

Covering S E C R E T



From PDI 1 200

Prime Minister

*Even allowing for
the reintermediation, this
is very worrying.*

Treasury Chambers, Parliament Street, SW1P 3AG
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1 August 1980

12

T.P. Lankester, Esq.,
No.10, Downing Street

1/8

Dear Tim,

MONETARY SITUATION

When the Chancellor spoke to the Prime Minister yesterday morning, he promised her a note on the current monetary situation for her weekend box. This is attached.

yours

John

A.J. WIGGINS

*Travis have
changed it - make
it less bland*

12

1
*am a little
worried about the
last sentence of the
draft refers to
News Agency
ref.*

JULY MONEY SUPPLY FIGURES

4 The preliminary analysis of the monthly returns for banking July show that £M3 grew by £2.9 billion (5.0%). An indication of this figure will be given by the Bank to news agencies, in the normal way, at the same time as the publication of the Eligible Liability figures at 2.30pm on Tuesday, 5 August. The full figures, together with the analysis of counterparts, will be published on Thursday, 14 August.

2. The Annex to this note sets out the main counterparts of this growth, as currently estimated, and compares them with the average of the last four months, as well as setting out the cumulative position in the first five months of the current target period. The figure of the growth of the money supply could change slightly - by perhaps up to $\frac{1}{4}\%$ - before the final figure is published on Thursday week: the figures for counterparts could change by more as the analysis of the returns is completed.

3. As the following paragraphs on particular elements bring out, the very high figure for banking July is due to some combination of:-

- i. reintermediation, that is bringing back onto banks' balance sheets business which was diverted during the operation of the SSD scheme, without actually affecting underlying monetary conditions: the most clearly identifiable example of this is the bill leak which has unwound to the extent of £1 billion during banking July;
- ii. the adjustment by banks of their balance sheet structure following the end of the SSD scheme: the proportion of banks' balance sheets lent to the private sector has been growing, and that lent to the public sector falling, for some time. The banks significantly increased their holdings of Treasury bills, gilts and local authority debt during the month;
- iii. a blip in monetary growth: for example, there now appears to be a well established 3 monthly cycle in the level of

bank lending to the private sector, and July was another high month in that sequence.

It is impossible to say precisely how much each of these elements contributes to the total, or indeed whether the underlying rate of monetary growth is also running above the top of the target range. We may learn some more about the extent of reintermediation from the discussions which the Bank is currently having with individual clearing banks about their figures, and from further analysis of the returns generally. Any conclusion about the underlying trend must similarly really wait for the banking August figures. However, as explained in the paragraph below on the development of other aggregates, there are some grounds for disquiet.

Main Developments in the Counterparts

4. The Central Government Borrowing Requirement was exceptionally low in banking July at £0.4 billion (the calendar month figure to be published on 11 August was only a little higher at £0.8 billion). There will however be a further high figure for the CGBR in banking August, partly because of the effect of the income tax refunds affecting the payments from employers to the Inland Revenue during the month.

5. The take-up of central government debt, particularly gilts, outside the banking system was much lower than had been expected, given the very high gross gilts sales by the Issue Department. The banks appear to have increased their holdings by £0.6 billion, a much larger amount than had been expected: this is an important element in the restructuring of banks' balance sheets referred to above. The overseas take-up of gilts (£0.3 billion) was relatively modest. The non-bank sector's holdings of other public sector debt was reduced during the month, largely because of the extent to which the banks were bidding for Treasury bills, probably partly as a result of the pressure on reserve assets ratios.

6. Banks lent £0.6 billion to the rest of the public sector during the month, overwhelmingly to local authorities. We have not yet any basis for

telling how far this was a form of "reintermediation", in which the banks were bidding short term local authority debt away from non-bank holders, and how far it was the result of a high local authority borrowing requirement during the month. We may have a better idea of this when we have the results of the local authority borrowing survey for 31 July.

