12. Monetary Control

Consultants

16 – 18 June 1980

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16 July 1980

HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

COMMENTS BY ASSOCIATION OF CONSORTIUM BANKS

Note by the Secretaries

The attached comments on the Green Paper by the Association of Consortium Banks are circulated for information.

M D K W FOOT
M L WILLIAMS

H M Treasury

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16 July 1980

HER MAJESTY'S TREASURY

MONETARY CONTROL CONSULTATIONS

COMMENTS BY THE SCOTTISH CLEARERS

Note by the Secretaries

The attached comments on the Green Paper by the Committee of Scottish Clearing Bankers is circulated for information. The Committee refer to the evidence of the CLCB; this was circulated as MCC(80)25.

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18th June, 1980

GREEN PAPER ON MONETARY CONTROL

I have pleasure in enclosing, for yourselves and for H.M.Treasury, copies of the Clearing Banks' preliminary Submission in response to the Green Paper (Cmnd. 7858) published on 20th March last. This Submission is preliminary in the sense that we should like to reserve the right to comment further on the overall situation presented by the Green Paper and the Consultation Papers covering the measurement of liquidity and the cash requirement, after the Banks have completed their examination of these documents.

You will note that a number of queries have been raised in various parts of the Submission concerning the future policy and procedures to be adopted by the Bank of England. In particular, the Clearing Banks would welcome clarification, in due course, of the following points :

1. The proposals for intervention techniques and open market operations generally.

2. The criteria which will be applied to requests for lender of last resort assistance.

3. Any new techniques or instruments envisaged for funding the Government's borrowing needs.

4. The form of interest rate trigger which would be adopted, and how it would apply, if an indicator system were to be introduced.

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SUBMISSION BY THE COMMITTEE OF LONDON CLEARING BANKERS ON THE GREEN PAPER 'MONETARY CONTROL'

Introduction

1. The green paper Monetary Control (Cmnd 7858) specifically invites comments on two of its chapters: chapter 4, in which the arguments for and against a monetary base control system are examined, and chapter 5, which considers the merits of an 'indicator system' for automatically adjusting the Bank of England's lending rate.

2. This submission accordingly concentrates on these two matters. First, however, it comments briefly on the green paper as a whole and on the conclusions reached in the first three chapters.

3. It is natural that the clearing banks should be profoundly concerned with the workings of monetary policy, since it is largely through the banking system that monetary control achieves its effects on the 'real' economy. In assessing proposed changes in monetary control, the banks must pay regard not only to their theoretical advantages and disadvantages but also to their practical implications for the day-to-day workings of the banking system. In fact, these two considerations are rarely in conflict. A control system which had disruptive effects on the banking and financial markets would be unlikely to achieve the desired policy objectives.

4. The clearing banks believe that the opportunity now exists to put the conduct of monetary policy on a much sounder footing than hitherto, while at the same time eliminating many of the anomalies and distortions which have resulted from successive forms of monetary control during most of the post-war period. They also believe that effective control of the monetary aggregates is essential if inflation is to be conquered and the foundations laid for a durable economic recovery.

The Control of the Money Supply

5. The clearing banks endorse the analysis of monetary control contained in chapter 1 of the green paper, and in particular the recognition of the inherent weaknesses of quantitative restrictions. They are fully aware of the reasons why the authorities have had frequent recourse to such restrictions in the past, but hope that it will prove possible to manage without them in future. The banks would not question the choice of £M3 as the Government's target aggregate, but they welcome the assurance that the authorities will have regard to a wider range of

aggregates when assessing monetary conditions. They emphasise the need to pay due regard to measures of liquidity which include the liabilities of other deposit-taking institutions such as building societies.

The Supplementary Special Deposits Scheme

6. In particular, the banks endorse the conclusion that the 'corset' "should not have a permanent place in the techniques for controlling the money supply" and welcome the news that the control will cease to operate this summer. As the green paper recognises, controls such as the corset tend to result in various forms of disintermediation, while further distortions result from anticipatory action before they are imposed and an increase in the monetary aggregates after they are removed.

Short-Term Interest Rates and Other Existing Controls

7. The banks appreciate the statement in chapters 1 and 3 and annex A of how action to influence interest rates works through to the control of the money supply: they believe this analysis will help to reduce misunderstandings about the nature of the control process. They also recognise the impracticability of 'fine tuning' the money supply, whether by interest rate adjustments or in any other way - a point of some relevance to the proposals for an indicator system, considered below.

