

MONETARY BASE -
POSSIBLE SPEAKING NOTES FOR THE GOVERNOR
AT THE MONETARY SEMINAR, 18TH JULY 1979

1. Our present system of monetary control rests primarily on the market mechanism of flexible interest rates. Movements in interest rates affect both the demand for money and also the demand for bank credit and for public sector debt. In addition we have made use at times of more direct controls such as the present Supplementary Special Deposit scheme.
2. We have chosen to set our target for monetary policy in recent years in terms of a target for the rate of growth of £M3 . But we are not solely interested in this one aggregate or in achieving the target through 'cosmetic' means. Outside commentators quickly see through 'cosmetic' distortions to the statistical series.
3. In our view, the difficulties facing monetary policy in recent years have been primarily the result of the serious inflationary and fiscal position of the economy and of Government's repeated unwillingness to take adequate monetary steps, notably in short-term interest rates, soon enough.
4. We now have suggestions that monetary control would be somehow 'easier' or 'better' if we moved to monetary base control. The essence of these proposals is fairly simple:
 - (a) choose some set of liabilities of the monetary authorities, the supply of which is within their control;
 - (b) impose a new kind of reserve requirement on banks so that they must hold, say, £5 of these specified liabilities for every £100 of deposits. You could, alternatively, set no requirement, relying on the prudential caution of banks not to go below this 5% ratio, but let us assume there is a requirement;
 - (c) then you have a ceiling on the total of bank deposits covered by the requirements, provided you exercise your control over the size of the base.

5. In the most fundamental sense, however, nothing would have changed. Control of the base would be essentially through open-market operations by the authorities, affecting short-term rates of interest. The response by the banks could in part be institutional adjustment (e.g. curtailing the overdraft system to avoid unexpected demands for funds from customers) but would primarily involve their buying or selling short-term assets such as Treasury bills and bidding more or less aggressively for funds. To achieve a more precise degree of control than at present over the money stock over some defined time period would involve greater interest rate volatility than at present and/or greater 'cosmetic' effects on M3.

6. These 'cosmetic' effects would arise if the banks were able to meet pressure on their base by selling large quantities of, say, Treasury bills to non-banks. M3 would then fall but a slightly broader definition of money would not. Gordon Pepper, in his paper, recognises this possibility and says, if it happened, that steps would have to be taken to make gilts (longer-term debt) more attractive to non-banks: i.e. ensure a real rather than a 'cosmetic' effect by more action on relative interest rates. We have our doubts as to whether short-term debt markets could be developed as easily as Gordon Pepper suggests, at least for instruments which did have some real rather than 'cosmetic' implications for private sector liquidity. But this is an area where our minds are anything but closed.

7. Another way of looking at the issue, in particular the need for greater interest rate variation to achieve greater control, is to reflect that our present problems stem largely from the facts that:

- (a) the PSBR is beyond our control in the short-term,
- (b) the demand for bank credit does not respond quickly to changes in the cost of credit,
- (c) the demand for gilts does not respond in any easily predictable way to a change in interest rates.

None of these things would alter if monetary base control were adopted.

8. Nevertheless, there may be merit in the view that, if the authorities focus on movements in the base, then the signal indicating the need for interest rate changes would be evident earlier and more clearly than under the present system.

9. If so, we should need only a flexible (non-rigid) form of base control, i.e. one in which a fairly lengthy time-period is envisaged for regulation of the base. Strict short-term control of the base would be inflexible and probably unworkable for the reasons set out in the Bulletin article.
10. Even for such a flexible approach, however, there would be a variety of technical questions, not least being the implications of any particular scheme for the financial institutions and for the Government's methods of financial operations. There are a number of issues here worth considerable further study.
11. Let me conclude by discussing two features of our present controls which have some relevance to the monetary base debate. The first is the future of direct control which would in theory be redundant under base control. It would be nice to conclude that such controls were no longer necessary but it is premature to leave only the interest rate weapon. In parallel with further studies of monetary base schemes, there should therefore be further work on possible changes/improvements to our present direct control. This is said, however, in the full knowledge that one will never find such a control which is not either avoidable or damaging to efficiency.
12. Secondly, we should like to pursue with speed the question of the abolition of the present reserve asset ratio and the adoption of more appropriate prudential controls on liquidity which could be brought in as the Banking Act comes into force. In our view the present ratio requirement is redundant. In the view of monetary base proponents, it is critically flawed by the fact that the authorities cannot control the supply of reserve assets, as presently defined. The removal of the present ratio would be a necessary step towards any future experimentation with base control and so, from both sides, seems a desirable move.

