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'isbility of operations

18. One result of the 1981 arrangements was to make our money market operations quite remarkably transparent, certainly relative to operations in gilts or the foreign exchange markets. This is one reason why the arrangements themselves need to be kept under review. We cannot easily break the rules of the game without being spotted and the fact of departing from established procedures can have a significant impact on market sentiment. The effect on sentiment will often be counter-productive, since the occasions on which we are most likely to want to make a change are precisely those when our bona fides is most likely to be in doubt. (If the market is short, putting upward pressure on rates is not a problem, but resisting a rise or initiating a fall can be.)

19. It is worth asking why we have chosen to make our operation so public and whether there is any going back now. If not, we have to accept that if present arrangements do not suit us for some reason we need to say so explicitly at a suitable moment.

Flexibility of present arrangements

20. Is it fair to infer from the preceding discussion that present arrangements are rather inflexible in the sense that they rather quickly come under pressure when market expectations about interest rates change? [The only case where this does not seem to be so is when the Bank is trying to put upward pressure on rates when the market is short; and even then our reluctance to use 2:30 lending may create difficulties at least so long as the markets think it is still available.] Have the arrangements turned out to be more inflexible than originally envisaged? As the system has developed, the Bank's operating targets are a particular set of dealing rates out to three months, subject to the constraint that the scale of operations should broadly match the system shortage or surplus. Compare this with the approach outlined in the Bank's 1980 background paper on monetary control, 24 November, which said:-

"Initially, the Bank's operational aim would be to keep very short-term interest rates within an unpublished band which would be determined by the authorities with a view to the achievement of their monetary objectives."

and

"The Bank's operations would be broadly intended to offset daily cashflows between the Bank and the money markets."

21. The main reason for the way the system has developed has been overfunding and the associated growth in the bill mountain. This has kept the market chronically short of cash, forcing the authorities to intervene continuously at much longer maturities than originally envisaged. A consequence has been that the authorities have typically found themselves in the position of having to take a view about interest rates every time there is a significant change in market expectations. Arguably we now have the worst of both worlds:-

very limited freedom to stand back from changes in rates, if that is what is wanted

and

less scope to resist unwelcome market pressures, whilst operating within the rules of the game.

22. One solution would be to reinstate MLR, posted dealing rates etc. But that would mean abandoning the main objective of the 1981 changes, which was to reduce the political profile of interest rate changes. Are there less drastic changes to present procedures that would result in a more flexible system, short of doing this? In principle, we could allow more "play" in either dealing rates or the scale of assistance, or some combination of the two. But the results could be either to reduce or increase the extent of official influence upon market interest rates.

23. Making the unpublished band for dealing rates less of a fiction would almost certainly require a sharp reduction in the stock of money market assistance. Assuming this could be achieved, it might then be feasible to conduct open market operations on terms that varied more closely with market rates. But this would probably mean accepting that the Bank's technical influence over rates would be minimal. As noted earlier, if the Bank's operations are only designed to offset daily cashflows between the authorities and the money market at rates that vary closely in line with the market rates, it is not obvious why they should have any leverage at all.

24. The alternative approach of allowing more "play" in the scale of assistance might, however, allow the authorities to retain a degree of influence over market rates, whilst maintaining a fairly low profile. It would represent a partial step back to MLR, but not one that required reinstating official posted interest rates; it would not be conditional on changing the average level of the bill mountain. For example, the operating aim might be to keep short-term market interest rate (rather than dealing rates) within an unpublished band, subject to some general constraint on the acceptable amount of over and under assistance (rather like the foreign exchange intervention guidelines). In practice, the Bank's dealing rates might not vary at all as long as market rates stayed within the band. But movements in market rates within the band would act as a trigger for the Bank to over or under assist up to an agreed limit which might sometimes be increased by agreement with Ministers, depending on the circumstances. This would represent a change in our present arrangements, but one in keeping with the spirit of the 1980 approach. Is it worth trying to develop further?