U 7. Sterling bank lending to the private sector was at a record level of £2.4 billion. However, the bill leak was reduced by £1 billion, so the adjusted figure is only £1.4 billion. This is very much in line with the peak levels of banking January and banking April. Unless there is a significant further element of reintermediation which we have not identified, therefore, this figure indicates that the level of bank lending is continuing at about its recent level, rather than declining. The increase in clearing bank lending (not seasonally adjusted) was £2.2 billion. Of this £1.3 billion was to manufacturing industry - a phenomenal increase of 21% of the stock outstanding in one month. The other major sector for which advances increased was the service sector though their increase was only some 6%. The increase in personal lending of just over £0.1 billion was more than accounted for by interest debited to accounts.

8. Sterling lending to overseas was also high (£0.7 billion): it would appear that this too included some element of reintermediation.

U 9. Taken together, these elements made DCE £3.7 billion, very little less than the total for the four previous months taken together.

The Other Aggregates

10. All the other monetary aggregates appear to have risen sharply in the month also. M1 rose by nearly £1 billion or 3.6%: this follows a run of months over which it had, on average, hardly moved at all. More significantly, measures of private sector liquidity which are less distorted by reintermediation also rose strongly. The narrower measure, PSL1, which is £M3 together with non-bank holdings of bills and of short

S E C R E T

- 4 -

term public sector paper, is estimated to have risen by 2.2%. This had been rising more rapidly in recent months than £M3, because of disintermediation, so since February its annual rate of growth has been just over 20%. The wider measure of private sector liquidity, PSL2, which also includes deposits with building societies, rose by nearly 2% in the month bringing the rate of growth since mid-February to about 17% per annum. It is the fact that these other measures, less affected by disintermediation and now reintermediation, are all growing fairly rapidly which gives cause for concern that not all the growth in £M3 this month was due to special factors, so underlying monetary growth may be exceeding the target range.

The PSBR

11. The PSBR in the first 3 months of the financial year is now estimated to have been £5 billion - subject to an error at this stage of plus or minus £250 million. This is significantly more than half the Budget estimate of £8½ billion/. ^{for the year} There are some grounds for thinking that this year the PSBR will be even more front-end loaded than last year, when one third of the final borrowing requirement was borrowed in the first 3 months - one element in this is the retiming of PRT which has removed £0.7 billion of receipts from those months, while because of the rising trend, receipts in the rest of the year are expected to be over £1 billion above what they were last year. A similar point arises on the forward oil sales, where BNOB is now delivering oil against the advance payments made in March. That said, the forecasters now consider that their central estimate for the PSBR this year has risen by rather more than £1 billion since the Budget. The largest elements in the change are additional supply expenditure of £0.4 billion, and a reduction in the estimate of excise duty revenue of like amount.

Conclusion

12. A large element of the exceptional increase in the money supply in banking July was almost certainly due to reintermediation, and other

- 4 -

S E C R E T

- 5 -

adjustments to the structure of banks' balance sheets following the end of the SSD scheme. This will almost certainly be accepted by the markets. The point will also be made that while it is difficult to interpret the data, and so to identify the underlying rate of monetary growth, it would be premature to conclude that the underlying rate was outside the target range. The market may well be willing to suspend judgement on that, so that any adjustment in market interest rates and the exchange rate will not get out of control in a way which forces the authorities' hand. But there must be a very real chance that the August figures would confirm the grounds cited above for concern that the underlying growth is too high.

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RECENT BEHAVIOUR OF £M3 AND ITS COUNTERPARTS

£ billion, seasonally adjusted

	Average banking March-June (4 months)	banking July	Cumulative banking March-July (5 months)
Central Govt. Borrowing Requirement	+0.71	+0.42	+3.27
Purchase of Central Govt. debt by non-bank private sector (increase:-)	-0.59	-0.41	-2.78
of which: gilts	(-0.55)	(-0.55)	(-2.76)
other	(-0.04)	(+0.14)	(-0.02)
Net other public sector	+0.05	+0.58	+0.79
Sterling bank lending to:			
private sector	+0.70	+2.43	+5.22
overseas	+0.10	+0.66	+1.08
Domestic Credit Expansion	+0.98	+3.68	+7.58
External and foreign currency finance adjustment	-0.28	-0.42	-1.56
Net non-deposit liabilities, etc.	-0.14	-0.34	-0.89
£M3	+0.55	+2.92	+5.13
% increase	1.0	5.0	21.0*

