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Hold for meeting on Thursday

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MONCK GROUP: 25 JUNE

MONETARY CONTROL: THE NEW ARRANGEMENTS

I attach a draft paper. For the most part it draws together subjects discussed at earlier meetings of the Monck Group. There are, however, two passages where the draft provides no more than a dummy - foreign exchange swaps - para 7 and the monetary implications of the new prudential norms.

AT

A TURNBULL
22 June 1981

MONETARY CONTROL: THE NEW ARRANGEMENTS

I. Introduction

1. The purpose of this paper is to set out:

(i) the form new arrangements, which are shortly to be put into effect, will take;

(ii) how they will function;

(iii) what they are seeking to achieve.

One of the features of the new arrangements it that they can be operated with a variety of styles of monetary policy; for example, with a high or low degree of discretion in the setting of interest rates, with greater emphasis given to wide or narrow aggregates. The focus of this paper is essentially technical, concentrating on how the new mechanisms can be operated rather than the form of monetary policy which they are made to serve. The wider issues on the determination of interest rates and the role of different monetary aggregates in this are discussed in the compansion papers [ ].

2. Following the debate on monetary control, culminating in the Prime Minister's seminar last November, the Chancellor announced a series of changes in the system of monetary control. These were set out in the Bank's Background Note

of 24 November. The process was carried forward in the Budget and in the Bank paper of 12 March. These changes had a number of aims:

(i) to allow greater scope for market forces in determining the structure of short term interest rates. The Bank would confine its operations to very short term rates, leaving the longer short term rates free to vary.

(ii) to reduce the bias for delay which was thought to characterise administered interest rate changes.

(iii) to achieve a lower political profile for interest rate changes.

(iv) to achieve more flexible market related pricing of overdraft facilities in order to reduce the scope for round tripping and the distortions to monthly money supply figures which this produced.

3. The Government announced in November that it was not in a position to make a firm judgement about the desirability of moving to a system of monetary base control. The changes to be made were seen as consistent with a further evolution in that direction.

II. Characteristics of the New Arrangements

4. Following the November statement, work was undertaken to design a system which would implement these objectives. After the Budget, the Bank put proposals to the banks and other financial institutions. Discussion of these is more or less complete and a final draft of the detailed provisions was circulated on 22 June. (A copy was sent to the Prime Minister on 19 June.) Subject to any points raised by market participants, the final text will be issued in mid July, with the intention of putting them into effect on 20 August (the start of banking September). The main features of the new arrangements are as follows.

(i) Operations in bills

5. The Bank is placing greater emphasing on open market operations and less on discount window lending. These operations are being conducted in bill markets rather than the inter bank market, largely through the Discount Houses. A number of consequential changes are necessary, first to ensure an adequate supply of commercial bills and secondly to ensure that the discount market is maintained at a size which is large enough to accommodate the Bank's operations.

(a) the list of banks whose acceptances are eligible for discount at the Bank and hence can be used in open market operations is being extended.

(b) eligible banks will enter an undertaking to maintain secured money with the discount houses at specified levels. (In order to maintain the efficient functioning of the gilt edged market similar undertakings to maintain specified amounts of call money with money brokers and gilt-edged jobbers have been agreed.)

6. The Bank's normal operating procedure will be to make a daily estimate of the banking system's net cash shortage or surplus which is published, and then to offset it by matching bill transactions. In the case of a cash shortage the Bank calls for offers of short term bills by the discount houses. It does not specify either a quantity or a price but only the kind of paper it wishes to deal in - Treasury or local authority bills, and the maturities it wishes to deal in:

Band 1 1-14 days
Band 2 15-33 days
Band 3 34-64 days
Band 4 64-91 days

The choice of the maturity is influenced in part by the Bank's view of the yield curve and in part by the expected pattern of future surpluses and deficits. The discount houses respond by making a range of offers for different amounts at

different prices. The Bank responds by accepting or rejecting these offers. This contrasts with the old arrangements under which the Bank posted dealing rates which were based on the Treasury bill tender. When the prevailing level of interest rates is thought to be about right, the Bank accepts offers of paper (in the case of cash shortage) at existing market rates. If it is felt that a rise in rates should be sought, the Bank does not accept sufficient offers to relieve the cash shortage. The market would then revise its offers upwards. If it failed to do so it would have to take its chance at the discount window which would normally involve a penalty.