TABLE I

The Bank's money market operations

The figures are illustrative of a typical day on which, prior to any operations by the Bank, there is a market shortage.

The daily arithmetic

The items listed are explained in the main text, in particular in the section 'Daily procedures'.

	£ millions	
1 Morning estimate of the day's position (before taking account of any official operations that may be in prospect during the day):		
Clearing banks' operational balances at Bank, above (+) or below (−) assumed target last night	+ 30	Not usually disclosed
Exchequer receipts (−) net of disbursements (+)	−210	
Proceeds of net official sales (−) of gilt-edged stocks	− 20	−220
Net receipts (−) of sterling on Exchange Equalisation Account (EEA)	+ 10	
Increase (−) or decrease (+) in note issue	+ 30	+ 30
Take-up (−) of Treasury bills by market, less maturities in market hands	− 20	−140
Local authority and commercial bills maturing in the Bank's hands	−120	
Bills being resold by the Bank to the market	—	—
Repayment (−) to Bank of earlier lending by it	—	—
Other, including other Bank customers	− 10	Not disclosed
	−310	
2 At about noon the Exchequer figure is revised to −190, and that for the note issue to +40. The revised total is	−280	
3 Soon after midday the Bank purchases bills from the market (see opposite) totalling	+260	
4 At about 2 pm the Exchequer figure has again been revised, to −160; and the figure for 'other' items has been revised to +10. The revised total, before taking account of the operations in (3), is now	−230	

5 If the estimate of −230 is correct, the bill purchases of 260 will leave the market with a net surplus of 30 on the day. The Bank decides to undertake no further operations.

6 When the town clearing has been settled it becomes apparent that the actual Exchequer figure was −170. Thus the true position for the day was:

Total market shortage	−240
Bank's operations	+260
	+ 20

The clearing banks' operational balances will be 20 above the assumed target overnight.

What is published

The Bank releases information in the course of the day to the main press agencies and by direct input to the Reuter Monitor service.

1 The following announcement is made at about 9.45 am:

'A shortage of around £300 million is expected today. Among the main factors are:

Exchequer transactions	−220
Decrease in note issue	+ 30
Bills maturing and take-up of Treasury bills	−140'

The overall figure is rounded to the nearest 50. The position of bankers' balances is only exceptionally disclosed, while that of other customers is never revealed. 'Exchequer transactions' include in this context the effect of gilt-edged and EEA settlements. Bills being resold to the market would usually be disclosed if significant, as would the repayment of any published lending.

2 The revision is not large enough to warrant publication.

3 Details of these operations are published. Thus, when the operations are complete, the following announcement is made:

'The Bank has undertaken operations, making the following purchases totalling £260 million:

Band 1	Bank bills, £75 million at $13\frac{1}{4}$%
Band 2	Treasury bills, £12 million at $13\frac{5}{16}$%
Band 2	Local authority bills, £18 million at $13\frac{5}{16}$–$\frac{3}{8}$%
Band 2	Bank bills, £155 million at $13\frac{5}{16}$–$\frac{7}{16}$%.'

The rates shown for bill purchases are rates of discount.

4 The revision is now large enough to justify publication, so the following announcement is made:

'The shortage of around £300 million published this morning has been revised to one of around £250 million, before taking account of today's operations.'

5 The following announcement is made, at approximately 2.30 pm:

'The Bank has not operated in the money market this afternoon.'

6 No further announcements are made.

ANNEX

MONETARY CONTROL: NEW ARRANGEMENTS, MBC and MLR

The Radcliffe Report draws attention to:

"the principle that, except in so far as its views influence market expectations (an important exception) the Bank cannot choose both a rate of interest and a quantity of debt to be held at that rate.... An important technical manifestation of this principle appears in relation to the control of the liquid assets "credit base" of the clearing banks. Because the Bank wants reasonable stability in the Treasury Bill rate.... It follows that the Bank cannot restrain the lending operations of the clearing banks by limiting the creation of cash, without losing its assurance of the stability of the rate on Treasury bills...."