Memo item

Sterling bank lending to the private sector plus "bill leak"	+0.86	+1.43	+4.88
PSL1 (% increase)	1.4	2.2	20.7*
PSL2 " "	1.2	1.8	16.8*

*at annual rate

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non-bank lending

PSL1 = M3 + T3 + bills + acceptances

PSL2 = PSL1 + lending

reserves

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DRAFT RELEASE TO NEWS AGENCIES - 2.30 pm, TUESDAY, 5 AUGUST

A Bank of England spokesman said that preliminary information suggested that £M3 (seasonally adjusted) may have grown by about 5% during the month. This figure may of course need to be revised in the light of subsequent information.

The spokesman commented that the July figures were massively exaggerated by the unwinding of distortions within the financial system that had built up over the period of operation of the Supplementary Special Deposits Scheme (the "corset"). As one example of this, provisional information indicates a fall in the volume of bank acceptances held outside the banking system equivalent to about one third of the recorded increase in £M3. Other forms of post-corset adjustment cannot be measured as precisely. But there appears to have been a correspondingly large increase in the banking system's claims on the public sector which had been run down through the corset period; and there may also have been some switching of foreign currency or offshore sterling transactions back into domestic sterling associated with the ending of the corset.

While it is difficult to interpret the data, and thus accurately to identify the underlying rate of monetary growth, the authorities have **no** reason to conclude that the July figures represent a sudden upturn. ?

THE MONETARY CONTROL SEMINAR

Introduction

1 There is no fixed timetable for the day's proceedings; we would, however, hope to cover most of the subjects raised in paras 2-9 below (ie to discuss various aspects of the debate on monetary base control (MBC) in theory and in practice) in the morning sessions.

The time horizon for monetary control

2 The first issue is the period over which control is sought. Is there general agreement with the view expressed in the Green Paper that month-by-month control is not essential and that it is doubtful in any case whether any form of control could act with such precision?

3 We would then like to discuss the way in which MBC works and to clarify the implications of MBC for the behaviour of banks. In particular would MBC affect the volume of funds that banks were willing to provide at any given price? In this context, the Group might consider the views put forward by Dr Mervyn Lewis in the attached paper (to be published shortly in *The Banker*). Is the distinction he draws between retail and wholesale banking a valid one? Would the banks respond to control of the base in the way he suggests?

4 This naturally leads into questions about the implications of MBC for interest rates. We would welcome views on the implications of achieving a given monetary target by MBC rather than the present methods. Would interest rates on average be higher or lower; and would the volatility of interest rates be increased or reduced?

Mandatory forms of MBC

5 The discussion might then move on to mandatory forms of MBC. Having set a mandatory minimum then (except in a system of lead accounting) it is argued in the Green Paper that the authorities

would have to ensure that sufficient base was in fact available at the time when the requirement was to be met. Is this agreed? If so, the main issues then concern the methods by which it would be made available and the interest rate at which assistance was given. What would be the role of the authorities' judgment and what the role of the market in setting interest rates under such a system?

6 A mandatory system has been criticised as inequitable, implying a discriminatory tax on banking. It has also been suggested that disintermediation could occur in response to mandatory MBC as it did in response to the corset. Do these arguments point towards a non-mandatory form of MBC, at least as the better option to consider for the long term, if some form of MBC is favoured?

Non-mandatory MBC

7 A non-mandatory MBC would probably involve more fundamental changes in the structure of financial markets. We would welcome discussion of the nature and the extent of these changes.

8 A non-mandatory control works only if the demand for base has a predictable relationship to the money supply over an operationally relevant time period. But varying degrees of liquidity would also be offered by Treasury bills, etc, even if these assets were no longer rediscountable at the Bank of England. Would the existence and variability of the stock of such assets complicate any relationship between the base and money? If so, does it carry implications for debt management policy under a non-mandatory regime, either because of the implications for banks' likely demand for base or because we should take account of the size of the stock of near-money assets created by central government and other borrowers in assessing monetary conditions?