8. The decision to end the reserve assets ratio control is welcomed, not only for the reasons mentioned in the green paper but also because of the unintended shortages and gluts of reserve assets that have sometimes resulted from the Bank of England's day-to-day intervention on the money markets. Moreover, the reserve ratio has in recent years become an increasingly artificial control, in the sense that the assets in question are not ones which the banks would now choose to hold in large volumes of their own accord. The need to hold excessive amounts of such assets can distort the interest rate structure (as the green paper recognises) thereby complicating the task of monetary management. It also places the controlled institutions at a competitive disadvantage by adding to their cost of intermediation. The need to avoid imposing artificial constraints on the balance sheets of banks is now widely recognised as an important precondition of an effective monetary policy, if disintermediation is to be avoided.

9. The banks are currently giving separate consideration to the Bank of England's discussion paper The Measurement of Liquidity. If the proposals contained in that paper were to be implemented, the practical effect of ending the reserve assets ratio control would be greatly diminished, since banks would have to maintain substantial holdings of their erstwhile reserve assets as primary liquidity. The main change would be that the required holdings would be expressed as a norm rather than a minimum, which will introduce a desirable element of flexibility. However, without anticipating the banks' detailed representations on this paper, it is worth observing that the proposed liquidity controls do seem to go beyond what is really necessary for prudential purposes. For

that reason, the banks' welcome for the abolition of the reserve ratio must remain a somewhat qualified one for the time being.

10. For monetary purposes, it is suggested that a cash requirement should be imposed on all banks and licensed deposit-taking institutions. At present, only the London clearing banks are required to maintain cash balances at the Bank of England, and they have long argued that the balances maintained are greatly in excess of functional (clearing) requirements. As the balances are non-interest-earning, the banks are effectively subject to a unique tax, which renders them at a disadvantage when competing for lending business with non-clearing banks. The banks will obviously wish to return to this subject once the Bank of England has released its detailed discussion paper: in the meantime, they warmly support the principle that any cash requirement should be applied more widely and equitably than at present, at least to all banks and possibily to other financial institutions as well.

11. The banks note that, while reserve assets are due to disappear, the Bank intends to retain the option to call for special deposits. It is not entirely clear from the green paper what role calls for special deposits are expected to play under the revised arrangements, and some clarification would be welcome on this point. While the banks would not necessarily wish to deny special deposits a place in the authorities' armoury, they believe that the problem of soaking up unwanted cash surpluses should normally be resolved by direct official intervention on the money markets. (The abolition of the reserve asset ratio will of course eliminate the need to use special deposits to soak up excess reserve assets.)

12. While welcoming the clear analysis of monetary objectives and techniques in the early part of the paper, the banks are surprised that it has not been thought necessary or appropriate to provide a fuller explanation of the Bank of England's traditional techniques of market intervention. These techniques are largely peculiar to this country and generally involve the intermediation of the discount market. There is reason to believe that the efficacy of monetary control would be enhanced if the Bank were prepared to increase its range of intervention techniques. Although the problem of unintended shortages and gluts of reserve assets will now be alleviated, at least four problems with the Bank's intervention techniques may remain. One is that the existence of two separate money markets operating side by side inhibits the free flow of information on which efficient markets depend. Deveploments in this direction could usefully be the subject of further discussion. A second is that divergences in interest rates between the two markets can impede the transmission of the authorities' interest rate policy to the wider market. A third is that assistance to the discount market at 2.30 p.m. comes too late to ensure orderly market conditions: there is often a period of uncertainty beforehand and sometimes a period of confusion afterwards. Finally, there are no satisfactory arrangements for relieving very large shortages beyond the capacity of the discount market.

13. The question of intervention techniques is, of course, of vital importance in the context of liquidity as well as monetary control; but there is no discussion of the case for change in The Measurement of Liquidity either. The banks strongly believe that the debate on these important issues would be better informed and more fruitful if the Bank were to encourage fuller discussion of its intervention techniques.

14. Before going on to consider monetary base controls, the banks note that there has been extensive debate on the possibility of developing new techniques and instruments for funding the government's borrowing needs. In view of the critical importance of government borrowing and funding for the development of the monetary aggregates it would be helpful for the Bank to explain its current thinking in this area. This would allow the possible initiatives discussed in the green paper to be considered on a more informed basis.