2. Any form of monetary base control involves directing official money market operations at regulating the supply of cash (or the banking system's reserve assets). It is the antithesis of the approach described in the Radcliffe Report, under which the Bank stood ready to vary the supply of cash to whatever extent was necessary to sustain a particular level and structure of short term interest rates. The Bank's methods of operation have clearly changed very substantially since the Radcliffe Report; but nor would we usually regard them as a version of monetary base control. The Annex briefly summarises present control arrangements,and compares them with the arrangements under which the Bank operated prior to 1981, and with a "fully fledged" MBC system.

The 1981 Arrangements

3. Present methods of operation are described in some detail in a BEQB article on "The role of the Bank of England in the money market" (March 1982). Key features include the following:-

(i) The Bank's operations in the market are conducted chiefly through transactions in bills with the discount houses, with the objective of "keeping very short term rates within an

unpublished band which would be determined by the authorities with a view to the achievement of their monetary objectives".

(ii) Daily operations are intended to broadly offset the daily cashflows between the Bank and the money markets. The calculation of the system shortage allows for the monetary base to be demand determined: what this means in practice is that the Bank automatically supplies cash to finance the rise in the note issue, and to allow bankers' operational balances to return to the "target" level agreed with the banks themselves (currently £169m). Errors in estimating the shortage result in fairly small day-to-day divergences in operational balances from target; when these arise, the calculation of the next day's shortage allows for balances to return to target levels (see table).

(iii) Other than through bill operations, the Bank may supply or withdraw cash from the market by late lending to the discount market; by sale and repurchase operations (repos) in gilts or export credit paper; by placing funds directly in the LA short term deposit market; or - at least in principle - by releasing or calling Special Deposits. While the Special Deposit Scheme remains available, Special Deposits have not been called since 1979, and they have been zero since August 1981. (Unlike Supplementary Special Deposits, which were non-interest bearing, Special Deposits earn interest at a rate close to Treasury bill rate).

(iv) The Bank deals in bills in 4 maturity bands, at rates that lie within an unpublished (but readily detectable) band. The bands are:-

Band 1: 1-14 days
Band 2: 15-33 days
Band 3: 34-63 days
Band 4: 64-91 days

where maturity refers to residual, not original, maturity. The Bank does not usually buy bills with a residual maturity of more than 3 months.

(v) Lending through the discount window (in exceptional circumstances) is at rate of the Bank's choosing. Both the amount and the terms of 2:30 lending are published. Late (2:45) lending is usually on penal terms, but these are not published (though the amount is).

(vi) After 20 August 1981, the Bank ceased to post a minimum lending rate continuously. But it reserved the right to announce in advance the minimum rate which, for a short period ahead, it would apply in any lending to the discount houses.

Comparison with Pre-1981 Arrangements

4. The system of monetary control prior to August 1981 was described in the Green Paper on Monetary Control (Cmnd 7858, March 1980). The main instrument for influencing short term interest rates was discretionary variations in MLR, "made effective through money market operations conducted through the discount market". The process of making changes in MLR effective depended on the deliberate over-issue of Treasury bills at the weekly tender to create artificial money market shortages which were subsequently relieved by the discount market borrowing or selling assets to the Bank. The Special Deposit Scheme (first introduced in 1960) offered a means of regulating the liquidity of the banking system. The Reserve Asset Ratio was originally introduced in 1971 as a monetary control that would have the same effect, but it had ceased to serve this function long before 1981; by the end of 1973 it had become apparent that the banks' main response to reserve asset pressure was to bid for wholesale funds, resulting in interest rate differentials that provided incentives for round-tripping.

