There are a number of practical steps by which public understanding of the Government's position on interest rates could be got across:

(i) Guidance could be prepared for the Press Office and Economic Briefing setting out the way in which interest rates will be determined and how this should be presented.

(ii) A guidance note could be prepared for Ministers on the same lines.

(iii) On a suitable speech occasion a Treasury Minister could include a passage about interest rates under the new arrangements.

Finally, it will be necessary to consider the terms in which the Bank's operations in the money market are described e.g. in the Quarterly Bulletin. Para   above indicated that we will not want to reveal the width or location of the band. The description, therefore, will have to be carefully constructed so as to give the public an adequate account of developments without undermining the Bank's freedom of action.

<u>(ix) Procedure</u>

37. The procedure for reviewing monetary developments and prospects and for deciding on the interest rate band will represent a development of current practice. Shortly after the publication of the provisional money figures for one month, an exercise is undertaken to assess the prospects for the current plus the following two months. This, together with a report on recent money market operations, is then discussed at a Treasury/Bank meeting chaired by Mr Ryrie - the Bank team is lead by the Deputy Governor. The meeting will consider not just the monetary prospects but also developments in the economy more generally, against the background of the short term forecast or, between rounds, of updating reports. The meeting will attempt to form a view about interest rates and in particular whether changes in the interest rate band are required. It will also consider the prospects for funding and what our objectives should be over the coming months.

38. The outcome of the meeting will, as now, be a submission to the Chancellor (the Bank representatives will send their own submission to the Governor) which will set out the monetary prospects and, if necessary, make recommendations on the interest band. It may then be necessary for Ministers to discuss the proposals with the Governor and the Prime Minister.

39. Although this procedure is built around the banking month and the publication of the money figures, there will certainly be occasions when interest changes need to be considered outside this timetable. Once MLR has gone, however, there will no longer need to be a presumption that changes are made on a Thursday; indeed it will be desirable to prevent an easily predictable pattern of behaviour by the authorities from becoming recognisable.

23.6.81

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1. MR TURNBULL 23/6

2. CHANCELLOR

cc Mr Middleton
Mr Monck
Mrs Gilmore
Mr Davies

MEETING WITH MESSRS RIDDELL AND RUTHERFORD: MONETARY CONTROL

Given the publicity in this morning's press on the Bank's draft provisions for the new monetary control arrangements which were circulated to the banks yesterday, you may be asked this afternoon about developments in this area. It is important to stress that they will implement the announcements made in November last year and the Budget. They involve no new initiatives. If pressed on the details, you can legitimately refer the journalists to the Bank.

Background

2. Following the completion of consultations on the Green Paper on Monetary Control published in March 1980, you announced last November that a number of improvements would be made. These included detailed consideration of new prudential arrangements for the banks so that the reserve asset ratio could be phased out; changes in the Bank's open market operations and a reduced role for discount window lending in ways that would allow the market a greater role in the determination of the structure of short-term interest rates; and consideration of the future of the clearing banks' cash ratio. These steps were seen as desirable in their own right. They would also be consistent with a gradual evolution towards a monetary base system, though the Government were not at that stage in a position to make a firm judgement about the desirability of such a move.

3. In the March Budget it was announced that the reserve asset ratio, at the conclusion of talks with the banks, would cease to be a minimum requirement. As a first step it had been reduced in January. Thereafter it would be adapted to have a transitional role as a prudential norm round which there would be variation, until the detail of the new arrangements had been settled.

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4. The Budget also described the changes in money market operations which had been implemented since November: that in its dealings with the discount houses the Bank now rely mainly on buying and selling bills, direct lending to the market has been greatly reduced, while the rates at which the Bank conducts its open market operations have become more flexible. In conducting its operations in bills the Bank no longer quotes rates for more than one month ahead. Instead, it responds to bids and offers. The Bank would aim to keep very short-term interest rates within an unpublished band, and in due course suspend altogether the practice of having an announced MLR. This would have the advantage of allowing the market a greater role in determining the structure of short-term interest rates.

5. Following the Budget discussions were begun with financial institutions about these and other changes, including the future of the cash ratio.

Latest Position

6. The paper circulated to the banks yesterday is a continuation of changes announced last November and in the Budget. Mr Turnbull's minute of 11 June (copy attached) described the main provisions of the note.

7. It is unlikely that you will be asked about any of the detailed provisions in the note. Questions may be put however on what this means for Monetary Base Control, the phasing out of MLR, and the basis for setting interest rates. The journalists may also have heard reports of a seminar with academics on monetary control.

8. On MBC, the Chancellor can say that we are still not in a position to judge whether a move to MBC is desirable. The new arrangements do not rule it out. Indeed they may help us to

learn more about the relevance of the monetary base. But to move to this system before we were convinced of its value could cause problems.

9. On MLR, the Chancellor's Budget statement was fairly specific in indicating that we would in due course suspend altogether the practice of having an announced MLR. But we should not be drawn into putting a timetable on this. The general point can be made that retention of an MLR would be inconsistent with the new arrangements as it would present a clear signal of the authorities' views about interest rates which would prevent the expression of a market view. It would also retain the high political profile of administered changes, which the Government wants to end. The timing of when MLR will be ended is still under consideration. On the criteria for setting interest rates, there is nothing to add to your Budget statement.