Monetary Base Control

15. The clearing banks share the main objective of the advocates of monetary base control, namely more effective control over the money supply. However, they have been concerned about the apparent impracticability of many of the specific proposals that have been put forward. In particular, they have been conscious that any controls which applied artificial restrictions on the amount of business a bank could undertake would run the same risks of encouraging disintermediation as the 'corset'; while any controls which involved very short-run restrictions on the permitted growth of base money (or any other monetary aggregate) could lead to quite unacceptable interest rate volatility - if indeed such control could be achieved at all.

16. The green paper divides its consideration of monetary base control between those schemes which would not and those which would involve a mandatory requirement that banks hold base money. The clearing banks entirely agree with the analysis of schemes without a mandatory requirement. Non-clearing banks have little or no functional need for cash balances at the Bank of England, while (as mentioned above) the clearers' functional need is well below their current holdings. In any case, there is no reason to expect a particularly stable relationship between voluntary holdings of base money and the main monetary aggregates: as the green paper recognises, such holdings "could be expected to be a function of the expected values of both the average volume, and the variability in that volume, of all transactions -including inter-bank payments - passing through the banking sector". Most important of all, a non-mandatory scheme could only be effective if the Bank were to induce a rise in the banks' demand for base money by radically altering the workings of the money markets, and in particular by withdrawing (or at least greatly reducing) its lender of last resort facilities. A reduction in the efficiency of London's money markets would be a high price to pay for a monetary control system which still might not be effective.

17. The arguments about schemes with a mandatory equirement are rather less clear-cut. Much would depend, as the green paper makes clear, on whether lead or lagged accounting was involved.

18. Under a system of lead accounting, holdings of base assets on a given date would set a limit to the permissible level of deposits at some future date. For such a system to be effective, two conditions must be met: first, banks must be able to forecast their future balance sheets with sufficient accuracy, so as to hold the right amount of base money; secondly, there must be penalties for under-predicting (and possibly also for over-predicting) the actual level of deposits. The first condition is very unlikely to be met, given the workings of the overdraft system and the banks' role as providers of residual finance to the public sector. As for the second condition, the banks agree with the forecast in the green paper that if the penalties were of any significance they would lead to disintermediation and other artifical adjustments designed to avoid them. Accordingly, the banks would oppose any system of mandatory monetary base control involving lead accounting. (For this and other reasons, the banks would oppose the system of negotiable entitlements considered in annex B.)

19. Different considerations apply in the case of lagged (or current) accounting, where the need to hold base assets is a function of deposits at some past (or current) date. The central question would be how to reconcile the demand for base money (which would depend on a past level of deposits) with the desired supply of base money (which would depend on the state of the monetary growth targets), given that the two might well be out of line. The green paper considers three ways in which reconciliation might be achieved.

20. The first option would be to make the mandatory base such that banks would normally hold excess balances. As the green paper recognises the resultant fluctuations in the ratio of base assets to deposits could make the linkage between the growth of base assets and the growth of the money supply very weak, at least in the short term. In effect this option would involve a combination of mandatory and non-mandatory holdings of base assets, and would suffer from the same drawbacks as a non-mandatory scheme, discussed above. The banks agree that such a system would be unsatisfactory.

21. The second option considered would involve a system of penalties for banks which failed to hold the requisite level of base assets on the relevant day. This would allow the authorities to limit the supply of base assets to the amount consistent with their monetary targets, even if it were known that the demand by the banking system was in excess of this amount. Individual banks would seek to avoid the penalties by bidding for base money, but the system as a whole could not. As well as tending to give rise to disintermediation, such a system would have the grave drawback that the penalties would fall not on those banks which had expanded their lending rapidly, but on those which happened to be caught short in the clearing. Because of their position in the financial system, the main effect of unanticipated day-to-day movements of

funds is inevitably felt by the clearing banks, and they would bear the brunt of the penalties. Indeed, the knowledge that an expansion in total bank lending would in due course lead to a shortage of base money would not necessarily give an individual non-clearing bank any cause to modify its lending behaviour. The whole burden of adjustment would be likely to fall on the clearing banks.

22. If neither of these options is acceptable, the authorities must be prepared to meet the banking system's demand for base assets, even if this involves departing from their own target figure. The third option considered would involve meeting the banks' demand for base assets, but meeting it by relieving the markets at progressively higher interest rates. The green paper does not make it clear whether the primary intention would be to force up the overall structure of short-term interest rates in response to excessive demand for base assets or rather to penalise those individual banks which found themselves in need of lender of last resort facilities (as implied in annex B, paragraph 20). The more the scheme did penalise individual banks, the more it would suffer from the same drawbacks as the second option; once again, the penalties would not necessarily fall on those institutions which had expanded their lending excessively, and the result could be the growth of avoidance techniques and disintermediation.