5. Information on how the Bank conducted its daily operations at times of unwanted interest rate pressure is sparse. Prior to 1971, at least, the Bank's position as jobber of last resort to the gilts market did sometimes put it in the position of supplying additional cash to the market in exchange for gilts, at times of falling prices, thus effectively taking some of the pressure off prices. But it is not easy to say how far, in practice, the Bank

bought in Treasury bills at such times, at posted dealing rates, to reinforce its view on MLR. The 1980 Green Paper implies that liquidity operations of this sort might be employed, though it puts most emphasis on the expectational impact of published official rates. For example:

"Market interest rates beyond the very short term are often heavily influenced by expectations about the future movement of MLR... If there is a strong expectation of any early cut in MLR, it may take persistent penal lending to stem a fall in say 1-3 month rates in relation to MLR: or, if an early rise in MLR is expected, even generous help by the Bank to relieve any shortage of funds, or the deliberate creation of easy conditions, may not be enough to induce the houses to hold on to longer term, say 1-3 month assets, and therefore to prevent the comparable money market rates from rising. Thus, in practice, the Bank's money market operations are intended to influence expectations in a much broader way rather than supply to influence the immmediate cost of money to the discount market."

6. The major changes made in 1981 were the ending of posted dealing rates and a continuously published MLR, both of which gave the Bank's dealing rates a much lower profile. The switch from discount window lending to operations in the bill market was intended to have the same effect and, even at the time, was regarded as being mainly of presentational significance. The ending of the practice of over-issuing Treasury bills has, in the event, been of no real significance, given the growth of the bill mountain. Maturing bills have ensured large and almost continuous market shortages, requiring regular operations even in longer maturity paper (Bands 3 and 4). With a substantially smaller bill mountain, however, the 1981 arrangements would have much reduced the scale of the Bank's daily intervention in the money markets, probably confining it, as originally intended, to Bands 1 and 2.

7. Whatever the practice prior to 1981, or the intention at the time the new arrangements were announced, it is clear that substantial variations in the supply of liquidity are not a

significant part of the Bank's current armoury of techniques for influencing short term rates. Special Deposits may be available in theory, but in practice releasing Special Deposits was not an option in early July (unless we could have contemplated creating negative Special Deposits). Official operations closely matched the ex post system shortage (as they have in previous periods of pressure) and daily deviations of bankers' balances relative to target rarely approached even £100m.

Comparison with Monetary Base Control

8. Does the fact that the Bank would typically scale down offers of bills in excess of the expected system shortage, even at times of unwanted and sharp upward pressure on interest rates, imply that, in practice, our present system is closer to monetary base control, than to a system where short term interest rates are the main operational instrument? Only up to a point. It is true that the Bank's operations in early July might have been very little different had we been operating an MBC system. MO was on target and the Bank's operational aim would have been to keep it there; there would have been no reason to vary the supply of cash to the banking system to damp the rise in interest rates.

9. In other circumstances, however, there could be more significant differences. Compared with our present system, MBC could imply - depending on how strictly it is operating in the short term -

(i) a willingness to move the Bank's dealing rates up or down in response to deviations in MO from target, irrespective of what other indicators were suggesting about monetary conditions. This rather weak form of MBC is what we have tended to regard as the most practical operational option. There is no necessary reason why this should lead to greater interest rate volatility than we have at present. That would depend on the volatility of MO, and the degree of short term control over it that was sought;

(ii) a deliberate attempt to over or under do assistance to the money markets on a daily basis, depending on whether MO is below or above target. If this meant large deviations in bankers' balances from desired levels, it would certainly generate larger fluctuations in rates, at the very short end of the market, at least in the short run. But whether it would mean more volatility in 3-month rates, or in banks' base rates, is conjectural. On the whole, we have tended to think that this is a real risk - partly on the basis of US experience (difficult as it is to interpret). What is clear, however, is that such a system would only be practical if the banks held much larger operational cash balances than they do now; no doubt brief experience of such a system would rapidly encourage them to do so.