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## VISIT TO WASHINGTON AND NEW YORK

My main concerns in visiting the USA were with the technique of market operations, but the conceptual framework of monetary policy was inevitably a recurrent topic, both within the Fed and outside it. So I have divided my comments into three sections - the framework of policy, the execution of policy and the institutional environment.

### 1 The framework of policy

I spoke with no dedicated monetarists, inside or outside the Fed, which probably means I did not encounter a representative cross-section of opinion. Within the Fed, there was a general feeling of satisfaction with the way things had turned out, by end-1980, with the October 1979 experiment. But the satisfaction was not that of having found an enduring answer to fundamental questions, rather that of having done better than before and, in the process, having out-faced some fearsome technical problems.

October 1979, and particularly Paul Volcker's commitment to the new system, is rationalised on the basis not of intellectual conviction but of a widely perceived need to secure freedom for much greater variability in interest rates - in a context of high and variable inflation - than could ever come out of a system where the setting of rates was an explicit discretionary act of policy. That freedom was gained by substituting a numbers game which the Fed reckoned

they had a reasonable chance of winning and ultimately, by the end of 1980, had done so. They find no reason to be apologetic about the erratic behaviour of interest rates during the period, except perhaps for the depth of the plunge in the second quarter, and regard it as an acceptable price for keeping the money aggregates broadly on track. 97

There is, within the Fed, implicit acceptance that the path of the money aggregates (notably MIB) is the best means they can find for guiding the course of policy, but no real conviction. They are very much more conscious than we are of the transient relevance of any particular definition of the money stock, especially because of the current structural changes (ATS and NOW accounts) in the means of payment, which are adding substantially to their already massive technical problems in plotting their target path. It is generally conceded that, within only a few years, the technological revolution in payments mechanisms will make it impossible to define any version of the money stock which would fulfil the conceptual requirements of monetary theory.

This broadly agnostic philosophical approach leads the Fed to have little patience with the monetarists who seek greater purity in the Fed's operation. Contemporaneous reserve accounting is dismissed as a total irrelevance, involving substantial resource costs which cannot be justified. A more penal rate for discount window lending is seen as unnecessary. Paul Meek made the point - reflecting Charles Freedman's analysis - that the management of non-borrowed reserves can drive Federal Funds to a perceptible premium above the Discount Rate (not a massive one; he was curious why the Green Paper laid such emphasis on the dangers of interest rate instability in an UBC system). If the Discount Rate is then increased without ever matching Fed Funds rate it can nevertheless, with continuing constraint on non-borrowed reserves, ratchet Fed Funds rate yet further upwards. On my observation, the monetarists' charge (and the market's total conviction) that the Fed has not really abandoned the targetting of interest rates is unfounded; but there is certainly (see below) some feed-back, reflecting the weaknesses of the Fed's information and control systems.

My two main discussions outside the Fed on the framework of policy were with Irving Auerbach of Aubrey Lanston, and with Henry Kaufman. Neither is at all happy with the present set-up, and for broadly similar reasons. Variations in interest rates, they argue, impose no restraints on the behaviour of banks because, by lending at variable rates, they have transferred interest rate risks to their borrowers. Emphasis on control over the supply of money ought therefore to be replaced by emphasis on the demand for it. At that point their paths diverge, Auerbach to argue against plotting a smooth course for the money stock in favour of greater interest rate stability, Kaufman to flirt with various forms of credit control, one example cited being a variable multiplier (to its capital base) for the total balance sheet of banks. He did not seem to have thought much about domestic or external disintermediation. 98

The market practitioners seemed on the whole to have concentrated on how the new system works, describing it to a man in terms of new processes by which the Fed sets itself interest rate targets, rather than on why it is constructed as it is. An exception was Bob Stone at Irving who, alone among the bankers I saw, believed that banks' asset formation could be responsive to a prospective shortage of resources to finance it for reasons other than the (weak) influence of interest rates on demand. He saw much merit in the traditional approach during his days in the Fed, of attaching great importance to the borrowed/non-borrowed composition of reserves. In his view, moderation in the money stock could be had at much lower levels of interest rates, if only the Fed would force banks more heavily to the discount window. Even if the money were cheap, they would intensely dislike being there.