23. In so far as the third option was operated in such a way as to induce changes in market interest rates in response to departures of the base from its target, then the system would be very similar to the suggested indicator system. The main difference would be that the increases in rates would be less directly related to increases in the money supply. (The green paper does not make it clear how the "scale of progressively higher interest rates" would be determined, and in particular whether rolling averages would be used, as is suggested for the proposed indicator system.) Despite its similarities to the indicator system, this option would suffer from some technical difficulties of its own. In particular, the banks endorse the analysis in the green paper of the problems of deciding the appropriate level of base assets, and of achieving that level on any given day. The banks are concerned at the likelihood of undue day-to-day fluctuations in interest rates resulting from unanticipated flows of funds between the banks and the public sector. While fully accepting the need for a more flexible interest rate policy, the banks would hope to avoid a situation in which they had to reduce the quality of their own services (say by curtailing overdraft facilities) in order to avoid the need for 'penal' assistance from the Bank.

Indicator Systems

24. If the authorities are to use the interest rate mechanism effectively in their attempts to control the monetary aggregates, two conditions must be met. First, it is necessary to establish accurately the size of interest rate adjustments necessary to bring about the desired rate of monetary growth. Secondly, the Bank of England must be free from constraints, both internal and external, which prevent it from achieving the necessary level of rates.

25. It must be accepted that an indicator system, as described in the green paper, will do nothing to help meet the first of these two conditions. Indeed a shortcoming of the system would be that, except on those limited occasions when the trigger was overriden, the interest rate response to the rate of monetary growth would be pre-ordained and the authorities would be precluded from taking full account of the wide range of statistical and other information that can be brought to bear when deciding interest rate policy under a discretionary system. They might be inhibited from making due allowance not only for short-term distortions in the money supply figures but also for possible changes in financial behaviour which reduced the value of £M3 as the key monetary indicator. In particular, there could be circumstances in which the short-term effect of an increase in interest rates would be to increase rather than reduce £M3: it would be perverse if this led to yet further rate increases. Finally, there would be circumstances where the appropriate response to excess monetary growth was to use fiscal means to influence the PSBR rather than to use the interest rate weapon, or where other policy considerations (such as the exchange rate) argued for a different level of interest rates.

26. The advantages of an indicator system would be essentially psychological and political. The present, discretionary arrangements for adjusting interest rates certainly suffer from what the green paper terms a 'bias towards delay'. At present, a decision to increase interest rates is seen as a positive policy measure with important political consequences. Moreover, the connection between interest rates and the money supply is rarely so clear as to make the case for an adjustment self-evident. The result is the "built in tendency to avoid increases in interest rates that could prove in the event to have been unecessary" that the green paper describes. This reflects not only overt political pressure to keep rates down, but the fact that in an uncertain world a positive decision to alter rates generally seems harder to take than a negative decision to leave matters as they are. An indicator system could help to make the choice between adjusting rates and leaving them unchanged a more neutral one. If so, it would provide a further earnest of the authorities' resolve to control the money supply, and could thus have beneficial effects on expectations.

27. An indicator system would have a number of operational advantages over many of the alternative methods of monetary control. Above all, it should avoid imposing any artificial constraints on individual banks, or causing harmful disruption to the operational behaviour of banks; it would therefore be unlikely to impair competition or efficiency. An indicator system linked to sterling M3 would also have the merit of ensuring that interest rate adjustments were linked directly to movements in the monetary aggregate that the authorities most wished to control.

28. However, the banks recognise that an indicator system would not be without its difficulties. First of all, it would be necessary for the Bank to determine what percentage increase in interest rates should result from a given percentage deviation from trend in the money supply. This, of course, is a problem under the present system of discretionary

rate adjustments, but it would be exacerbated under an indicator system since the Bank would be greatly limiting its current freedom to apply a policy of trial and error. For this reason, the banks believe that an indicator system might need to be based on a rolling average of weekly money supply figures for considerably longer than the four or five weeks suggested in the green paper, if purely transient fluctuations in the money supply are to be adequately dampened. They also agree that the extent of any automatic adjustment in the operating rate should be limited to a margin of (say) three percentage points either side of MLR, at least for the time being. Yet even if these steps were taken to prevent the system from becoming unduly volatile, an indicator system could lead to an unhealthy preoccupation with very short-term monetary developments, as the market attempted to anticipate movements in the operating rate. On the other hand, a system which led to relatively frequent, relatively small adjustments in rates could well be less disruptive than the present one in which adjustments tend to be less frequent but larger.