9 Most forms of MBC would involve to some degree a modification of the lender of last resort facility. It has been suggested that some form of 'half-way house' could be devised, which might limit rather than abolish lender of last resort facilities (and so preserve many of the characteristics of the present system) while still moving towards the principle of non-mandatory MBC - that cash

is a distinctive asset which banks will feel the need to hold in some predictable relationship to their deposits. Is such a half-way house possible on either a theoretical or practical basis? What would be the implications for the structure of financial markets and for the main borrowers and lenders?

Broader issues

10 We would like then to broaden the scope of the discussions and to consider briefly some of the general issues in the debate over rules versus discretion in the conduct of monetary policy.

11 In this context, we might consider the system of automatic interest rate adjustments outlined in Chapter 5 of the Green Paper.

12 There will also be an opportunity for members of the Group to raise other issues relevant to the debate over monetary control. We do not expect clear conclusions to emerge but we do hope for some indication of the range of views on the direction in which monetary control methods should develop.

IS MONETARY BASE CONTROL JUST INTEREST RATE CONTROL IN DISGUISE?

Is monetary base control merely "a means for the markets to generate the interest rates necessary to bring the rate of growth of the money supply back towards the desired path" (Green Paper - our emphasis), or is it something more? If the former, most of the participants to the flagging monetary control debate could eventually reach some form of accommodation, in which interest rates are left more to market forces. Many of the critics of present monetary policies really wanted no more than this in the first place.

The idea that control of the money supply via the monetary base is different from interest rate control was stated forcibly by Milton Friedman to the House of Commons Select Committee (as reported in The Observer, July 6):

"Direct control of the monetary base is an alternative to interest rates as a means of controlling monetary growth. Of course, direct control of the monetary base will affect interest rates, but that is a very different thing from controlling monetary growth through interest rates."

If monetary base control is different, we must ask how it works and provide a frame of reference for evaluating its costs and benefits vis-a-vis interest rate control. Our concern is with the behaviour of the banking system, for this is where the money supply problem currently exists.

Base money (alias high-powered money or simply cash) is important to the banking system because it is the ultimate means of payment. Convertibility into cash is one of the characteristics expected of deposits which are treated as 'money', while transferability in the settlement of debts and to make payments is a distinguishing feature of banking services. In an overdraft system, transfers can also be made from accounts in debit, so that liquidity services are provided on both sides of the balance sheet. Banks can be

visualised as purchasing primary securities, pooling them to eliminate risks and combining them with capital, labour, materials and high-powered money to create 'liquidity'. High-powered money has the role as an input into banks' production function.

How much high-powered money is required by the banks depends on the nature of the production process and on institutional arrangements. Banks providing liquidity services face uncertain demand for cash from deposits and from loans where there are undrawn facilities or open credit lines. They are able to employ the law of large numbers to keep cash at low levels, but cannot eliminate the need for cash completely. As a bank lends or invests, the loss of cash puts it in a position where any subsequent deposit withdrawals or loan demands may necessitate sales of securities at a loss or interbank borrowings at unknown rates. These possible costs must be balanced against the benefits of increased income. In this way, the availability of cash limits banks' acquisition of non-cash assets.

Control of the money supply is exercised by restricting the quantity of the factor of production, base money, to the banking industry. Since the monetary authorities have a monopoly over the production of this factor input, they can make it available in less than perfectly elastic supply: in the limit, the supply could be made perfectly inelastic. Banks are then in the same position as firms in any industry for which the inputs required for production are available only at sharply increasing cost. For an individual bank, the restriction of the supply of base money imposes an external cost as banks in the system expand deposits and bid for reserves. (Each bank's supply response is a mixture of a movement along a short-run cost curve and a shift of that cost curve as rising factor prices impose an external pecuniary diseconomy.) An individual bank can react in a variety of ways: by bidding for inter-bank funds, raising deposit (and loan) rates, improving services, cutting back on new facilities, cancelling or reducing existing facilities, selling CDs, disposing of bills or bonds. The route actually chosen will be the one most profitable to the bank.