Economic Intelligence Department
13th July 1979.

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THE GOVERNORS

Copies to Mr. McMahon
Mr. Dow
The Chief Cashier
Mr. Goodhart
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Mr. Foot

THE SEMINAR ON MONETARY POLICY

Introduction

1. We understand that this seminar will last about 1½ hours and consider two main topics:

- (a) monetary base control, and related matters;
- (b) operations in, and the structure of, the gilt market.

This note is in 2 parts. The first deals with (a) and with topics of close relevance which you may wish to bring into the discussion. It seeks to summarise the main points on base control of which Ministers should be reminded and also points a possible way ahead for the period after the seminar. In support of this note, there is also a brief summary (following very much the lines of the recent Bulletin article which those at the seminar will have had the chance to read) of what the base is and what the controversy is about. These could serve as speaking notes. In addition, there are the other rather weighty papers that have been circulated to the members of the seminar, together with our comments on them. Finally, there is a short separate note setting out the case for abolishing the present reserve asset ratio, the relevance of which will be noted below.

I. 'Bases', Ratios, Corsets, etc.

Monetary base control

2. The papers by Pepper, Griffiths and Wood all favour some form of monetary base control. Middleton's paper recommends further study of a number of possible schemes. Given this, it is desirable that Ministers should not think that the Bank's mind is closed on the subject. The recent Bulletin article went out of its way to leave discussion open on schemes which did not envisage some (unworkable or unacceptable) rigid short-term control of the base.

3. Nevertheless, it would also be wrong for Ministers to think that we find the present system of monetary control inherently defective. The strains of recent years have owed their origin primarily to the serious inflationary and fiscal position of the economy and to Government's repeated unwillingness to take adequate monetary steps, notably on short-term interest rates, soon enough.

4. Control of the base does not offer any magic new weapon. Indeed, it implies dropping any direct control such as the 'corset' and relying solely upon the interest rate weapon. But the private sector's demand for bank credit will remain as little affected in the short run by changes in short-term interest rates; and the effects of a rise in such rates on the sales of long-term gilts will remain as uncertain as they are now. Only through greater (perhaps much greater) short-run volatility of interest rates than in the past or through the development of more 'cosmetics' (for example, keeping £M3 down only through engineering sales of Treasury bills by banks to non-banks and thus - like the present bill leak - achieving control at the price of unregulated growth in a slightly broader aggregate) can base control 'improve' on the present system.

Direct controls

5. If Ministers find the prospect of sharp interest rate changes unpalatable, then the only other option that presents itself, other than much greater patience with existing methods, is some form of direct control. The present version - the corset - very adequately demonstrates the strengths and weaknesses of such an option and also the fact that the longer the control is in place the more glaring are the weaknesses. If it is laid down, however, that the locker should always contain some direct control for an emergency, the question is whether the present form could be improved upon. This is a subject to which the Bank and HMT have given much thought and will wish to give more. But it would be right to stress now that the more we think about it the more we are obliged to judge that the development of the wholesale money markets in this country, and their close linkage to the Euro-markets, renders direct control on banks an increasingly feeble and increasingly messy instrument.

The reserve asset ratio

6. Another feature of the present system to which the Bank have given thought is the reserve asset ratio. In our view it is

superfluous, for the reasons set out in the separate paper attached. With the Banking Act about to come into force, now would in any case be a good time to discuss the future of the ratio before licensed deposit-takers have to take on an obligation the monetary control value of which is so doubtful and the prudential value of which is less than it could be. But the present discussions make the time more opportune still, because to those who favour base control, the present reserve ratio has the critical flaw that the supply of reserve assets appears to be outside the direct 'control' of the monetary authorities. An essential feature of their preferred solutions is that the reserve base of the banking system be defined to cover only assets over which the authorities have such complete 'control'. The abolition of the present ratio would therefore clear the way for any future experiments with base control without affecting the efficiency of the present controls. As explained in the separate note, this step would be accompanied by action by BAMMS to establish relevant prudential norms (which incidentally, because funds with discount houses undoubtedly rank as primary liquidity, would mean that the houses would not face so uncertain a future as might otherwise seem implicit in schemes for base control).⁽¹⁾

Possible next steps in ratios, 'base', etc.

7. It would be valuable then if Ministers were to accept the prospect of a Bank initiative on the present reserve asset ratio. It remains then to ask what else can be hoped for from this part of the seminar.

