13. Monetary Control

Consultants

18 - 30 June 1980

Confederation of British Industry

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REPORT OF THE WORKING PARTY ON MONETARY CONTROL

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THE CBI WORKING PARTY ON MONETARY CONTROL

CBI's Economic and Financial Policy Committee (EFPC) set up a working party to consider the Green Paper, 'Monetary Control' at its meeting on 4th March, and the group duly had its first meeting under the chairmanship of Mr George Duncan on 29th April. The terms of reference agreed by EFPC were:

'To consider from the point of view of UK business the Treasury/ Bank of England consultative document on monetary control and any changes in the monetary system which the authorities might institute as a result of their consultations, and to monitor the working of any changes in the period immediately after their inception.'

The Working Party's report, however, preceded the implementation of any changes and accordingly relates only to the first part of the terms of reference.

The Committee stressed that the major concern of the Working Party should be the likely effect of the proposals on the cost, type and amount of finance available to trade and industry and expressed the wish that if the Bank of England Consultation Document, 'The Measurement of Liquidity' had a significant bearing on this issue, the terms of reference should be widened to include consideration of it. The Working Party decided that 'The Measurement of Liquidity' was relevant and accordingly the Report records its views on both documents.

The composition of the Working Party was as follows:-

Chairman:- Mr G Duncan - Chairman, Lloyds and Scottish

Members:	Mr I G Bonas	- Chairman, Bonas Machine Tools
	The Hon F Cornwallis	- Chairman, Town & Country Building Society
	Mr S T Graham	- Director and Chief General Manager, Midland Bank

Cont......

Professor G. Maynard	-	Director of Economics, Europe and Middle East, Chase Manhattan
Professor W B Reddaway	-	Department of Applied Economics Cambridge
Mr S F Robin	-	Assistant Managing Director Great Universal Stores
Mr T M Rybczynski	-	Economic Adviser, Lazard Bros
Mr S F Thomson	-	Finance Director, Ford UK

Secretary: Mr R P Bootle - Economic Directorate, CBI

The Working Party's report was endorsed by EFPC on 3 June 1980 and a summary of its main points received CBI Council's approval on 18 June. The Report therefore represents a statement of CBI's views on the subject.

Economic Directorate 18 June 1980

1 INTRODUCTION

This report considers the Green Paper 'Monetary Control' and the Bank of England Consultation Document, The Measurement of Liquidity' from the point of view of UK trade and industry. Although it discusses some general points on the efficiency of monetary policy, its focus is on possible effects on finance for trade and industry. Accordingly, many technical issues which may be of particular concern to bankers or economists are ignored.

Assessment of the likely impact of the proposals in the Liquidity document is made difficult by the absence as yet of a clear idea of the likely extra cost to the banks, if any, of having to meet the new liquidity requirements.

In any event, it is clear from the reaction of the banks and the response of the Bank of England that substantial changes to the proposals in the liquidity paper are to be expected. Furthermore, the Bank has yet to publish its discussion document on the important related subject of cash requirements for the banks. The observations of the Working Party must, therefore, be subject to modification as the position on these matters crystalises.

Although there are points of connection between 'Monetary Control' and 'The Measurement of Liquidity', the two papers are distinct enough to be treated separately and this is the approach adopted here. After the following section summarising the Working Party's conclusions, the report is divided into two sections, Part I on 'Monetary Control', and Part II on 'The Measurement of Liquidity'.

2 A SUMMARY OF THE MAIN POINTS

Part I - 'Monetary Control'

2.1 The Working Party shares the Green Paper's general opposition to quantitative controls and therefore welcomes the abandonment of the 'Corset', and the replacement of the Reserve Asset Ratio by prudential criteria for liquidity and the broader application of the cash requirement. It stresses, however, that re-intermediation should not be allowed to lead to an effective tightening of the monetary targets.

2.2 The choice of method of monetary control is secondary to the issue of the authorities' preparedness to accept the implications for fiscal policy and interest rates of keeping the growth of Sterling M3 within the announced target.

2.3 The Working Party believes that within limits, greater volatility in short term interest rates would be an acceptable consequence of improved short and medium term control of the money supply, particularly if this were also to result in the avoidance of spasmodic larger changes in interest rates.

2.4 The reservations expressed in the Green Paper with regard to the appropriateness of a pure monetary base system are endorsed by the Working Party.