29. An important question is the frequency with which the Bank of England would 'override the trigger'. Here the authorities would be in something of a dilemma. On the one hand, they would not wish to abdicate control over the level of interest rates if they feel, rightly or wrongly, that the 'indicated' rate was inappropriate to their monetary objectives. On the other hand, they would not wish to 'override the trigger' too often, since this would seriously devalue the system and could have an adverse effect on market expectations. It must be largely for the Bank itself to judge whether it would have to 'override the trigger' so often as to make the system pointless.

30. An important issue for the clearing banks is the frequency with which their interest rates would need to adjust in a situation where the operating rate changed far more frequently than at present. The green paper stresses the need to ensure that changes in the operating rate worked through rapidly to the general level of short-term interest rates, even if this involved changes in the Bank's money market operations. The clear implication is that the Bank would not wish to see the banks' own interest rates isolated from the operative rate. On the other hand, it is presumably not intended that the banks' base rates, and those lending rates linked to base rate, should move as frequently as the operative rate. The banks would certainly hope to insulate the bulk of their customers from the disruptive effects of excessively frequent movements in interest rates, even if their larger corporate customers had to accept a greater degree of volatility.

31. Nevertheless, whether or not a formal indicator system is introduced, it must be expected that very short-term interest rates will change more frequently from now on, although it is to be hoped that movements will be less abrupt than on occasions in the past. Under the indicator system, market rates for longer periods would be conditioned mainly by the markets' expectations of future changes in the operative rate, and the banks hope that such rates would adapt smoothly to changing circumstances. In time a return to monetary stability should allow rates to steady again in any case. In the meantime, the benefits of a

more flexible interest rate policy will only work through to the real economy if the financial institutions and markets are allowed to respond without inhibition to the short-term market conditions that the authorities create. These benefits would be lost if the banks were prevented, for political or other reasons, from making the appropriate adjustments to their own interest rates in the light of market conditions.

32. The effectiveness of the proposed indicator system would also be diminished if the linkage between the operative rate and rates ruling in the interbank market proved to be too tenuous. The abolition of the minimum reserve asset ratio is helpful in this respect, since it should reduce the erratic short-term fluctuations in interbank rates that result from unintended reserve asset shortages. As remarked above, the banks believe that serious consideration should be given to a modification of the Bank's intervention techniques. If the Bank were to lend in the interbank market, the operative rate could be made effective in that market directly. (The implications of the Bank's separate proposals for the control of bank liquidity are also relevant to the functioning of the money markets and hence to the efficacy of monetary controls.)

33. The banks believe it would be helpful if the Bank were to provide the markets with more indications of its own forecasts of those seasonal and other flows which are expected to influence the monetary aggregates. Indeed, as a general rule, the more the Bank can do to ensure that market expectations are rational and well-founded, the better the prospects will be for effective monetary control. This is true under the present discretionary system of control and would remain true under an indicator system.

Conclusions

34. The clearing banks agree with the conclusion in paragraph 4.16 of the green paper that it is doubtful whether a mandatory monetary base control system would produce the desired results. Of all the options considered, the only one that might prove feasible is a lagged requirement under which the authorities provided the necessary base assets, but at progressively higher rates of interest. However, such a system could easily discriminate against the clearing banks and would suffer from more technical problems than the proposed indicator systems, which offer the same potential benefit of ensuring timely adjustments in interest rates.

35. The clearing banks see a number of possible difficulties with an indicator system. They see its main advantage as being the removal of the 'bias towards delay' in the adjustment of interest rates. In an ideal world, this bias would not exist, and the Bank would be able to make the rate adjustments it considered necessary to keep monetary growth on target. But in the actual world, the banks recognise that a purely discretionary system may not result in the necessary adjustments being made at the correct time, although it does enable the authorities to formulate their interest rate policy on the basis of wider

considerations. Much would depend on how often the Bank felt the need to 'override the trigger'. If the Bank felt that it would be obliged to do so at all frequently, it could hardly be called an indicator system. But if the Bank is reasonably confident that the need would arise only very occasionally then the banks would, on balance, not wish to oppose an experiment with an indicator system. In any event the banks support the authorities' resolve to pursue a more active interest rate policy in future.

12th June, 1980