One immediate difference from the interest rate mechanism presently operated is the involvement of the banks. Following the removal of the corset, the banks are now almost passive spectators in the process of monetary control. In response to an increase in MLR, their 'job' is to raise base rates in line (which they have done), but that is about all. The Bank of England, as it were, appeals directly over their head to the public's demand for credit. In the meantime, the banks can continue to push out facilities with relative impunity. If borrowers are not daunted by the higher interest rates, the banks could conceive their job to include bidding for deposits and reserves to sustain any expansion of advances. Monetary base control, by contrast, impinges directly upon banks' decision-making and provides a pecuniary incentive for them to participate in the process of adjusting their balance sheets to the dictates of monetary policy.

A second difference concerns the adjustment mechanism, which, under monetary base control, would be chosen by the banks on profit-maximising grounds. At present, the form of the adjustment (eg interest rates operating upon credit demand) is chosen by the authorities. If that fails, the authorities must either raise rates further, or wait for credit demands to subside. Until the latter eventuates, banks are supplied with cash to prevent them running out of reserves. Left to themselves, banks could well choose to respond to a reserve shortage in the same way - by raising deposit and loan rates. Should interest rates fail to restrain the demand for money or credit, this could not be the end of the matter. A reserve deficiency would still exist and banks would be forced to try something else. Some assurance would exist that the adjustments would proceed until monetary growth came into line. The idea that there is some new breed of banker who will always eschew asset management for liability management is patently false. If interbank rates are bid up high enough, it would pay some banks to sell bills and bonds to the private sector in order to obtain funds for lending out in the interbank market. Liability management is allowed to succeed because the Bank provides the reserves needed to validate deposit expansion.

Perhaps the most important difference is in terms of the implications for behaviour next time round. Once banks are forced to make up reserve shortages by borrowing interbank at 'penalty cost' or by

selling securities at a loss, they are likely to exercise much greater care in future when granting facilities and open credit lines. Unused facilities are a valuable source of liquidity to customers, and banks might, in different circumstances, be expected to vary the 'price' for this service. There would also be an incentive for banks to refrain from lending and build up reserves when reserve shortages are anticipated. Accordingly, surges in monetary growth may be less likely to occur.

In this description, monetary base control is qualitatively different from interest rate control. At the aggregate level it operates by imposing a quantitative restriction upon banks' intermediation. This is translated directly into individual banks' profit calculus. Both the initial response and subsequent adjustments are determined by market forces, and the rewards and punishments these forces give to banks would seem very considerable benefits indeed. Unfortunately, it is not as easy to be clear about the possible costs.

For restraint upon cash to be an effective control device, it is not enough that its supply be inelastic, as is witnessed by the idea of using negotiable licences to control banks' deposit expansion. As with base money, the supply of negotiable licences would be monopolised by the authorities. As banks expand beyond allowable limits, variations in the market price would raise costs against individual banks. Yet it is generally agreed that such a scheme would encourage banking to be done outside the controlled area - particularly in offshore markets. Would the same consequences follow from monetary base control? If banks' holdings of base money were involuntary, as under a reserve requirement, this might well be the case. But we have argued that banks' demand is a voluntary one based on a production function for liquidity services, not an arbitrary restriction upon an institution designated to be a 'bank'. Institutions in the Eurosterling market (not that such a market can really be said to exist, thanks to the Bank of England) which provided substitute liquidity services, would require inputs of high-powered money, just as is the case in domestic markets. What competitive advantages would they have over domestic banks to be able to attract the deposits and reserves needed for liquidity production? Much the same question must be asked of the idea that non-banking intermediaries in domestic markets would provide substitute liquidity services.