8. Clearly, the conclusion of Middleton's paper - that certain schemes for base control should be examined further - will be hard to resist, albeit that enough is already known for the general merits and demerits to be apparent. Such further study will have the benefit of throwing up the tricky institutional problems they are likely to

(1) There is a further reason why it would be valuable for BAMMS' action on the prudential front in the context of the Banking Act to be raised. The various papers favouring base control tend to argue that the reserve requirement they suggest would also have prudential value. But limiting the definition of primary liquidity solely to cash and bankers' balances (the generally preferred definition of the base) is an unnecessary and unhelpful view of what should constitute liquidity for the banking system.

pose and of disabusing Ministers of any idea that the theoretical simplicity of base control carried through to the real world. (1)

9. However, it would seem more appropriate if the Bank were to take the lead in such studies, consulting others as necessary, perhaps with the aim of producing a further published paper (following the Quarterly Bulletin article) which could open the way to experimentation if thought advisable. Two points on such a line of action are, however, worth making. The first is that it would be difficult to consult outsiders on the specific subject of monetary base control - and we suggest impossible to hold any worthwhile general discussion - unless and until we were allowed to publish our willingness to abolish the reserve asset ratio and introduce the 'prudential norm'. Otherwise our hands would be hopelessly tied. Secondly, given the complexity of the issues involved it would be optimistic to look for a speedy move to a further publication on 'monetary base'. By contrast, however, we feel it would be possible to publish a document on the reserve asset ratio (leaving room for further discussion on the 'base') early in the autumn. A first preliminary draft on this, and on the future of corsetry, is under way and should be available by July 27th.

(1) One problem of particular relevance to the Bank is the question of our future income. A form of base control which required all banks to hold non-interest-bearing deposits with the Bank would provide income in the way that the clearers' balances do now. However, some schemes - such as that introduced into the discussion by Middleton - would not have such a requirement and would put even greater pressures on the clearers to end their present agreement with us.

II. Debt Management

The seminar will have before it a Treasury paper to which is annexed a copy of the Quarterly Bulletin article.

The Treasury paper comprises:

- (i) a short piece on the financing of the PSBR describing the debt instruments in use other than gilt-edged stocks and concluding that "the sale of gilt-edged is likely to remain the main form of financing the PSBR outside the banking system for as long as the PSBR is significant".
- (ii) a list of possible changes in the gilt-edged market which are commented on either by reference to the Quarterly Bulletin article or separately.

We do not dispute the conclusion at (i) above so long as it is also the case that the operational target for the execution of monetary policy is set in terms of growth of £M3.

The major issues as we see them are two: the structure of the market; and the indexation of the debt. The Treasury paper refers to the latter but not the former.

On structure, our approach has been to examine various changes in the techniques of marketing gilt-edged which could only operate successfully with a different market structure. Our conclusion has been that the benefits, if any, in terms of marketing gilt-edged are highly speculative and provide no basis on which to initiate a major change in structure; and that, in any case, the transition to a new structure would seriously impede the discharge of our responsibility so long as that remains the almost continuing financing of a large borrowing requirement.

On indexation, our present attitude to the indexation of government marketable debt is to regard it as sensible and prudent to bring ourselves to a state of readiness to make an issue, but to regard the decision to do so as only capable of being taken in a broader context as a major issue of government policy.

There remain a series of technical questions on which the Treasury paper, mainly resting on the Quarterly Bulletin, comments adequately:

(i) Methods of Issue

- (a) The public offer versus placement in the Issue Department (Treasury Annex I pages 3 & 4): Agree.
- (b) Variations on the tender theme (Treasury paper pages 4-6): Quite content to review with the Treasury the working of the minimum price tender system in a few months' time. The Treasury accept our arguments against the "auction" whether occasional or otherwise.

(ii) Market Tactics (Treasury Annex I pages 6-9)

- (a) Tap Price Tactics: with the amendments to the attached draft which I shall put to Bridgeman, the Treasury paper is satisfactory.
- (b) Frequency of New issues: content with the Treasury's comments.

(iii) Range of Securities (Treasury Annex I pages 10-13)

Content with the Treasury's comments.

We would like to secure:

- (i) acceptance that a change in the present structure could be contemplated for reasons of gilt-edged marketing only if there were very strong evidence that the second state would be better than the first;
- (ii) agreement that it will be necessary before long to issue further stocks maturing in the early part of the next century.

We would not object if:

- (iii) a full study of indexation were commissioned and that meanwhile we and the Treasury were to bring the work we have already done to a point where a decision to issue an index-linked stock could be implemented without delay.

13th July 1979.

JSff.