

Prime Minister

ALAN WALTERS

MS 20/10

PRIME MINISTERGORDON PEPPER ON MONETARY CONTROL1. Pepper's description of the "new arrangements".

Although Pepper does not say anything which can be construed as wrong, he does fail to give an adequate description of the new arrangements. He is, however, perfectly correct in saying that the Bank has not changed to a system of control over banks' reserves. This we never intended. We envisaged the new arrangements as a way of allowing market forces to impinge more directly on the determination of short term interest rates. We also thought that it would be an intermediate stage on the road to some form of monetary base control. Pepper has been talking to the Bank and presumably the Treasury and has got the firm impression from them that they do not think that any move to a monetary base control, that is a control of the Bank reserves, will be forthcoming. I am sure that the Bank are strongly of this view. They would like to use an exchange rate EMS type of mechanism. In other words they would like to control, by direct intervention, the exchange rate and allow the money supply and bank reserves to be determined endogenously. Pepper does not say that the Bank would prefer exchange rate targets, but I believe he is substantially correct in that part of the story.

He is wrong, however, in asserting that the "new arrangements" are to a large extent cosmetic and I believe also he is wrong to assert that the Bank is effectively a lender of "first resort". The point is that the Bank does give whatever quantity of overall assistance the market wants; but not at an almost fixed rate - as it did under the MLR system. Now the rate can move up very rapidly as we saw in September. The general interpretation then, which appeared in the Financial Times just before Pepper made his speech, was that the market had pushed up the rates and the Bank had let the market do its work. This would never have happened under the old system. Moreover, I think we should be looking shortly towards widening the bands within which the market does determine the interest rate. The essential point is that the market operators can no longer count on getting assistance at a fixed rate. They have to judge the risks of paying a substantial penalty for being short of reserves.

/In my view

In my view, the rapidity with which the market interest rates moved up, and were seen to be driven by market forces and not Government policy, was one of the main new features of the last significant movement in rates.

2. The Exchequer surplus and its implications for the banking system.

Pepper is certainly correct in that we expect the Exchequer to be in considerable surplus during the unwinding of the dispute and the tax paying season. I believe he is correct also in identifying the fact that the banks have very limited holdings of public sector debt. Pepper, however, goes on to imply that we'll have a re-run of 1980. The drain of sterling deposits will mean that the Bank will be forced to supply additional assistance. Instead, however, of supplying it through the discount window it will, on Pepper's prediction, be buying huge amounts of eligible bills.

I think this situation is different from mid-1980 in two important ways. First, interest rates do respond much more quickly to the market forces than with the old MLR system. We have not delayed raising interest rates on this occasion. Secondly, the liquidity of the corporate sector is fairly high. It is the personal sector that is the main borrower. There is no "distress borrowing" likely in the next few months, as there was in 1980. Third, much of the additional borrowing is likely to be business which was hitherto outside the banking system, such as trade consumer credit, moving into the banks. The extent of this, however, has yet to be determined.

I suspect it is more likely that sterling M_3 will grow somewhat over the target rate, say about 12% in the year ending March 1982, in which case the banking sector's domestic surplus will be almost eliminated. But these facts should emerge when we have finished discussion of the various special factors which emerged because of the new competitive aggressiveness of the banking sector. (I doubt very much whether the recent rises in interest rates will have any substantial effect on the growth rate of M_3 during this financial year.)

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ALAN WALTERS

20 October 1981

PRIME MINISTER

Gordon Pepper argues - uncontroversially - in his talk that the August changes in monetary control are a half-way house to the current US system. More controversially, he argues that there will be a massive surplus in the money market over the next 5 months as the Civil Service dispute unwinds and the tax-paying season follows: and that we may expect that bank lending to the private sector will greatly exceed the growth in sterling deposits which would be consistent with the monetary target. He hints that this would automatically lead us to consider introducing a quantity control on the Bank's interventions.

I don't think there is any automatic link between the situation he envisages and a decision to move to a US-type system. I suspect that the Bank and Treasury would argue that his estimate of the growth of bank lending is on the high side; and that they would say that the recent increases in interest rates were designed just to prevent excessive growth of bank lending from happening. They would also argue that a move to a quantitative system would, in the circumstances envisaged by Gordon Pepper, lead to unstable and very high interest rates.

MCS

Would you ask
Man Waller for his
comments?
no.

16 October, 1981.



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THE PRIME MINISTER

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THE NEW BANK OF ENGLAND SYSTEM OF MONETARY CONTROL

*A talk by Gordon Pepper to the
Lombard Association on 14th October, 1981*

Will someone please explain why I, who am a stockbroker, am addressing you, who are bankers, about the Bank of England's transactions with the banking sector? It should be the other way round. I am very conscious that many of you, particularly those who are officials of discount houses or treasury departments of banks, know a great deal more than I do about the practical operation of the new system. The notice convening this meeting states that I am leading a discussion - I insisted on that. I am looking forward to the discussion in the confident expectation that I will be the learner.

