Speak GPS

Chancellor of the Exchequer

cc Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr Ryrie
Mr Burns
Mr Williams
Mr Culpin
Mr Fforde - B/Eng

The Governor
Copies to Mr Dow
Mr Page
Mr Loehnis
Lord Cobbold
Mr Coleby
Mr Dawkins
Mr Flemming
Mr George
Mr Goodhart
Mr Walker
Mr Quinn

MBC SEMINARS

You might like to see the attached accounts of the two seminars earlier this week. The different styles reflect the different nature of the discussions. Mr Lankester's minute records what happened with the Prime Minister - though I cannot at all recall saying anything like the first sentence attributed to me. What I said was that there was general agreement on Monday that £M3 coulld not be controlled in the short term - ie less than six months but that it would be possible to control the base over much shorter periods. The key question raised at the seminar was whether this was desirable or not.

PEM

P E MIDDLETON
3 October 1980

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MONETARY CONTROL SEMINAR: CHURCH HOUSE, 29 SEPTEMBER 1980: RECORD OF THE DISCUSSION

A list of those attending the seminar is attached. Mr Middleton and Mr Fforde were in the chair. As background for the Seminar, the Bank and the Treasury had circulated a paper "The Monetary Control Seminar".

2. Introducing the seminar, Mr Middleton suggested that the discussion should mainly proceed on the assumptions that policy was directed to the control of the money supply, however defined; and that the exchange rate was floating. He said that further written comments on the Green Paper would be welcome, but they should be sent within the next two weeks.

The Time Horizon for Monetary Control

3. The morning session discussed the issues raised in paragraphs 2-4 of the circulated paper. Professor Newlyn, introducing the discussion, suggested that "means of payment" was a more appropriate criterion for distinguishing between money and non-money than "liquidity". £M3 was unsatisfactory on this basis. He thought that the distinction between controlling money supply growth by changing interest rates (which influenced the demand for money) and by operating on the monetary base (which affected supply) had been blurred in the Green Paper.

4. Professor Bain felt that the main problem with present control techniques was the bias for delay while the authorities waited to see if a divergence persisted. But the cost of trying to correct a divergence was itself substantial. The Wilson Committee had therefore taken the view that the markets and the authorities tended to react too soon to a divergence; greater variability was acceptable, both because short run variations were irrelevant to the longer run objectives, and because money was needed as a buffer to cope with fluctuations in financial flows. More precise monetary control might be possible, but only if money was no longer used as this buffer;

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money substitutes would develop that performed the same function. This in turn would be counter productive as it would weaken the link between money and nominal incomes.

5. Professor Bain went on to say that he thought Mervyn Lewis' distinction between retail and wholesale banking was not operational since the retail banks operated in wholesale markets. The only difference that might arise between monetary base control (MBC) and the current system lay in banks' expectations about future interest rates. For example, under MBC they might expect a faster increase in interest rates in the event of a divergence from target than under the present arrangements. This need not involve rationing, but it could influence their behaviour. Bain concluded that whether or not MBC succeeded in controlling money supply growth more precisely, it would mean greater interest rate variability and uncertainty in the economy. This could in turn lead to somewhat lower interest rates through the depressing impact on investment.

6. Professor Griffiths took issue with Bain. He agreed that fluctuations were not important, providing the authorities met their annual target. But fluctuations had been so substantial in the past, a smoother money supply growth path was needed to improve the market's confidence that the target would be met. Later in the morning Tony Courakis made a similar point. The markets were currently suspicious of the authorities. In Germany overshooting did not damage the markets' expectations because of their underlying confidence in the authorities' ability to hold down inflation. The main issue therefore was whether MBC would improve confidence in the UK. Professor Minford agreed that the question of confidence was crucial. It related, however, to the whole of Government policy, including the PSBR. Monetary control was a largely technical issue.

7. After these initial statements, discussion largely focussed on how the banks would react to MBC. In particular three areas were explored.

1. The development of money substitutes and disintermediation.

2. The link with the base and £M3.

3. The effects on interest rate volatility and the implications of this for private sector borrowers, in particular the future of the overdraft system and the cost of borrowing.

8. Professor Alford drew the Seminar's attention to the difference between recorded £M3 and underlying £M3, emphasising the crucial importance of controlling the latter. He made the point several times during the day. Professor Buiter commented that the development of money substitutes pointed towards base control extending over the widest possible range of institutions. It was suggested by Griffiths, however, that disintermediation was not too much of a problem so long as borrowers were indifferent at the margin between borrowing from controlled and other institutions. Geoffrey Wood argued that disintermediation would be once and for all.

