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E A George Esq
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Dear Eddie

DOMESTIC MONETARY CONTROL AND EXCHANGE CONTROL

At Geoff Littler's meeting on 7 September it was agreed that the Treasury would take the lead in preparing a paper on whether there was a need for direct controls as part of the authorities range of instruments for achieving the target growth for the money supply, but that we would show it to you in draft.

2. Since then the paper has become relevant to the more urgent discussion about what the implications might be for domestic monetary control of relaxation of exchange control. Peter Middleton had a meeting on those aspects particularly relating to exchange control with Doug Dawkins last Friday, following up his earlier correspondence with the Chief Cashier, and the end of the present draft reflects that discussion.

3. I ought to have a revised version of the paper awaiting Geoff Littler on his return next Monday, so that it would be available for the Chancellor on his return at the end of next week. I would therefore like to discuss the draft now enclosed with Charles, yourself and any others in the Bank interested - I am also sending copies to David Holland and Doug Dawkins - and I will ask my secretary to arrange a meeting as soon as is convenient this week.

Yours sincerely

Michael

J M BRIDGEMAN

(1) Lumps together diff types control / EC relates to w/sd.
(2) Implies too much case against it rest on EC abolition
(3) Mixes up mon. base discussion — some forms.

CAEG 8/10 3

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J M Bridgeman
Under Secretary

24 September 1979

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DIRECT MONETARY CONTROLS

Note by HF Group

Introduction

1. This paper considers the advantages and disadvantages of complementing the general policy instruments available to the domestic monetary authorities with more specific instruments related to the size, structure or components of the balance sheets of particular institutions, usually banks but not necessarily so. The general policy instruments, namely variations in fiscal policy (and hence the PSBR), changes in interest rates, brought about either by changing MLR or through open market operations, and intervention policy, seek to keep the growth of the money supply within a target range by effecting the general supply and demand for liquidity and credit: they affect particular institutions only through those changes in market conditions. The specific controls go beyond this by requiring each institution to observe some quantitative limitation on its balance sheet, whether expressed as a ratio or as an absolute amount. The present controls in this form are the reserve asset ratio with special deposits, and the Supplementary Special Deposit scheme. In the past there were bank lending ceilings from 1965 to 1971. ~~The various types~~ of monetary base control which has been suggested also come into this category.

2. The paper goes on to consider the practicability of having such direct controls if the exchange control over outward

portfolio control is relaxed.

3. The need for direct controls is discussed in the paper in relation to the ability of the authorities to achieve a target for £M3, although broadly similar arguments would apply if the target were specified in relation to another, broad monetary aggregate (but not, or at least not with such force for M1)

Not really for M1.

The Limitations of General Policy Measures

4. The authorities face a number of problems in achieving a £M3 target, over a period significantly less than a year if they rely on general policy measures alone:-

i. the PSBR is difficult to forecast and to control in the short run: policy changes, whether in taxation or expenditure, take time to take effect - (announcements of planned changes in the PSBR can nevertheless have important effects on expectations and so on monetary growth before the PSBR itself changes);

ii. the rate of increase of bank lending also fluctuates from month to month: the effect of interest rates on bank lending is substantially lagged, and difficult to isolate empirically;

iii. in recent years the authorities have been able to secure substantial gilt sales over periods of a year or so [a few months]; but with existing gilt market

EAJG

techniques at least, it is difficult for the authorities to secure an even or predictable flow from month to month;

iv. the effects of external factors are difficult to predict and to control. For example, as we have seen in recent months, there can be substantial external effects on the money supply even when intervention is relatively modest.

5. These factors together mean first that there can be considerable fluctuations in the rate of monetary growth from month to month, even after seasonal adjustment, and second, that there can be a substantial lag between a policy change and its impact on monetary growth, effects through expectations apart. The combined effect makes it difficult for both the authorities and markets to assess month by month the underlying rate of growth and whether general policy measures already taken will be sufficient to bring the growth of the money supply within the target range. If reliance is placed solely on the general policy instruments the authorities can probably only reasonably aim to achieve a desired rate of money supply growth over a period of a year or so.