If we had met two months ago, when the new system was starting, a suitable introduction would have been a description of the new system, but I assume that nearly all of you are aware of most, if not all, of the details. If we were meeting in six months time, my introduction would be a progress report on how the new system was working in practice, but insufficient time has elapsed for that now. We are in no man's land. I will, instead, highlight what appear to me to be the important changes and try to put them into perspective.

A quick description is that the new system in the UK is similar in many respects to the system which existed in the US prior to October 1979. Under that system, the Federal Reserve tried to achieve its published targets for the money supply by controlling interest rates, raising them to curb excessive monetary growth and lowering them to stimulate inadequate monetary growth. In October 1979 the Fed altered its control variable. It started to give greater priority to controlling the growth of bank reserves and less to interest rates. If the money supply is growing too rapidly, the growth of bank reserves is curtailed. If it is inadequate, the Fed pumps more reserves into the system.

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The new monetary system in the UK is a half way stage between the old system in the UK and the new one in the US. The second stage of the change will be the important one, if it occurs. For example, if you want to forecast interest rates in the US, specifically the Federal Funds rate, you must forecast the banks' demand for reserves and compare that with the rate at which the Fed is likely to supply them - interest rates will rise if demand exceeds supply and vice versa. Again, if you want to detect whether the Fed is easing or tightening, don't look at the Federal Funds rate but at the behaviour of bank reserves. The Fed, in fact, started its current period of ease as long ago as July.

If the UK goes the whole hog and adopts a system similar to the current one in the US, history will record that the changes last August were of major importance. But if we do not take the second step, the verdict of history will be that the changes last August were merely of operational detail.

For the remainder of my talk, I will assume the latter. From what I hear, few among the authorities are planning to take the second step. My guess is that it will come only as a result of a financial crisis, which is what happened in the US, or when the UK authorities are convinced that the present system is inadequate for control of the money supply, which will not be for many months.

Assuming no second step, what has changed? My text could be "plus ça change, plus c'est la même chose".

The first point is that the Bank is now trying to peg the seven day interest rate rather than the three month one. I will be more precise later. Under the old system the Bank tried to influence the three month Treasury bill rate and, through this, banks' base rates, three month money rates representing roughly the average cost of funds to a bank. MLR was a peculiar hybrid. Such lending by the Bank was often overnight and very rarely longer than a week. Alterations in this very short term rate carried special implications for changes in three month rates. The new system, in contrast, is tidier; the authorities are now trying to control interest rates of the same term as their own operations.

The change means that market forces can have a greater influence than in the past over the shape of the money market yield curve - at its simplest, over the difference between seven day and three month interest rates.

Market forces can be grouped into three categories. The first can be called economic expectations. For example, if sterling is weak, people will become bearish and the three month rate will tend to rise, as happened in July. In this sense market forces will in the future influence three month rates and, through them, banks' decisions to alter base rates and building societies' decisions to alter mortgage rates.

The second category of influences in a market also concerns expectations but this time about official action. If the authorities show no signs at all of altering seven day interest rates, expectations of a general change in interest rates will wane, as happened in August. On the other hand, signs that the authorities are on the move will reinforce expectations of a change, as happened at the end of September.

The third category of market forces is the direction of the flows of funds in the market, ie. whether money is easy or tight. I will discuss this later.

Notice that, apart from comparatively minor fluctuations, there is no question of market forces being allowed to determine the seven day rate. The Bank has stated in its latest Quarterly Bulletin that the authorities will look at the same factors when changing seven day rates as they did with MLR. Nevertheless, the behaviour of three month rates will give a clearer indication than in the past about the state of expectations in the market.

One by-product of the authorities controlling the seven day rather than the three month rate concerns round-tripping. When three month rates were controlled, seven day rates could fluctuate upwards to an extent which permitted prime borrowers to make a profit from increasing their overdrafts and depositing the money short term. As the authorities are now controlling seven day rates, they are in a better position to prevent this type of round-tripping from occurring (three month rates can still rise but there are few arbitrage transactions between overdrafts and three month deposits because a rise in base rates during the three months could turn the expected profit into a loss).

There is an interesting by-by-product. The Bank allowing seven day rates to rise to a level which encourages round-tripping is a clear signal to banks that base rates should be changed; it can be argued that this happened right at the end of September.

I now come to the information which the Bank is publishing over Reuter Monitor. Again I will assume that nearly all of you are familiar with it. For those who are not, the Bank publishes details of its transactions every morning and afternoon. The details include the spread of rates at which official deals have taken place, the type of instrument, e.g., eligible bills or repos, and the term of the instrument. The last is divided into four bands. Band 1 is up to two weeks, Band 2 between two weeks and one month, Band 3 two months and Band 4 three months. My earlier references to seven day interest rates should, more precisely, have been to Band 1 rates on bills. I have also been simplifying. For example, I have not distinguished between seven day rates in the bill and inter-bank markets. One possible subject for the discussion is round-tripping out of bills, ie. borrowing by issuing very short term bills, instead of by overdraft, and making a turn by investing in the inter-bank market.