9. Christopher Johnson felt strongly that the relationship between the base (MO) and £M3 would be uncertain. The experience of the Swiss authorities had led them to adopt a MO target. It was a mistake to think that base control removed the authorities' discretion; they would have to forecast MO. Lead accounting would inevitably give rise to disintermediation; but penalties under a lagged accounting system would not necessarily work if the banks thought it worth expanding market share. Professor Sargent also thought that there would be technical problems about controlling the base; in particular the authorities would have to take a view about future movements in interest rates. (At a later stage Peter Wood pointed out that the banks' desired cash ratio could fall substantially over time as a result of technical progress in cash management). Against these arguments, supporters of MBC, particularly Minford, maintained that MO was the only variable that could be controlled.

10. There was widespread agreement that MBC would mean greater variability of interest rates, although less agreement about the implications of this for the overdraft system and the company sector. David Kern saw the end of the overdraft system. Ian Morison, on the other hand, thought it more likely that banks would increase their excess balances; but how banks in fact adjusted would depend on the penalties for missing the base requirement. Johnson suggested that the US experience showed how disastrous the volatility of short term rates could be for the long term credit market. He saw the clearers having to charge commitment fees for undrawn facilities, i.e. as compensation for the risk of a base squeeze. Sargent agreed that the cost of the additional risk faced by banks would be passed to the private sector, although he said that the overdraft system was anyway in decline. He certainly thought it unlikely that MBC would have much restraining effect on banks. John Atkins expected that the maturity of roll-over loans would be reduced, and that banks would move to a formula related base rate system. This, however, depended in part on the denominator of the base requirement. Courakis thought increased volatility of short term rates was less important than the greater certainty that MBC offerred.

11. After the coffee break, Peter Wood said that banks were anyway trying to reduce overdrafts to customers with wholesale accounts. He saw the development of a range of credit instruments with greater reliance on, e.g. bill finance. He was sceptical of arguments that banks' behaviour would change; banks decentralised structure and the close personal links between local managers and their customers made it difficult for head office to impose portfolio choices. Griffiths was among those who expected that banks would simply increase the cost of overdrafts; he thought that there would be changes in the banks' behaviour, and argued that changes were necessary to control money supply. The private sector would be better-off as a result of lower inflation and hence lower uncertainty. Andrew Smithers thought that the overdraft system reduced banks' willingness to resist wage claims but he found little agreement in the room.

12. Victor Morgan did not expect more interest rate volatility, simply a precautionary increase in banks' cash to deposits ratio. This sparked off an exchange about the predictability of the relationship between money supply and money incomes. Bain pointed out that if companies were forced to rely on term loans, fluctuations in their cash flow would be reflected by fluctuations in their deposits, rather than in overdrafts. As a result there would be greater variability in the demand for money. Courakis and Minford pointed out that it was difficult to predict how the net variability would change; or whether the impact of shocks would be less easy to predict. Christopher Foster expected the private sector to economise on its money balances. The public sector could, however, take some of the burden off the private sector if it could make its own cash flow less volatile.

13. At this point, Tim Congdon pointed out that a shift to MBC could mean a once and for all increase in £M3 arising from a number of factors. He mentioned in particular a precautionary increase in banks' cash to deposits ratio to guard against less readily available lender of last resort (LLR) facilities, and increased deposits to provide excess reserves as a buffer stock against fluctuations in overdrafts. This would seem to blow a hole in the MTFS. (Alford spoke of an earthquake to expectations.) There followed an inconclusive discussion of the relevance of such a once and for all shift. Courakis and Geoffrey Wood pointed out that the development of money substitutes would work the other way. Peter Middleton noted that a long transition period could add to uncertainty whatever the gains in the long run. Buiter said that if shocks could be expected to the demand for for money, an interest rate policy would be theoretically superior.

14. Gordon Pepper agreed that the present aggregates would change their nature, because the liquidity of different assets would change. He expected the private sector would hold a greater volume of those assets in PSL1 but not £M3. For this reason

it would perhaps be important to focus on M1 in the transition. Pepper was sceptical about some of the arguments about interest rate volatility; over the medium term interest rates might fluctuate less. Moreover, excess reseves and other buffers would moderate fluctuations; there was no need for short run control. At the moment a central government surplus tended to push interest rates up; the opposite of what was required for monetary control.