6. If it were not for the problem of expectations it is unlikely that fluctuations about the desired trend - which offset themselves over the year as a whole - would have much

effect on either output or prices, since the effects of monetary factors are thought to be lagged and diffused over a period. But the effect of such a divergence on expectations can undermine this conclusion. If for example, the underlying rate of monetary growth appears to be higher than the target range and the authorities take action to correct it, the market may become sceptical after a time about whether that action will prove sufficient. Such scepticism by the market may itself aggravate the situation, for example by causing a hiatus in gilt sales. It may as a result be necessary for the authorities to take further action to counter those expectations, so leading to a greater change in interest rates or other policy measure than the authorities originally thought necessary: this "overkill" would probably have to be reversed later, as it led to too low a rate of growth in the money supply.

7. The risks of this happening should reduce as the market's confidence in the authorities' intentions grows, eg as successive targets are met. Thus monetary growth in Germany was for some years significantly greater than the published targets without casting doubt on the Government's determination to control inflation. But the importance of the Government being seen to achieve its monetary targets is not confined to financial markets if, as now, the Government uses monetary policy as its main weapon against inflation, since the speed and extent to which it will affect the rate of inflation depends on affecting expectations generally.

The Case for Direct Monetary Controls

8. In these circumstances, the case for having some more specific control or controls is:-

i. they may cause banks to act on bank lending through "rationing" customers as well as through the general effects of interest rates;

?

Is this part of case for? Inefficiency. Disintermediation but lower interest rates

ii. they may generate the changes in market interest rates necessary to achieve the monetary target more reliably than the authorities themselves either can, or are likely to;

Not so in most cases. What does this mean?

iii. they can effect a wider range of interest rates, than/can be affected by the general instruments, and in particular they may be able to affect relative interest rates;

No

Yes, but the result may be, (is intended to be?) cosmetic.

iv. by reinforcing market confidence that the monetary target will be achieved they will reduce the risk of hiatuses in gilt sales, and so tend to bring forward in time the effect of general policy measures on the growth of money supply;

Perhaps, but announcement effects will decay over time, particularly if direct controls erode.

Omits the main advantage that Govts see in that it may for a time allow M to appear to be met with lower interest rates.

v. this should produce a steadier rate of growth - say from quarter to quarter - and help the effect of monetary control on expectations in the economy generally.

Largely cosmetic

9. Moreover, there is a prima facie case for thinking that if the authorities had more policy instruments at their disposal it might be easier to reconcile different policy objectives at times when they conflict, for example those relating to external and domestic monetary policy.

e.g. see Bastiaanse, but case is difficult to make clearly, but is a fair point

10. Although direct controls are expressed in quantitative form they are not an alternative to interest rate changes and indeed work primarily through changes in interest rates or their relativity. The main technique available to banks who wish to reduce their lending to the private sector is to increase their lending rates; there is only limited scope to ration lending especially given the normal partial utilisation of existing facilities. As borrowers turn to parallel markets, either because of changes in banks interest rates or because of restriction of facilities, the increase in interest rates will spread throughout the financial system. Thus, for example, the SSD scheme has its impact through changes in relative interest rates, with bank lending rates and rates on public sector debt both rising relative to bank deposit rates. Similarly, as the Bank economists made clear

in their Bulletin article, a monetary base control would operate by triggering interest rate changes: indeed, many of its advocates see this as its primary aim.

11. The inherent fluctuations from month to month in the main components of money supply growth, especially public sector borrowing, bank lending and external factors, mean that any attempt to achieve a smooth path for monetary growth from month to month would either be impracticable or could only be achieved by violent swings in interest rates as the banking sector would be forced to absorb the fluctuations arising elsewhere, subject only to what is said below about a safety valve through "disintermediation". There is therefore a trade off between interest rate variability and the time period over which it is intended to smooth changes in the growth of the money supply; the exact trade-off will depend on the particular control, eg the present SSD scheme relates to a 3 month moving average. But there would seem to be a reasonable prospect of direct controls enabling the authorities to achieve control over a period of 6 months, and possibly less.