But are liquidity services the distinguishing characteristic of money? If they are, then perhaps one-third of £M3 should be excluded from the definition. This is a conservative estimate of the amount that represents wholesale funds of the non-bank private sector, much of which is held in banks which specialise in wholesale banking. This type of banking differs substantially from retail banking, which is the model outlined earlier. Retail banks exist by producing liquidity services; they endow claims with attributes of capital certainty, convertibility and transferability. The economic basis of wholesale banking is to lower transactions costs in markets for corporate borrowing and lending and to intermediate within the term structure of interest rates. In contrast with retail banking, in which virtually all deposits are in sterling and withdrawable on demand (or at very short notice), wholesale deposits are for various maturities and in a variety of currencies. Unlike retail deposits, where each bank may have millions of small accounts, to which the law of large numbers can be applied, each bank in wholesale business may have only a few hundred large accounts and is not large enough, relative to the total market for wholesale funds, to apply the same principles.

Because the economic basis of wholesale banking is different and the balance sheet structure differs, a different 'production process' applies. A substantial degree of matching of currency and maturity is the rule, even when, with non-bank business, substantial maturity transformation occurs. (Maturity transformation in sterling wholesale banking is only slightly less than that which now occurs in Euro-currency business.) A critical role is played by the interbank market in 'reconciling' the public's preferences with those of the banks. Funds are channelled from ultimate lenders to ultimate borrowers through several banks. What begin as short-term deposits finish up as rollover loans of several years' duration. Each bank is mismatched, but not to any great extent, and no one bank is left with a large share of the transformation. This is in marked contrast to retail operations, in which the transformation is undertaken fully by the bank accepting the deposits. It follows that the Bank's proposals about prudential liquidity, with the higher requirements in interbank funds, strikes at the heart of wholesale banking, and indicates a failure to understand this type of intermediation.

Our immediate concern, however, is that, for wholesale banking activities, there is no demand for base money. In this sense, much of the British banking system has already progressed to a cashless society. Even the concept of a reserve ratio has little meaning, for the demand for marketable securities (bills, CDs) to cover an open position depends on the mismatching, maturity by maturity, not upon any scale measure of the total balance sheet.

Restraint upon the supply of base money will curtail retail banking and those substitutes for retail banking which involve the production of liquidity services using inputs of high-powered money (or, in a pyramid of credit, claims against retail banks). If, as we have argued, wholesale banking involves different services and different production processes, it is unlikely to be constrained directly by monetary base control. The vital question, then, is, should it?

Analogies are helpful, but which is the correct one? At one extreme, we could, as Friedman does, liken the production of money to that of motor cars, with high-powered money like steel. Steel is a vital and irreplaceable input to the production of motor cars, at least in the short run. By restricting the supply of steel, control could be exercised over the production of motor cars, even though there are different brands and different models. Alternatively, we could envisage money to be like containers. There are several different types of container (steel cans, glass, aluminium, plastic) and many different production processes involving quite different inputs. Each type of container, and its associated input, has its distinctive merits, but all can be substituted at a price. Is the same true of different forms of banking and finance more generally?

Thus the monetary control debate is really a debate about the first principles of monetary economics. Is the aim of monetary policy to control something special called money, or is it to control all borrowings and lendings and all forms of financing in the economy? In the latter case, the Bank's interest rate policies are clearly appropriate. But if money does have a special place, it is unnecessary and inefficient for the Bank to control all borrowings and lendings

when a more direct means of controlling the relevant money supply is available. Monetary base control will involve interest rate variations as a by-product or as a means to an end, but it may not prove necessary to deflate all borrowings and lendings and alter all credit conditions in the economy on the way. Altering all financing demands in order to change one particular form of financing is a blunt instrument.

There is something to be said for both views. Proponents of monetary base control have, somewhat slavishly, applied a theory developed in the United States, with its preponderance of retail banking, to the quite different environment of the British banking system. On the other hand, it is surely the case that those bank and non-bank claims which are backed (directly or indirectly) by base money are more liquid than much of wholesale money, which differs little in character from commercial paper. By ignoring the importance of base money to liquidity production, the Bank has overemphasised wholesale banking and failed to distinguish money from credit.

24 July 1980
M K Lewis