2.5 The indicator system with over-ride is broadly supported as the best of the alternative regimes of monetary control.

2.6 None of the regimes discussed in the Green Paper is thought to have major implications for the overall cost of bank finance averaged over time. There is a suggestion that greater volatility of interest rates could cause a decrease in average short-term rates relative to average long rates, and the discouragement of overdrafts relative to term finance but these consequences are far from certain, and neither is thought likely to occur on such a scale as to have a seriously adverse effect on corporate borrowers.

Part II - 'The Measurement of Liquidity'

2.7 Observations on the liquidity paper must be regarded as provisional in that the percentages it employs for the various ratios are only tentative, and significant modifications to the proposals are likely to result from representations by the banks. It is expected that these changes will serve to reduce the potential adverse consequences for trade and industry which would arise from the proposals as initially presented. Furthermore, even as the proposals stand, the extent of any effects must remain in doubt until a clear picture emerges of the likely extra costs to the banks, if any, of meeting the requirements.

2.8 In their present form, and with high percentages for the ratios, the proposals might tend to:-

i lower short-term interest rates relative to long-term;

ii raise the relative cost of roll-over loans;

iii raise the costs of wholesale banks relative to retail banks;

iv encourage banks to offer term loans rather than overdrafts;

v divert foreign currency business away from British banks and sterling business away from London;

PART I - 'MONETARY CONTROL'

3 GENERAL OBSERVATIONS

3.1 The existing methods of control do not operate effectively and have resulted in a number of distortions and inefficiencies in the banking system. Since these have in part arisen from the operation of the system of Supplementary Special Deposits (the 'Corset') and the Reserve Asset Ratio, the ending of the former in June and the predicted replacement of the latter by cash and liquidity requirements are welcomed.

3.2 Nonetheless, there is some anxiety lest after the end of the Corset, re-intermediation should cause an effective tightening of monetary policy. If this happens, the authorities should adjust the target accordingly.

3.3 The Working Party endorses the Green Paper's general opposition to quantitative controls. On the whole, these interfere with the efficient operation of the financial mechanism without offering compensating gains in more effective control over monetary conditions. The same does not necessarily apply, however, to directional guidance given by the Governor. Although it would be inappropriate to rely on this as a major tool of monetary policy, market imperfections are probably great enough for directional guidance to have a significant effect on the availability and cost of finance for industry, and the Working Party supports its continuance.

3.4 The Working Party supports the continued use of monetary targets and endorses the Green Paper's recommendation that Sterling M3 should be regarded as the basic monetary aggregate in the control system.

This system will, however, suffer from a weakness unless the authorities set targets which the market expects will be readily achieved. For if the figures for the first months of the period are at or above the target maximum, investors will postpone purchases of gilt-edged securities in anticipation of a drastic rise in MLR, and this postponement will accentuate the growth in Sterling M3.

3.5 Given the fairly slow response of the demand for bank credit to changes in interest rates, control of the money supply in the short-term requires the switching of marketable securities (largely public sector debt) from banks to non-banks, which is probably of little significance for the control of aggregate demand or inflation. Short-term control of the money supply is not therefore of primary importance in itself.

The medium-term is, however, a succession of short-terms and it is difficult to distinguish changes in the money supply which will prove to be temporary from those which represent a trend. Unless the Bank of England exercises some control over the money supply in the short-term there will inevitably be occasions when the Bank acts only once a trend is established. Moreover, this 'bias towards delay' as the Green Paper calls it, may then necessitate large increases in interest rates both to restrain the growth of credit and to persuade the market to buy gilts.

The Working Party therefore endorses the Green Paper's recognition that improved control of the money supply in the short run is desirable.

3.6 The Green Paper does not discuss alternative methods of funding the Public Sector Borrowing Requirement nor does it advance views on the role of the foreign exchange market. Since both of the issues are an important aspect of monetary control, the Working Party feels that the authorities' views on these matters are a prerequisite of a full evaluation of the monetary control proposals.

4. THE PREFERRED SYSTEM OF MONETARY CONTROL

4.1 Whatever the system used, the essential condition for effective control of the money supply, given any particular fiscal stance, is that the authorities be prepared to accept the level and structure of interest rates required by market forces. In the past, inconsistency between the interest rates required to make monetary policy effective and those thought politically acceptable has probably been a greater obstacle to effective control than any deficiencies in the control system as such.