Mandatory and Non-Mandatory Schemes

15. Many of the issues raised in the morning were developed in the first afternoon session. Professor Rose started the discussion. He argued that any element of taxation, which would be inevitable under a mandatory system, would encourage disintermediation overseas. The likely desire of banks to hold excess reserves would make it difficult to interpret movements in the base during the transitional period. He noted that the clearers had failed to pass on to borrowers the penalties they had to pay under the SSD scheme. This stickiness of clearers' lending rates coupled with a restricted lender of last resort facility and flexible money market rates would inevitably mean disintermediation. In a more competitive environment the clearers might behave more like the non-clearers, but in the past political and related pressures had discouraged marginal cost pricing, and therefore some tendency to disintermediation was still to be expected. Professor Rose saw other changes; the risks associated with call money would make demand deposits less attractive, and, as in countries with no overdraft system, a much larger trade credit market could develop. Behind all these issues, however, lay the question of why the banks operated in the way they do at present.

16. Professor Griffiths picked up this last point, saying that the current problems stemmed in part from the authorities' inability to control bank lending. The other important and related difficulty was the need to rely on gilt sales to control money supply growth. A change to MBC raised two issues: the

problems of specifying the system (i.e. the definition of base money, the relation between MO and £M3 targets, and lender of last resort (LLR) facilities), and the transitional arrangements. He thought that the result of a change would be greater fluctuations in short term interest rates, a MLR related to interbank rate and a market in base money. Professor Griffiths went on to discuss the specific questions raised in paragraphs 5-9 of the circulated paper:

(a) The nature of LLR facilities: the authorities would operate in the money markets to correct divergences of the base from target. The public sector's financial controlneeded to be improved, but the burden of adjustment would fall on the banking sector. MLR would be fixed so that the LLR facility was not used too readily by banks.

(b) Mandatory US non-mandatory: A mandatory system would operate as a tax. Interest should be paid on reserves, to compensate the clearers for loss of profitsand to reduce the incentive to avoid the control. Either system, not only a non-mandatory one, would mean changes in financial markets. Professor Griffiths thought that the demand for base money under a non-mandatory scheme would be stable; and he saw no difficulties for debt management policy.

(c) Transitional arrangements. It was unclear what half-way house there could be.

17. Brian Williamson pointed out that there would be a sharply reduced role for the discount market and other money market principals. In effect, the discount market could no longer provide the means for absorbing fluctuations in money market flows; and this would happen at a time of increased volatility of interest rates. New instruments might develop over time, but there would clearly be a transitional problem. This was

a clear cost of a switch to MBC. He would prefer to see the present system operated more flexibly.

18. The discussion concentrated first on a mandatory system, in particular the related issues of penalties, buffers and the LLR arrangements. Foster made the point that banks' reserves would depend on the scale of penalties, whether these were fines or the terms of LLR borrowing. Occasional LLR borrowing did not matter, but it was important to penalise particular persistent borrowers. Pepper pointed out that under the present arrangements a money market shortage backed up on the discount market, who had access to LLR; thus a mechanism would need to be devised to ensure that the overshooting bank was forced to borrow at the Bank. Andrew Britton saw the advantage of excess reserves acting as a buffer; the market could allocate the excess and there would be less incentive for disintermediation.

19. Charles Goodhart pointed out that Griffiths' suggestion of pegging MLR to interbank rates could lead to spiralling interest rates (at least until bank lending adjusted) as it would always be worth an individual bank borrowing in the interbank market, rather than from the Bank. Penalties could have a similar effect. This gave rise to a lively discussion, with a number of speakers pointing to ways the system could adjust (e.g. banks selling other assets, or through the euro-sterling market). But there was general agreement that very short term rates could rise very sharply, depending on how MLR was set. Congdon noted that notes and coin could provide a very substantial buffer if that was included in the base.

20. Courakis came down strongly in favour of a non-mandatory system; he also thought half way houses were undesirable. The main question then became the degree of discretion with which the authorities operated. Minford agreed with the suggestion that a non-mandatory system would mean specifying a target for MO. He thought that there could be a transitional period during which £M3 remained as the target. Pepper said that he

envisaged a mandatory system as an interim arrangement; it might still prove difficult to increase £M3 if that was required.