7. Operations in commercial bills can take the form of outright purchases or sales, or of repurchase agreements. The latter are used when the Bank wants to target the reversal of the transaction on a particular day when an imbalance in the money market is expected. In addition to operations in commercial bills, the Bank will operate on local authority and Treasury bills. In the case of the latter, the practice of deliberate over issue at the weekly tender in order to create shortages which are then relieved has been discontinued. The weekly tender has been progressively reduced from £300 to £100 million. Treasury bills are used in so called mop-up operations if a surplus is apparent late in the day. Such operations are normally with the discount houses in the first instance,

but on occasions Treasury bills may be offered directly to the banks.

7. There are a number of other techniques which have been used for coping with money market imbalances.

(a) repurchase agreements for gilts. These were used during 1980 but were finally run off in December. Such operations are regarded very much as a last resort, but in extreme circumstances it would be possible to reactivate them.

(b) foreign exchange swaps. On occasions swaps have been made over the end of banking months, but within calendar months, on the presumption that they would not be "visible" in any published statistics. However, there are doubts about whether such actions are consistent with the legal framework within which the EEA operates. It may only be possible to use this device if it is seen as consistent with exchange market and reserves management. Thus the scope for these operations may be limited.

Discount window lending

8. Though discount window lending is being reduced in importance, it will still have a role to play. The Bank's background note of 24 November stated "Initially, the Bank's operational aim would be to keep very short-term interest rates

within an unpublished band .... The Bank would normally charge a rate on its discount window lending somewhat above comparable market rates but within the unpublished band ... The Bank's (bill) operations would be broadly intended to offset daily cash flows between the Bank the money markets."

9. Two distinct sets of circumstances can be envisaged. In the first, discount window lending might be used as a deliberate operating technique when it is desired to increase market rates - either within an existing band or concurrently with a raising of the band - or to resist a decline in rates which the market is bringing about. Implicitly, the rates at which bills were being offered by the market would not be acceptable, or not in sufficient quantity for the whole shortage to be relieved, and a visit to the Bank would become necessary for the Houses to square their books. The size of the penalty to be applied when lending to them would reflect the size of the increase in market rates that was desired. It would be unnecessary to charge a rate higher than the top of the band, and the November paper said that the Bank would not do so. Nor would the Bank wish always to charge a rate exactly equal to the top of the band, if the objective remained to conceal precisely where the band lies. When lending is undertaken as a deliberate act of policy execution by the Bank, it would be done under the so called 2.30 arrangements, and the fact and details of the lending would be immediately made known.

10. There are other possible circumstances in which the Bank might wish to use discount window lending as a deliberate technique of market management, but without having any policy objective on interest rates to pursue. An example is provided by the events of last March 2. On that day the market was massively short because of the payments of Petroleum Revenue Tax that was due; but the projections for the immediate future suggested that a considerable reflux would take place over the next week or so. Market management considerations therefore indicated that much of the cash provided should be repayable in about seven days, and this would not have been possible by outright purchase of bills. In principle, bills could have been bought on a repurchase basis, but the available supply of bills was too limited for that to be done. The only available technique was, accordingly, to lend at non-penal rates. In such circumstances, the lending would be explicitly described as an exception to the normal rule of "lending somewhat above comparable market rates".