The authorities have stated that very short term interest rates will be kept within unpublished bands but you may have noticed that I have avoided using this terminology. Many academics have criticised the Bank for the decision not to publish the bands, on the grounds that uncertainty leads to inefficiency. The reply, which is now apparent, is that the rates are in fact being reported daily over Reuter Monitor and this reduces much of the uncertainty.

One point to note when watching Reuter Monitor is that any change in Band 1 rates is most important, because these are the rates which the authorities are meant to be controlling. If there is a shortage of Band 1 instruments, a change in Band 2 rates may be significant. In contrast, changes in Band 3 and Band 4 rates will not usually indicate an alteration in policy as the authorities will normally be merely following a change in market rates. Another point to note is that the lowest rate at which the Bank deals is the most significant because, if a house offers bills at a lower price, (i.e., at a higher rate), the Bank will normally buy them just to reduce the cost of the purchase.

The next change of significance is that the Bank has stopped making prices in bills. The houses must now submit bids, or offers as the case may be, with the Bank choosing which to accept. This move towards the Bank dealing in quantity rather than in price will be very important if the UK authorities decide to go the whole hog towards the current US system.

A rather different point is that an individual house may still regard the Bank as a price fixer. The Bank is such a large operator that quite a few dealers in the market argue that rates can never be set by market forces. The answer is to analyse why the Bank chooses a particular rate. If the choice is made because the desired quantity of bills has been offered at that rate, the market rather than the Bank has determined the rate.

But the Bank has not changed to a system of control over banks' reserves, as I have explained already. The Bank is still giving whatever quantity of overall assistance the market wants. This brings me to an important reason for the changes which were introduced in August. In the middle of 1980 the Bank came under widespread criticism for having allowed its lending of last resort to become lending of first resort. There were, in particular, large loans to discount houses and repos with banks for gilt-edged stock.

The new system is designed to roll back lending of first resort so that it once again becomes lending of last resort. The majority of the authorities' operations are now in the bill market and come under the heading of open market operations. The minority are loans from the discount window. The smallness of the latter appears at first sight to be a reduction in assistance, i.e., lending is now much smaller. The apparent implication is that the Bank has reverted to being a lender of last resort. The change is, however, to a large extent cosmetic.

This brings me to banks' demand for reserves in excess of the mandatory $\frac{1}{2}\%$ to provide an income for the Bank. As long as the Bank continues to give the market whatever quantity of assistance it wants; banks' demand for reserves will be minimal - just sufficient to cover errors and fluctuations in the daily clear. Banks' current demand for reserves is not a guide to what it would be if the Bank were deciding on the amount of assistance to give each day, as would be the case if it were controlling the quantity of bank reserves.

I mentioned earlier the third category of market forces - the flow of funds in money markets. Under the old system, rates of interest tended to rise when the Exchequer was in surplus. Money flowing to the Exchequer left the market short of funds. A bank or discount house requiring funds appeared as a seller of bills during a business day with the Bank giving assistance, i.e., buying at the end of the day. If the seller appeared in the market before the buyer, prices tended to fall, i.e., rates rose. Under the new system in the US the direction of the flow of funds in the market can also be ascertained. As explained earlier, rates will rise if

banks' demand for reserves is greater than the planned supply from the Fed. Under the new system in the UK, however, the direction of the flow of funds is indeterminate. The Bank declares its hand sooner than under the previous system, by publishing its forecast shortage of money over Reuter Monitor, but the direction of the forces on interest rates may not be at all clear.

If the Exchequer is expecting a substantial surplus in the coming weeks, the Bank will not confine its purchases of bills to very short dated ones because there will not be enough of them in the market for purchases at a later date. The Bank therefore also buys longer dated bills. The rates on these are likely to decline as a result. If they do, some finance directors of companies will choose in the future to issue a commercial bill rather than use an overdraft facility. The supply of bills will, in this way, increase, which will help to ensure that the bill market is sufficiently large to accommodate the authorities.

During the next five months the Exchequer is forecast to be in massive surplus, as the Civil Servants' dispute unwinds and the tax paying season follows. During this period, bank lending in sterling to the private sector could exceed the growth of sterling deposits of UK residents by more than £4,000m. The banking sector can take the initiative to raise these funds in only two ways, it can borrow from overseas, which would be bullish for sterling, or it can run down its holdings of public sector debt. The difficulty is that surplus holdings of public sector debt are insufficiently large. As in the middle of 1980, the banking sector's holdings of central government debt will reach a working minimum before the drain on funds has stopped. Substantial additional assistance will be needed. It will probably take the form of the Bank buying huge amounts of eligible bills. I will be surprised if the Bank's holdings of these do not reach a record level by the end of the financial year.

The question which is important for the structure of the banking system and for financial markets is what will happen if bank lending continues each month to exceed the growth of sterling deposits of UK residents that is consistent with the Government's target for the money supply. The measures which were introduced in August allow eligible bills rather than Treasury bills to become the main element of liquidity. A certain amount of central government debt was released as a result. This room for manoeuvre will be used up before the end of this financial year. The problem which first appeared in an acute form in the middle of 1980, and which was one of the reasons for the introduction of the new system in August, has not been solved. It is likely to occupy more and more minds in the coming months.