10. There are two possible seminars which could be referred to. The first was with academics, Griffitsh et al. Although originally planned for early July, it is not now clear when, if at all, this will take place. If asked you could say you know of the proposal but that the date is not fixed. Alternatively, the journalists may have got wind of your proposed seminar with the Prime Minister. There is no need to volunteer any information about this, but if they raise it you may want to play it down by suggesting it is simply a stock-taking session when we shall be reviewing how the implementation of the changes made so far has gone and looking forward to the establishment of the new arrangements, which we hope to start on 20 August.

Dins Lennon

T LENNON
23 June 1981

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24.6.81

MR MIDDLETON

cc Mr Britton
Mr Monck
Mr Turnbull
Mrs Lomax

Mr Fforde) Bank of
Mr Goodhart) England
Mr George)
Mr Coleby)
Mr Foot)

Mr Walters - No. 10

MONETARY CONTROL

You may find it useful to have a brief note of what was agreed at your meeting on Monday, 22 June.

The Role of the Narrow Aggregates

2. We discussed Mrs Lomax' paper of 19 June. The principal conclusion, that if we were to wish to target a narrow aggregate M1 would be the best, was agreed. A number of drafting comments were made, and Mrs Lomax undertook to prepare an Annex on the implications of adopting an M1 target over the MTFS period on various assumptions.

Setting Short-term Interest Rates: The Use of Forecasts and Outturn Data

3. It was agreed that a paper on the lines of that attached to Mr Britton's minute of 18 June should be put forward as part of the briefing for the Prime Minister's seminar, though perhaps as an annex to the broader-ranging note on the determination of interest rate policy. Mr Britton would revise it in the light of the discussion.

Prime Minister's Seminar

4. The seminar was currently scheduled for 10 a.m. on Friday, 31 July. (The Prime Minister was seeing Mr Brian Griffiths on 14 July but no date was fixed for a meeting with Mr Meltzer, and might not be.) There would be four principal papers for the seminar.

(i) A steering brief outlining the decisions to be taken.

(ii) A description of the way the new system should operate.

(iii) Mr Britton's paper on the determination of interest rates, with an annex on the use of forecasts and outturn data.

(iv) Mrs Lomax' note on the role of the narrow aggregates.

Paper (ii) was in preparation in Mr Monck's group and would be circulated after a meeting of that group on 25 June. Mr Britton and Mrs Lomax would recirculate their papers in time for a further discussion chaired by you at the end of the week beginning 29 June. The steering brief would be prepared after that meeting.

Howard Davies

H J DAVIES
24 June 1981

BANK OF ENGLAND
Threadneedle Street
London
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24 June 1981

Mrs Rachel Lomax
H M Treasury
Parliament Street
London SW1

Dear Rachel

I attach another research paper, which has a bearing on the issues discussed at the Middleton/Fforde meeting earlier this week. This paper, by Trundle and Temperton, reviews the errors, that might have been made, had we used equation-based forecasts, and compares these with th errors made in the actual forecasts in the most recent NIFs. I found this paper extremely interesting, and hope that you will find it the same.

There are several points to note. First, you will see from the Appendices how the co-efficients in the equations change as more recent observations are added. It is noticeable that the overall equation for M1 has not been particularly stable, but the instability appears to be concentrated in the co-efficients for output and prices. The short run interest rate effects have had considerable stability over this period. On the other hand, all the co-efficients in the equation for notes and coin have exhibited instability, particularly the interest rate co-efficients.

Second, the paper shows clearly that the estimation of the forecast error using the equations depends crucially on how the current equation residual is assumed to be treated. I am not happy myself about the approach used in the current note, which involves the assumption that the residual will revert to zero in the next quarter. Not only do I doubt whether this is, in practice, what forecasters

would normally do, but also it exaggerates quite markedly the apparent forecasting error over the short run.

I have, therefore, asked the authors to redo the whole exercise, using the assumption that the residual in the base period is expected to remain constant, i.e. following the line $A^1 E^1$ in Figure I. When they have redone the exercise on this basis, I am also asking them to compare whether these forecasts contain significantly more information on subsequent developments than an assumption of an unchanged rate of monetary growth from the past.

I am hoping that this additional work will be largely completed by the end of this week, so that I could send you the next version early next week, because one of the authors is going on his main summer holidays by the end of the week.

I am copying this letter and attached note to Alan Walters and Andrew Britton.

Yours sincerely

C A E Goodhart

23. 6.81

MR GOODHART

Copies to Mr Allen
Mr Iles
Mr Sheppard
Group 7/2 & Annex

EQUATION BASED FORECASTS OF MONETARY AGGREGATES
(USING NIF ASSUMPTIONS)

We have been examining the short term forecasting performance of our equations using various versions of the NIF from 1975 to date. Our last note reported some early results from looking at what was actually forecast in the NIF. This would have been based partly on the basis of the then best equations and partly on judgment.