11. Thus it may not be appropriate in all circumstances to impose a penalty but in general the lending rate should be somewhat above comparable bill rates in order to ensure that bills operations remain the main means for supplying cash. A modest fraction - e.g. $\frac{1}{4}$ per cent would generally be sufficient. On occasions, however, a larger penalty might be required, the limit being the upper end of the band.

(ii) Interest rate band.

12. The Bank will aim to keep very short-term interest rates within an unpublished band, the level of which will be determined by the authorities according to the requirements of its monetary policy. The band will relate to [eligible bills] of 0-14 days maturity. Although the Bank's open market operations will still extend to longer maturities it is only at the very short end that it will seek to control rates. It is proposed initially to set a width of 2 per cent which would be achieved on average over a week. The aim would be to keep actual dealing rates within an outer limit of 1 per cent on either side of the band. The width of the band would be reviewed from time to time, in the first place after six months. It should be noted that maintenance of bill rates within the band is consistent with wider fluctuations of inter bank rates e.g. if shortages or surpluses develop late in the day.

13. Why have a band and why keep it unpublished? One of the objectives of the modifications to monetary control arrangements we are now introducing is to allow market factors more influence over short-term interest rates, both for their informational content and to facilitate prompter adjustment by de-politicising as far as possible the process of interest rate formation. There will still of course be substantial official influence over the general level of rates through the interest rate band at the very short end of the money market, but that influence will be less dominant

and will be capable of being changed more flexibly if the level and width of the band are not revealed at the time. Otherwise, as with MLR in the past, official interest rate decisions will tend automatically to set the whole pattern of short-term rates - including bank base rates and mortgage rates - and so will continue as major political decisions which can lead to a "bias to delay". It is accepted that the proposed arrangements will mean more uncertainty about official interest rate intentions in the financial markets but this is a necessary part of allowing the market's own expectations a greater role.

14. Given that we do not wish to reveal details of the band at the time, it follows that we will not wish to reveal, even after the event, details of the rates to which the band applies, how precisely it is operated, or how wide it is, since to do so would make it much easier for the markets to discover the key parameters within which we operate and to use this information - rather than their own market judgement - to forecast future interest rates.

15. To a substantial extent fluctuations within the band will reflect "noise". Movements in the longer short rates beyond the horizon of the band will be more informative than fluctuations of the rates confined within the band. But this is not necessarily to say that the latter can have no informational content. If overnight to 7 day rates move to the top of the band without any corresponding movement in three

month rates we might assumes that the market expected the fluctuation to be temporary. In this case we would interpret the movement as "noise" in the system. If, on the other hand, short rates moved to the top of the band for a period, and rates further out adjusted in sympathy, then the market would clearly be signalling its belief that the authorities were prepared to allow rates to rise generally - in other words to move the band. This would also be the case if longer short term rates rose but technical factors were continuing to hold down very short rates.

16. Should the Bank's operating instructions be to keep rates towards the centre of the band or should the Bank on occasions aim towards a particular area of the band? If the "noise" within the system were rather great and sent interest rates moving across the whole range of the band, this would not be a practicable proposition. Only experience will tell, but it is possible that a band of plus or minus 1 per cent may prove more than enough to accommodate noise. Aiming at a particular area would then become a possibility. It is as possible to envisage circumstances in which the case for an upward shift of the band was accumulating but a normal occasion for decisions was not imminent. The authorities in these circumstances might want to push rates within the band towards the upper limit or not seek to resist a tendency for rates to stay near the upper limit. It is important though that such tactics should not be seen as prejudging the outcome of the regular process for reviewing interest rates.

Such action would therefore have to be agreed between the Treasury and the Bank at the time of pressure, if the possibility had not been allowed for and agreed at the monthly meeting.

17. What should be the width of the band? The proposal for 2 per cent does represent a significant change in market practice. Too narrow a band would leave existing arrangements in practice unaltered, and could not be expected to have any significant effect on the banks' behaviour in a direction that might be helpful to monetary control. Too wide a band could risk creating a damaging degree of volatility. The precise figure of 2 per cent is a matter of judgement, as is the additional outer band of a further 2 per cent.

