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R20 Prime Minutes ②

Greenwells are extremely critical of current system of monetary control but relatively relaxed about rapid growth of £M3. They see much of growth in interest bearing deposits as result of high real interest rates.



AT 27/5.

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We must discuss with

Two recent events raise very serious doubts about the efficiency of the present system of monetary control. An efficient system would have prevented a rise in interest rates as sharp as the 4% in January. It would also have prevented the money supply from jumping by 3%, as happened to sterling M3 last month. The one event would certainly not have followed the other.

the Treasury.
Do you think that would let us have less control?

Monetary control post-August 1981

The mechanism of monetary control was last altered in August 1981, following the publication of the Green Paper on Monetary Control in March 1980 by the Treasury and the Bank of England and three subsequent papers by the Bank. The most important practical change was in the Bank's intervention in the money market. Instead of making regular loans to discount houses, the Bank was to concentrate on open-market operations in bills, which were divided into Bands 1, 2, 3 and 4, according to their length. Instead of "administering" the three month Treasury bill rate, the Bank explained that its operational aim would be to keep very short-term rates within an unpublished band. A clearly stated objective was to allow market factors a greater role in determining the structure of short-term interest rates.

On rereading the stated aims and objectives, it is quite remarkable how few have been achieved. Further, the distortions to the system have been massive, most obviously with the bill mountain and the distortions to the broader money and credit aggregates from arbitrage transactions.

Lender of first resort

In all the discussions which followed the 1980 Green Paper, the one point which the Bank appeared to acknowledge was that it had become far too much a lender of first resort rather than one of last resort - hence the change from loans to discount houses to open-market operations in bills. In practice, the Bank has remained a lender of first resort, supplying every bit of liquidity that the market has wanted.

This can most easily be demonstrated in conjunction with another of the authorities' stated objectives. In his budget speech of March 1981, the Chancellor said that the new system could permit a gradual evolution to monetary base control, the Bank having explained earlier that a necessary preliminary for this was for the authorities to be able to monitor banks' functional demand for balances with the Bank. The new mechanism was designed to do this.

The size of banks' demand for such balances was quickly apparent - it was virtually nil. Previously, the balances maintained by the London Clearing Banks had been mandatory. Under the new regime, the operational balances, maintained by banks as a whole, fell to the

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minute level of $1/8\%$ of eligible liabilities. In fact, the most important reason why banks now need balances with the Bank is merely to guard against errors in the Bank's daily predictions of surplus or shortage.