Which

The Limitations of Direct Controls

12. The major problem with any form of direct controls is that it leads to the financial system developing alternative channels for funds outside the control - this both reduces the efficacy of the control as an instrument of macro-economic

policy and reduces the efficiency of the financial system, and possibly can cause prudential problems. The direct ceilings on bank lending in the 1960s led to the development of the secondary banks. The present SSD scheme is leading to increased holdings of bank acceptances outside the banking system. A monetary base control [Depends in large part on the form of the control] is likely to have a similar effect - at times of pressure banks will have to widen their margins between borrowing and lending rates to cover the cost of bidding for base assets, and so create the opportunity for disintermediation.

13. The result of such disintermediation is that the effect of the controls on liquidity and credit will be much less than their effect on the monetary statistics eg £M3 and DCE. For example a company will find a bank acceptance, which is outside £M3, virtually identical as a liquid asset to a bank Certificate of Deposit, which is included in £M3, while a borrower will find a bank accepting his bill little different from a short term loan. The extent of such avoidance is likely to be the greater, not only the longer and harsher the controls are biting, but also the more sophisticated is the financial system. Thus the present scope for the development of non-bank credit channels is probably much greater than in the late '60s, when relatively crude ceilings on bank lending were imposed. It is probable that direct controls are now unlikely to have a sustained effect on the availability of credit, except to individuals and some [un]incorporated businesses.

14. Such disintermediation can, in some circumstances, be an advantage. This is because it may enable the monetary statistic to respond far more rapidly to the control, than could the underlying conditions: disintermediation effectively provides a "safety valve" for the banking system, enabling it to adjust to the control without enormous changes in interest rates. To the extent that the rapid response of the monetary statistic affects expectations, it can in turn generate substantive effects eg through gilt sales or the exchange rate.

15. However, the market would eventually see through any attempt by the authorities to control £M3, which relied heavily on the cosmetic effects of disintermediation. The result would inevitably be to discredit the target range for £M3, and so to undermine the policy of which it forms a critical part.

16. We probably have not yet reached that stage with the SSD scheme with the acceptance credit avoidance. We, and the market, are aware of the volume of bank acceptances held outside the banking system and are accordingly able to make some adjustment to the recorded growth of £M3 when assessing monetary conditions. Moreover the acceptance credit market has been long established and its growth causes little if any damage on the institutional structure.

17. It does however demonstrate that it is impracticable to block such disintermediation through extending the boundaries of a control. If bank acceptances were brought within the SSD control, the business would be channelled into the growth of non-accepted bills or trade credit on which we do not have information. Thus any measure to limit the growth of acceptances would, by giving an incentive to other forms of disintermediation, reduce our information about monetary conditions as well as moving the problem beyond the sight of the Bank's supervisors.

18. Direct controls also reduce the efficiency of the financial system since they inhibit competition between controlled and non-controlled sectors, and possibly within the controlled sector. For example a monetary base control applied only to the banks would prevent them from competing on even terms with other financial institutions and (in the absence of exchange controls) overseas banks. The SSD scheme has a particularly marked impact on competition as it effectively allocates market shares in respect of a substantial proportion of the banks' business.

19. The disintermediation caused by direct controls can also lead to other problems. For example, if the alternative channels are not opento some sectors, such as unincorporated businesses, there will be distortion in the allocation of credit. Again, in the case of bank acceptances as the volume

of bills outstanding increases, their quality will deteriorate and the capacity of the market will be stretched. Costs will increase, even for prime borrowers. If new markets develop, the lack of prudential supervision could lead to problems. These various problems will become more serious the longer a control bites sufficiently to offer an incentive for disintermediation; and will not necessarily unwind when the control ceases to bite or is removed.

The Effect of Possible Changes in Exchange Control

20. The prospective ending of most, if not all exchange controls however literally introduces a new dimension into the problem of disintermediation. At present, there may be some disintermediation overseas, but the extent is limited by the exchange control rules preventing UK residents from holding sterling bank deposits outside the UK and placing limitations on UK residents borrowing in sterling from overseas. But if these rules were relaxed, a bank facing a squeeze in the UK could simply persuade some of its major customers to switch their deposits to or borrow from an overseas affiliate. This could all be done from London at the stroke of a pen and the additional costs involved would be negligible. The slight widening of margins between borrowing and lending rates by UK banks in these circumstances would also create an opening for foreign banks, not subject to such controls. (The authorities

in the US and Germany are already viewing with some alarm the recent substantial increase in offshore business by banks in those countries wishing to avoid onerous reserve deposit requirements.)