4.2 It is considered that after the removal of the Corset and the extension of the cash ratio, the authorities will have available the instruments required to exercise adequate control of the money supply. The banking system will effectively rest on a monetary base and control of the money supply will almost always involve changes in the base. The choice between systems of control, however, rests upon how far the level of the monetary base should simply accommodate a level of interest rates determined independently, and how far it should be the force determining interest rates in relation to market forces. This amounts to a choice about how far the Bank of England's discretion over interest rates should be restricted by rules.

4.3 The first alternative is to leave the Bank's discretion unimpaired. It would still be possible to improve on past performance in short-run control provided that the authorities are prepared to accept the necessary level and structure of interest rates. The Working Party believes, however, that allowing the Bank of England complete descretion would preserve the bias towards delay in changing interest rates inherent in the present system, and it would prefer to see interest rates more responsive to monetary developments.

4.4 The Working Party feels that a pure monetary base system would operate through the same mechanisms as other systems; control would be effected ultimately through the generation of changes in the level and structure of short-term interest rates. Its distinguishing characteristics, however, would be the extent to which changes in interest rates would be automatic and the minimal scope for discretion allowed to the Bank of England. As well as endorsing the Green Paper's reservations concerning the practicality of such a system, the Working Party feels that it would be inappropriate for interest rates to be wholly determined by market forces in response to a pre-set level of the base. It would wish the monetary control system to be able to accommodate clearly transient and erratic fluctuations in monetary growth without undue changes in rates, and to allow the authorities the opportunity of using interest rates, for example, to influence the value of Sterling.

4.5 The indicator system represents a compromise between the need to adjust interest rates more quickly and the desirability of avoiding unnecessary fluctuations. The Working Party therefore prefers an indicator system based on Sterling M3 but with a facility for the Bank to over-ride the indicator provided that sufficient explanation is given.

It is again emphasised that considerable importance should be attached to general acceptance of the need to seek better control of the monetary aggregates through changes in fiscal policy and/or interest rates. It would be necessary, therefore, for there to be a clear understanding of the circumstances in which the use of the over-ride would be regarded as legitimate.

5 RELEVANCE TO FINANCE FOR TRADE AND INDUSTRY

5.1 Any of the systems discussed in the Green Paper would lead to greater volatility in short-term interest rates if the authorities sought to control the money supply more closely in the short-term.

The Working Party believes that, within limits, these fluctuations would not cause undue problems for trade and industry, borrowers being more concerned interest rates over the medium term. Moreover, if greater volatility would, by contributing to better control of the money supply, reduce fluctuations in interest rates over the medium term, a positive advantage would have been achieved.

5.2 Concern has been expressed at the possibility of the effects on trade and industry of even tighter monetary control resulting from the proposals in the Green Paper.

The suggested changes to the monetary control system would seem likely to improve its effectiveness and so in periods of financial stringency the adverse effects on trade and industry might indeed be more pronounced. Equally, any relaxation could be more certain and immediately implemented. In any event, it is desirable to have the most efficient system of control.

5.3 In general, it is considered that no aspect of the three systems of control discussed in the Green Paper would have major effects on the overall cost of bank finance when averaged over a reasonable period. The extension of the requirement to hold cash balances at the Bank of England to all banks, however, would raise the costs of the non-clearing banks and this in whole or in part would be passed on to their customers. An assessment of how great this effect would be must await the publication of detailed proposals on the cash ratio but is not thought likely to be significant for bank borrowers on average.

5.4 It has been suggested that a system which involved greater interest rate volatility could encourage banks to offer term-loans rather than overdraft facilities. Since the flexibility of the overdraft system is valuable, the Working Party would not consider this development to be desirable, but it feels that the overdraft system need not be threatened by greater interest rate flexibility in general, provided bank base rates are allowed to be flexible as well, and expects that the banks would try to tailor the type of finance available to suit the customer's needs.

5.5 As far as term loans themselves are concerned, since the risks for banks of lending for fixed interest terms longer than those for which they are borrowing would be increased by greater interest rate volatility, there might be an encouragement to lend for shorter terms than at present, thus lowering short rates relatively to long. Again, it is not thought, that this would happen on any great scale and should not prove to be a major concern for borrowers.

PART II - "THE MEASUREMENT OF LIQUIDITY"

6. GENERAL OBSERVATIONS

6.1 An assessment of the likely impact of the proposals is made difficult by the probability of significant changes being made to the initial recommendations as a result of representations by the banks. It is likely that as a result any adverse affects would be minimised.

6.2 In proposing to take account of the maturity of assets and liabilities in assessing liquidity needs and to express regulations as norms rather than minimum requirements, the 'Measurement of Liquidity' adopts principles which are endorsed. Some details of the proposals as they stand, however, do give rise to anxiety.