This note adopts a different approach using the latest preferred form of the notes and coin (NC) and M1 equations, but determining the coefficients over the known data period for each NIF used. Forecasts of NC and M1 are obtained by using forecasts of the independent variables to generate those of the monetary aggregates over the following four quarters.

Table 1 below shows the average forecast error[1] of the equations for each of the forecast periods (from one quarter to a year). The first line in the block for each aggregate shows the average forecast error over the whole sample period (15 NIFs) while the second and third lines show the errors for the first ten and the last five NIFs.[2] It is possible to compare our last five equation-based forecasts with those actually forecast in the NIF. (Monetary aggregates were not forecast in the first ten NIFs.)

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[1] "Average forecast error" here means RMS of forecast errors in annualised percentage points.

[2] The first ten and last five observations were calculated on a slightly different basis. The latest "actual" observation was taken to be that of the quarter just completed for the last five NIFs. This was to enable equation-based forecasts to be compared with the actual monetary forecasts because we considered that in Autumn (ie December) 1980, for example, forecasters would have a fairly firm idea of the Q3 actual for the monetary aggregates. For the earlier ten NIFs we took the last actual as one quarter earlier because data for the independent variables are not available so rapidly.

Table 1

RMS of forecast errors (annualised percentage points)[1]

	1-quarter ahead	2-quarters ahead	3-quarters ahead	4-quarters ahead
NC				
(i) Whole sample (equation based forecast)	9.8	7.4	5.4	4.4
(ii) First 10 NIFs (equation based forecast)	8.5	5.5	4.0	4.1
(iii) Last 5[2] NIFs (equation based forecast)	12.1	10.1	7.9	5.4
(iv) Last 5 NIFs (actual forecast)	7.4	7.4	7.3	6.5
M1				
(v) Whole sample (equaton based forecast)	7.2	6.1	5.2	5.2
(vi) First 10 NIFs (equation based forecast)	5.8	5.0	5.3	4.9
(vii) Last 5 NIFs (equation based forecast)	9.4	7.8	5.0	5.9
(viii) Last 5 NIFs (actual forecast)	10.6	9.4	7.6	8.3

An important assumption used to calculate the above results concerns the residuals. The last actual observation of the monetary aggregate is unlikely to lie on the fitted line. The forecasts, however, clearly do lie on the line as shown in figure I. As this note involves testing the performance of our equations we have assumed that the errors are not expected to persist and therefore that money will return to the fitted line in the following quarter. This adjustment will be greatest in terms of annualised percentage points in the first quarter. Thus in figure I the slope of the line AB represents the forecast first quarter growth rate, AC that for the second quarter and

(1) The data from which we have calculated these RMSs are shown in Appendix 1 (equation-based forecasts) and Appendix 3 (actual NIF forecasts).

(2) Last five NIFs for the 1- and 2-quarter ahead forecasts; last four NIFs for the 3-quarter ahead forecast and the last three NIFs for the 4-quarter ahead forecast. The 1981 FSBR NIF is not included in any of these forecasts as actuals are not available.

so on. Over time the forecast growth rate approaches the trend growth rate AE or equivalently A'E'. If it was inappropriate to set the residuals to zero in this case then that procedure would tend to have made our shorter forecasts less accurate than the longer ones. Such a result is indeed observed.

An alternative is to apply the forecast growth rate (the slope of AE) to the last observation A' producing a levels forecast of E'. This, however, assumes a sudden change in trend and involves setting the residual in the levels equation to a constant (AA') which seems equally arbitrary. A third alternative is to calculate forecast rates of growth on the actual value one year before the forecast. Thus a two-quarter ahead forecast in Q1 would be expressed as a percentage of the Q3 level in the previous year.

This third approach may well be a useful alternative to that adopted here. It does, however, make it more difficult to describe variations in the rate of growth over the next four quarters as each rate of growth does not have a common base. We were still attracted by this approach but, on balance, chose the first method (setting the residuals to zero) because we felt we should test our equations as though they were believed to be the true structural model. However, the variability of the parameter estimates (see Apppendix 2) casts some doubt on the belief that we have identified the 'true' structural equations.

On this basis, it appears that the Ml equation did better than the actual forecasts of Ml in the NIF over all forecast periods [lines (vii) & (viii) in table 1] but NC actual forecasts were better than the equation based forecasts except for the four-quarter ahead forecast(1). For both aggregates for all forecasting periods the forecasts based on the last five NIFs were worse than those in the first ten in terms of annualised percentage growth rates. This difference is not explained by an increase in the average rates of growth in these aggregates. The average rates of growth of NC and M1 were [14.8] and 16.0% pa in the earlier sample period and 8.4 and 7.6% pa in the later period respectively.

Economics Division
Monetary Policy Group
23 June 1981

P V Temperton/J M Trundle (3178)

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(1) It should be noted that these results are based on a very small sample (a maximum of 5 NIFs).

FIGURE I

Residuals Assumption in Forecasting