21. The euro-sterling market (currently about £6 billion) is likely to grow anyway, and this process may be hastened by the ending of exchange controls. If there were not any direct domestic monetary controls, it need not present a significant danger to domestic monetary control: there would be no immediate incentive for UK residents to use the market to place sterling which they wanted to hold again for domestic purposes, and to the extent that they did it would be susceptible to the effect of the general monetary instruments - PSBR, gilt sales, interest rates etc. However, if there were direct monetary controls, there would be an incentive for UK residents to use the euro-sterling market for sterling held for domestic purposes. The interest rate sensitivity of large deposits in the domestic market suggests that the scale of disintermediation is likely to be such as to negate almost completely the substantive effect of the control. At the same time, it would not be possible to identify how much of the growth of the euro-sterling market was due to this factor - we would not know how much should be regarded as effectively an extension of the domestic money supply.

22. It would not seem practicable to avoid such disintermediation through euro-sterling either by retaining some exchange controls, or by some monetary control. The Exchange Control Act power under which holding sterling overseas is controlled is a somewhat indirect one, and it is doubtful whether it could be used in isolation to control sterling bank deposits overseas. Moreover even if it were possible to maintain the rate against overseas sterling bank deposits by UK residents, it could not be enforced without retaining much of the existing arrangements for monitoring payments overseas for all purposes. Even thenit would be easily evaded by multinationals and others placing deposits through overseas affiliates. The alternative of the Bank asking UK banks not to avoid domestic monetary controls by switching domestic business to overseas affiliates would probably be respected by UK owned banks, but would leave the way clear for foreign banks - it would place UK banks at a disadvantage without stopping the loophole.

23. The other costs of disintermediation would also be much greater if it went through the euro-sterling market. It would represent not just a diversion of business away from usual banking channels, but also away from the UK financial system - admittedly some of it to subsidiaries of UK banks. It would add to the potential prudential problems of the euro-markets.

Conclusion

24. The potential advantage of direct monetary controls is that they may enable the authorities to produce changes in the rate of growth of the £M3 statistic more quickly - say over 6 months rather than 12 months - and, possibly, with less risk of needing to over-react with movements of interest rates or changes in the PSBR, than if the authorities relied solely on general policy instruments. They may therefore speed the ways in which monetary policy affects expectations. Their disadvantage is that the "disintermediation" to evade the control, which is an inevitable consequence of such controls, can reduce the effect of a given restraint of the statistic on the rest of the economy, can risk bringing the target into disrepute and can cause inefficiency in and, possibly, prudential risks for the financial system.

Erosion of effect, on/off problem, self-deception with interest rates too low.

25. It is not possible to say in abstract where the balance of advantage lies - the balance depends on the instrument involved, the circumstances of the time and, in particular, the role which domestic monetary policy is playing in overall macro-economic policy at the time. The present SSD scheme may well be nearing the end of its useful life - over time its effectiveness has decreased as ways round it have developed, and its costs have increased. If it were not for the changes in exchange control, a monetary base system might have offered on balance worthwhile advantages, especially given the

importance of monetary policy to the present Government's counter-inflation policy: the detailed examination of particular schemes commissioned by Ministers from the Bank and Treasury is designed to establish whether this is so.

26. But the relaxation of exchange control would seem to shift the balance decisively against direct monetary controls, by introducing a further, and readily accessible means of disintermediation, which would make the controls ineffective. Banks near the penalty zone in the SSD scheme would tend to shift some business offshore. Similarly under a monetary base scheme, at any time when bidding for additional base assets appeared too costly, they would shift business overseas: the monetary base would then not be an effective means of triggering significant shifts in domestic interest rates.

27. The corollary of a decision to dismantle exchange controls would therefore appear to be forgoing the possible, but far from unmixed, benefits to domestic monetary controls of a direct system of control, whether the existing SSD scheme or possible monetary base system.