## 2 The execution of policy

I was struck by the complexity of the process for arriving at the target variable of non-borrowed reserves. The medium-term monetary aggregate target has to be broken down into a shorter-term path, have seasonal corrections applied, and then be converted into a number for total reserves by making assumptions about the composition of bank liabilities, inside and outside the aggregate and having different reserve requirements. Another guess then has to be made about borrowed reserves, until recently a fairly faithful reflection of the interest rate difference between the Discount Rate and Fed

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Funds, but more recently showing signs of instability. Actual reserves are also influenced by the "float" which bounces around in an unpredictable way (unless acts of God like the weather in Chicago can somehow be allowed for!). All this means that the operators in the New York Fed may have considerable uncertainty about the true reserves position on the day; they are obviously the more likely to mistrust their information if the Fed Funds rate is behaving in a way which, on a broad judgment, seems inconsistent with their numbers. In this limited respect, their operations may reflect a view about interest rates, but essentially a technical view about what is consistent with their chosen reserves path, rather than a normative view about what is consistent with the ultimate objectives of policy.

○ The demands of the daily operation differ from ours in that it is possible to eliminate the greater part of our need to provide for the residual liability adjustment of government financial transactions. The mechanism which substitutes is adjustment to the government's asset balances with the banking system in the form of Tax and Loan accounts. Coupled with the high level of reserve requirements, this means that their open market operations typically represent a tiny fraction of the total amount of bank reserves, in contrast to our own which can on occasion be a multiple. By the same token, their operations are typically small in relation to the total amount of money market paper.

○ It was to be expected that these structural differences would help them to overcome or to avoid some of the problems we identify with our own open-market operations, notably the nature and extent of their influence on the time-structure of yields and on the relative yields of different instruments. What I had not been entirely prepared for was to discover that they almost completely avoid having any open market operations as we understand those words.

They have, in effect, managed to divide official operations into two separate parts. One part, which belongs to the execution of monetary policy, is essentially an operation in money; not in paper. The other, which does involve operation in market assets, is as far as possible a policy-neutral exercise in investment management.

Day-to-day market operations rely on the "repo" technique, and are predominantly overnight with occasional transactions for seven days. The form of the transaction is that of a purchase of assets with agreement on a subsequent resale. When operating for customers, the Fed deals only in Treasury securities, but when operating on its own account it takes Federal Agencies and bankers' acceptances as well. The price is expressed as a rate of interest over the term of the deal, and no distinction is made in respect either of the type of paper used or its maturity. The only distinction concerns the margin that is required between the value of the security and the amount of the consideration. It is for all practical purposes identical with our discount window lending - they even use the word "collateral" to describe the security dealt in - except that the rate of interest is arrived at through a competitive bidding process among the 35 traders with which the Fed deals.

Periodically - perhaps about once a month - the Fed engages in outright operations. These are undertaken by the Fed, and so understood by the market, as an act of investment management, rolling forward the portfolio of the Open Market account. Though inevitably net purchases will have a downward effect on market yields generally, the Fed is at pains to avoid any policy-sensitive impact. Its technique is to draw a yield curve before going into the market to invite offers - which may span over the whole range of coupon issues - and then to pick off those offers which provide the best yield in relation to the original curve.

Coming back to the daily operation, its intended amount is calculated by comparing the target path of bank reserves with the estimated actual, and seeking to adjust the latter. It is customary for the Fed's intentions to be notified to the traders some time between 11.30 and 12.00, giving them about twenty minutes to respond. The Fed then picks off the highest bids for its money, down to the point - known as the "stop rate" - at which its offered supply is exhausted. The money so created is immediately available as Fed Funds, and information on the "stop rate" is eagerly sought. The Fed discloses nothing about its operations, but news is almost instantaneously flashed up on the screens and is usually absolutely accurate, but not always. One might suppose that this would provide

an immediate and substantial influence on the Fed Funds rate, and evidently it often does, but not, to my surprise, when I was there watching it. Fed Funds rate stayed stubbornly at around 19½, with "stop rates" on successive days of 18½, and then below 18. This apparent market imperfection was attributed to "lack of collateral"; on the days in question it was customer repos that were offered, so only Treasuries would serve. But there are other, broader questions over the relationship of Fed Funds rate with other market rates that are taken up later.