6.3 Although the Bank of England's concern to establish a clear fromework for all banks and all types of banking businesses is understandable, such a framework should make due allowance for the natural differences between banks, and avoid as far as possible any changes which might unnecessarily penalise particular parts of the banking system or weaken competitive forces between banks. As they stand, the proposals appear to impose little additional burden on a bank with a large retail business but could pose difficulties for a bank relying on wholesale term deposits. Some relatively simple changes could alleviate this problem.

6.4 'The Measurement of Liquidity' is right to recognise the links between sterling and foreign currency business but the differential treatment of UK and foreign banks in this respect carries the danger of imposing a competitive disadvantage on UK banks which should be avoided. Moreover, since the sterling business of foreign banks is subject to control only when is passes through UK branches there is a danger that it will be switched to foreign banking centres. These dangers can be averted if the controls do not involve significant extra costs for banks (and their customers) from either low yields on extra holdings of liquid assets or the expense of monitoring liquidity positions.

6.5 The dangers referred to in (3) and (4) above and particular worries about the effects of the proposals on the term, cost and availability of finance discussed below, hinge upon the cost of holding liquidity. This will depend upon both the extent of banks' liquidity requirements and the availability of liquid assets. It is almost impossible to assess how great this cost might be and it would be helpful as an initial step if the Bank of England could give a view as to how adequate the present stock of liquid assets would be to meet the new requirements. At this stage, an assessment of the likely effects must therefore be preliminary, and the conclusions of this report could require substantial adjustment when the details of the liquidity requirements and their costs become clear.

7. EFFECTS ON FINANCE FOR TRADE AND INDUSTRY

7.1 The proposals on liquidity have aroused a good deal of technical criticism, some of which centres on anomalies or technical difficulties which are of particular interest to the banks. These aspects are ignored in this report except in so far as they would have consequences for the term, type, cost, or amount of finance. Again it is emphasised that the eventual form of the liquidity requirements might remove the potentially adverse effects of the present proposals. Also, the costs of having to hold liquid assets according to the requirements may turn out to be relatively small so that the extent of any adverse effects upon finance for trade and industry could be minor. In their present form, however, the proposals could have a number of effects on finance for industry which would give cause for concern. These are outlined below.

7.2 If banks' costs increase through having to hold a higher proportion of low-yielding liquid assets, they will either have to accept lower profits or pass these increased costs on to their customers; competitive conditions between the banks will largely determine the outcome.

7.3 The impact of the extra costs would not, however, be uniform. Since inter-bank deposits carry a 100% liquidity requirement and term deposits carry a higher requirement than maturity uncertain deposits up to 3 months, wholesale banks would be under a disadvantage compared with retail banks. They would clearly try to build up their commercial deposit-taking business (which would probably lead to improved rates for commercial depositors) and possibly even to strengthen or develop a retail business. If they were unable to change the balance of their business in this way, they would be under pressure to raise lending rates, although competition from the retail banks might act as a strong incentive to absorb increased costs rather than pass them on.

7.4 The effect of the tapering liquidity requirement is to impose greater liquidity costs on banks, the longer are their loans in relation to deposits. They would therefore prefer to lend somewhat shorter than at present, and to borrow longer. This preference would cause a steepening of the yield curve with short-term rates falling relative to long-term rates. This tendency would be reduced, however, if the change in relative rates persuaded depositors to deposit for longer periods or borrowers to borrow shorter.

7.5 Since overdraftscannot be off-set against deposits in calculating liquidity requirements, there would be an inducement for banks to offer term loans rather than overdrafts.

7.6 As the proposals stand at present, a roll-over loan is assessed by the total length of the loan rather than by the length of the roll-over period. Banks might therefore be encouraged to offer a choice between a roll-over loan exactly as at present (except somewhat more expensive) and a cheaper loan extended formally only for the roll-over period but with an understanding that roll-over facilities would normally be available.

7.7 The impact of the proposals could be radically changed by a few alterations. For instance, it would be possible to lower the overall requirements against maturity-certain business, to attribute a maturity to overdrafts, and to change the treatment of roll-over loans, without undermining the spirit of the proposals. Such changes would serve to allay some of the main objections to the proposals as presented. There would, nevertheless, remain the general reservation that there is a cost implicit in the quest to ensure that adequate liquidity is maintained by the banks. It is to be hoped, therefore, that the Bank will be able to strike an acceptable balance between ensuring the stability of banks and minimising the resulting costs a part of which, at least, will ultimately be borne by the banks' customers.