Other Issues

21. Christopher Johnson introduced the final session. He questioned the emphasis on money supply targets, in view of the possibility of joining EMS. Moreover, he preferred PSL2 to £M3, although it should also include overseas sterling deposits. He also argued that the market would be less concerned with monthly fluctuations if monetary developments were reported as changes over the previous 12 months. (David Kern had earlier suggested that the base period and recent developments should be presented as averages over a number of months.) Johnson thought insufficient attention had been given to other policy measures that affected banking behaviour. He mentioned liquidity requirements and qualitative guidance. He noted, however, that banks' consumer credit lending was much cheaper for the borrower (although still very profitable for the banks) than loans from other credit grantors.

22. Professor Rybzynski returned to the issue of rules versus discretion. Some discretion could not be avoided if the authorities or markets wanted to damp fluctuations. Moreover, an element of discretion would reduce disintermediation (for example, when deciding whether to provide base by LLR or open market operations). Rybzynski saw some advantages in the indicator system, although onus should be on the authorities to explain the reasons for not changing interest rates, rather than as now justifying their level.

23. Professor Artis said that our ignorance of the underlying relationships and the impact of shocks meant that there were risks with any system of rules. Rules were no help to expectations in labour markets. They should therefore be made more conditional, for example on changes in the exchange rate (as (in Switzerland) or unemployment. Professor Minford took strong

exception to this; the more conditional the rules, the less they would bite on expectations and the greater the chance of making a mistake. The simpler the rules, the better. This was followed by an inconclusive argument between Minford and Buiter about the risk of the exchange rate overshooting in response to a monetary contraction and the desirability of acting to prevent this.

24. Tim Congdon, building on some of his remarks in the morning, saw a parallel in the currency vs banking school debate. The banking system had developed over a long period, and some continuity was important. The present LLR arrangements meant that there was no risk of a banking crisis. There was a danger that a change in the control system could risk a banking failure. Ian Morison also drew attention to the disadvantages of a switch to MBC on the efficiency of the banking sector at the micro-level. It would require banks to hold additional reserves, changes in the overdraft system and end of the discount market. In effect, intermediation would be taxed. Griffiths pointed out that the banking system's record was not very good. He saw no feasible alternative to MBC that would both control money supply and allow competition.

25. Professor Miller outlined, on the basis of a circulated note, a different approach to monetary control. Any mandatory scheme imposed a tax, and since this in turn encouraged disintermediation, it would be more efficient to tax lending generally. There was a theoretical equivalence between nominal interest rate and money supply rules as a means of controlling inflation. Interest rates were preferable in view of the development of money substitutes. Courakis pointed out that this was dependent on the authorities knowing the underlying relationships. Peter Turner took the opportunity to mention his idea of using the price of negotiable entitlements as an indicator.

26. Peter Middleton, concluding the discussion, thanked everyone for coming.

M L WILLIAMS
1 October 1980

MONETARY CONTROL SEMINAR: 29 SEPTEMBER 1980: LIST OF PARTICIPANTS

Name	Institution
Professor R Alford	LSE
Professor Artis	Manchester University
J Atkins	Citibank
Professor A Bain	University of Strathclyde
Professor W Buiter	Bristol University
A Courakis	Oxford University
D Currie	London University
T Congdon	Messels
G E Gilchrist	Union Discount
D Gowland	York University
Professor B Griffiths	City University
M Hall	Loughborough University
C Johnson	Lloyds Bank
D Kern	National Westminster Bank
T Laugharne	Grieveson, Grant
S Lewis	Phillips & Drew
Professor C Foster	Coopers & Lybrand Assoc Ltd
Professor M Miller	University of Warwick
Professor P Minford	Liverpool University
Professor V Morgan	Reading University
I Morison	Inter-Bank Research Organisation
Professor W Newlyn	Leeds University
G Pepper	Greenwells
R J Petherbridge	Union Discount
G C Powell	Jersey, States Office
B Riley	Guernsey, States Office
Professor H B Rose	Barclays Bank
Professor T Rybzynski	Lazard Bros
D Savage	NIESR
Professor J R Sargent	Midland Bank
A Smithers	Warburgs
M Stewart	University College London
Professor B Tew	Nottingham University
P Turner	James Capel
B Williamson	Gerrard & National Discount
H Wills	LSE
G Wood	City University
P Wood	Barclays International Bank
W Higman	Morgan Grenfell

J S Fforde	)	
E A J George	)	
C A E Goodhart	)	Bank
A L Coleby	)	
M D K W Foot	)	
W A Allen	)	
F E Middleton	)	
A J C Britton	)	
N Monck	)	
R Lomax	)	HMT
R Culpin	)	
J Grice	)	
M L Williams	)	