18. A very wide band, such as the 5 or 6 per cent set by the Federal Reserve in the US would make sense only in connection with a guideline for the quantity of market intervention in a given period. Without such a guideline

a very wide band would serve only to increase uncertainty. While some element of uncertainty will be an essential factor in inducing changes in banks' behaviour such as the pricing of loans, there is little merit in increasing uncertainty per se, beyond the point necessary to give the Bank sufficient flexibility in its market dealings. With a band of around 2 per cent, the implications

for interest variability for the rest of the economy are more likely to depend on the frequency of adjustment of the band than on fluctuations within it. It is unlikely that building societies for example would adjust mortgage rates in relation to variations in very short term rates. Nevertheless, the new system is intended to permit more prompt and frequent adjustment of the general level of short term interest rates.

(iv) Bankers' balances

19. Under the old arrangements, the clearing banks maintained 1½ per cent of their eligible liabilities as bankers' balances with the Bank of England. This sum served as the fulcrum for money market management. Under the new arrangements all banks and licensed deposit takers will maintain a non-operational non-interest bearing deposit of ½ per cent of eligible liabilities - currently about £330 million. In addition the clearers will maintain operational balances, again non-interest bearing balances of £150-200 million. The non-operational balances will be a minimum to be observed at all times. Under the old averaging system, holdings of cash above the required level were tolerated more readily as they in effect bought the right to go below at a later date. Under the new system, any "excess" holdings will have an opportunity cost and the clearers will therefore have strong incentive to keep such holdings on the minimum required to operate the clearing system.

20. Observation of banks' desired cash holdings should make it possible to learn something about the properties of a monetary base system, particularly a non-mandatory one consisting of bankers' balances. However, while it is true that some element of voluntary or excess balances will appear for the first time, assets only slightly inferior to cash, such as money at call with the discount houses, will still be a feature of the system and the banks will operate in the knowledge that at the upper limit of the range they can get unlimited credit.

(v) Special Deposits

21. The Special Deposit Scheme will remain in place under the new arrangements, and will apply to all institutions with eligible liabilities of £10m or more. As before calls will be set as a percentage of eligible liabilities. Special Deposits carry Treasury bill rates. The authorities have to give 7 days' notice, and, because of the number of banks involved it may take up to ten days for a call to become effective, though releasing deposits takes only a matter of a few days.

22. Since the early 1970's Special Deposits have not been used to deliberately squeeze bank liquidity, since banks tended to respond to reserve asset pressure in ways which increased rather than reduced the money supply. Special Deposits were however used to mop up excess bank liquidity, to pre-empt a rise in bank lending by indirectly raising the

cost of wholesale funds. Under the old RAR, a call for Special Deposits was no different from varying the level of the reserve asset ratio. The same technical effect could (and can) be achieved by official sales of bills providing the banks are willing to buy and hold bills offered for sale. Special Deposits may sometimes be a surer way of offsetting fairly short lived fluctuations in liquidity. They also have an announcement effect, which can be useful if the authorities want to give a clear signal to the market.

23. Under the new arrangements, Special Deposits should still provide one way of mopping excess bank liquidity. The new prudential arrangements will be much more flexible than the RAR, and it is not intended that they should operate as a monetary control. But it is probable that the banks will have a reasonably stable demand for liquid assets - and will continue to regard Special Deposits as, to some extent, a substitute for bills and LA deposits. The chief difference may be that there will be much more elastic in the system; how much depends on how far the banks hold excess reserves, in response to changed money market tactics. The risk of distorting the monetary aggregate if Special Deposits are used to squeeze bank liquidity may therefore be rather less than under the old RAR. Since the option of varying the reserve asset ratio will no longer exist, Special Deposits - though possibly a rather weaker instrument - may still prove a useful addition to the authorities' armoury of instruments.