CBI Economic Directorate 17 June 1980

MCC(80)(Corrigendum)

COPY NO.

26 June 1980

HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

MCC(80)25 dated 23 June 1980 about the comments by the CBI should have been numbered MCC(80)24. Recipients might like to substitute the attached cover note (the opportunity has been taken to have it typed!).

M D K W FOOT
M L WILLIAMS

H M Treasury

MCC(80)24

26 June 1980

COPY NO.

HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

COMMENTS BY THE CBI

Note by the Secretaries

The attached Report of the CBI Working Party on Monetary Control is circulated for information. The Working Party was set up to consider the Green Paper from the point of view of UK industry; its terms of reference and its report extends also to the Bank's consultation document on the measurement of liquidity.

M D K W FOOT
M L WILLIAMS

H M Treasury

MCC(80)25 COPY NO.

26 June 1980

HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

COMMENTS BY THE CLCB

Note by the Secretaries

The attached comments on the Green Paper by the London Clearing Banks are circulated for information. As the cover note indicates, the Banks might wish to comment further when they have received the cash ratio paper.

M D K W FOOT

M L WILLIAMS

H M Treasury

Copy No 7

MCC(80)25
28 June 1980

HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

COMMENTS BY THE CBI

Note by the Secretaries

The attached Report of the CBI Working ~~Gp~~ Party on Monetary Control is circulated for information. The Working Party was set up to consider the Green Paper from the point of view of UK industry; its terms of reference and its report extends also to the ~~consultation~~ Bank's consultation document on ~~liquidity~~ the measurement of liquidity.

M D K W Foot
M L Williams

HM Treasury

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Copies to the Deputy Governor
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Mr. Page
Mr. Loehnis
Mr. George
Mr. Coleby
Mr. Goodhart
Mr. Cooke
Mr. Gill
Mr. Walker
Mr. Willetts
Mr. Somerset
Mr. Quinn
Mr. Foot.

Office of the Chairman

K.F. Einfeld

30th June, 1980

The Governor,
Bank of England,
Threadneedle Street,
London, E.C.2.

Dear Mr. Governor,

Monetary Control (CMND 7858)

Thank you for your letter of 5th June in which you invited Members of this Association to comment on the subject matter of the Green Paper overall and more specifically on the operational considerations involved.

I have canvased my Members for their views which are widely differing as one may have expected but the general consensus is as follows.

We do not feel that the difficulties with monetary base control can be completely surmounted by any of the systems recommended since the principle has been the application of a control mechanism to one particular monetary aspect where the interaction against the standard monetary growth measure £ M3 has much wider ramifications. Nevertheless there is an advantage in modification, possibly along the lines of continuation of some form of base control coupled with the system outlined in Chapter 5 for automatic adjustment to the Bank's base lending rate. This poses the question as to whether the proposed system for a method of automatically adjusting MLR has merit.

In many respects the scheme is efficient in as much as it would create rapid response, and would avoid many of the problems of lagged or even current accounting. There does seem to be a danger however in a rigidly automatic system of the type proposed and we would suggest that the pre-set graduated scale of adjustments to the Bank's lending rate should not be absolute figures but a range of adjustments with fixed maxima and minima. The target variables have historically shown substantial fluctuations over short timeframes, such a corresponding variation in MLR according to the automatic scale might lead to rapid distortions in short term interest rates. As the Green Paper points out, this mechanism would to a large extent either prevent the Bank from using the rate as a tool for control of other factors or at best might lead to a conflict of interest. This would be particularly relevant in a situation where a rise in interest rate trend for control of monetary growth could seriously conflict with control of a sterling exchange rate.

We envisage that such a system could create difficulties in money management for banks in an environment where sterling is freely convertible with the creation of an internal sterling market with distinctly separate rates and trends compared to Eurosterling. This might either create problems of management or lead to a weakening of the effectiveness of the interest rate mechanism through disintermediation or other externally generated monetary arrangements.

/...

30th June, 1980

The Governor,
Bank of England,
London.

Members of this Association accept that this is an enormously complicated subject and neither alternative seems to provide an ideal solution. Indeed the ideal solution probably does not exist since at least some of the problems of monetary control arise from political decisions.

I hope that these few comments will be helpful and I look forward to hearing from you again in due course.

Yours sincerely