Whatever the immediate reasons, we did have on those two days the paradoxical experience of less collateral being offered to the Fed than they had stood ready to buy. They did in fact accept all that was offered, even at quite low rates, which was a good test of their genuine indifference to the interest rate consequences of their technique. But they admitted that these were occasions when they would in those circumstances reject some offers if they regarded the rate as inadequate.

3 The institutional environment

There are several long-standing features, and one new one, of the institutional environment that are important in understanding what can be learned of relevance to our own situation.

The first concerns the regulation of banks. They are not allowed, under Regulation Q, to pay any interest on deposits (except those from other banks) of shorter than a specified maturity or period of notice; currently 15 days. The widespread use of the repo technique was the simple means of overcoming the resulting difficulty in employing money at short term. Repos are offered both by banks and by non-bank traders in securities, but banks are now subject to reserve requirements in respect of their repo obligations in non-Treasury securities. Competition also comes from money market mutual funds.

The result of these arrangements is to separate the Federal Funds market, in which only banks can place funds, from the heterogeneous markets in short-term funds using the repo technique. In principle

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all takers should be equal in the Treasury repo market, because banks can compete on equal terms with others, and the rate should, one might suppose, be equated by arbitrage with the Fed Funds rate. In practice it isn't, and a differential exceeding 200 basis points is common. The explanation is that the return from carrying Treasuries is inadequate for it to be profitable to finance them, even at a rate well below Fed Funds rate.

Repo money against other collateral will typically be a little more costly than that against Treasuries, but not much; and the return from carrying such paper will exceed that on Treasuries by a more handsome margin.

The consequence of these features is to provide a viable economic base for non-bank traders in securities and money market paper. They can finance their books at well below the Fed Funds rate - ie call money is available at well below the inter-bank rate - but predominantly from non-bank sources (although, surprisingly, Lanston were raising a significant part of their funding from banks). But profits for the US non-bank traders come less from carrying a book than from turnover, despite the fineness of the margins at which turnover is obtained; as well, of course, from guessing a future movement in yields right more often than not.

It is at this point that one has to mention the new feature which has come to play such a powerful influence in the market place, and that is the market in financial futures. All those I spoke to gave an unreserved welcome to the futures market, despite in some cases initial opposition or misgivings, though many stressed the increased need for vigilance in external regulation and internal control. The existence of the futures market is universally agreed to have added to the breadth and depth of the cash markets, increasing turnover (though at the cost of lower spreads) and the capacity to absorb new primary issues (eg from the Treasury) without adverse effect on the yield structure. Moreover, some doubt whether, without the futures market, securities traders would have been able to withstand the recent degree of interest rate volatility with as few casualties as there have been.

I was able to see, at the Discount Corporation, the new demands for gadgetry and dealer ingenuity which futures markets make. It is expensive, and a bit frightening, but there is no doubt that it has come to stay in the United States. No other market will be able to regard itself as really complete without it. Enormous questions remain, of course, over whether in the UK participation from outside the financial sector will be such as to enable the financial sector to make the same use of a futures market as can their counterparts in the US.

My final comments on institutions come from my visit to Aubrey Lanston, an operation which I found most impressive. By concentrating on a narrow front, Treasury issues alone, they are acknowledged specialist leaders combining the functions of gilt-edged jobber, gilt-edged broker and discount house; large parts of Akroyd and Smithers, Greenwells and Union Discount rolled into one. Their total numbers are between 60 and 70. They service a nationwide list of customers. I saw how they set about financing their book, which they aim to have completed by 1100, comfortably before the Fed operates. Lacking a direct official discount window, they maintain, as long stop, a sizeable facility with one of the big banks, but regard it as a matter of honour not to draw, and rarely do. Should they do so, it is understood that the bank could in turn go to the Fed's discount window, even as late as 5pm, and borrow without incurring the odium or penalties that might otherwise be inflicted.

If we were to be seeking alternative institutional structures, Lanstons would be a useful subject of study.

*Ans.*

9 February 1981

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