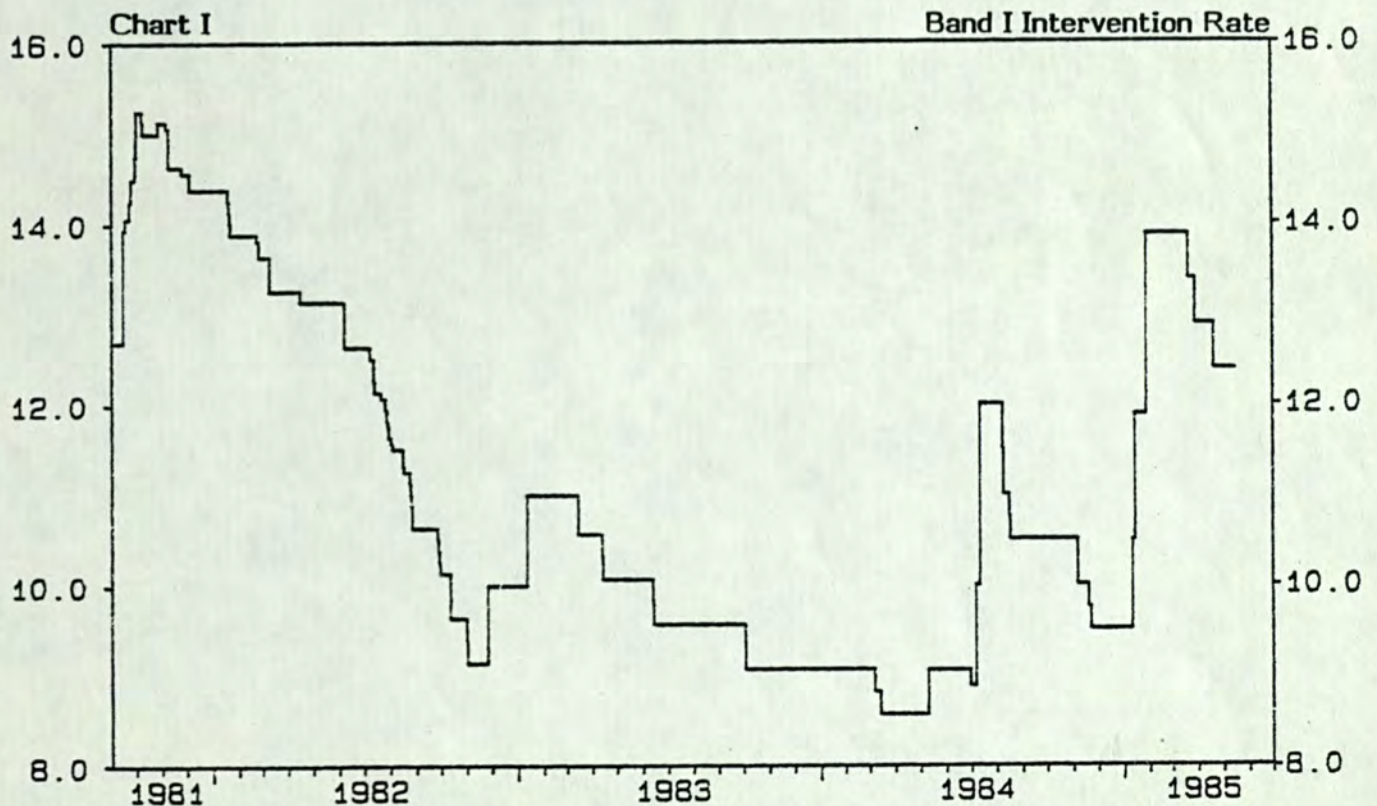
The reason why banks have so minimal a need for operational balances with the Bank is that "primary liquid assets" meet their requirement for reserves. This can readily be seen from the Bank's definition of primary liquid assets - they are assets "which are in all circumstances a ready source of cash, because the authorities stand ready either to purchase them or to accept them as collateral for last resort lending".

With such a definition of a primary liquid asset the Bank is, in effect, stating openly that it will continue to be an unlimited lender of first resort. This in turn means that the present mechanism of monetary control has no secure foundation.

Unpublished bands

As we reported above, the authorities intended to keep very short term rates within an unpublished band. There were two reasons for the unpublished band. First, fluctuations within a band allowed some role for market forces. Secondly, and more importantly, there was an attempt to avoid political resistance to upward changes in rates. It was felt that if changes in the bands were not announced, questions in the House of Commons and elsewhere were less likely.

Chart I, below, illustrates what has happened in practice. It shows the changes in the authorities' rate for Band 1 bills. It will be seen that the rate has not wobbled within a band but that instead there has been a single rate, and that it has been published! Market forces have had no role here.



Structure of interest rates

The outcome for the structure of short term interest rates has also been very different from the authorities' clearly stated intention. The structure of bill rates has been wholly administered. Further, since last July, there has been absolutely no attempt to permit a structure which reflects expectations in the market. As maturity lengthens from Band 1 to Band 4, the rate has always dropped by $\frac{1}{8}\%$ at each step. The term structure was not altered when there were expectations of a rise in rates early in January. Nor was it altered after rates had subsequently risen by more than 4%, when there were expectations of a fall. Market forces have had no role here either.

There is a further point. If market expectations change and the authorities do not allow the term structure of rates to reflect the change, the system is unstable until the authorities concede the expected new level of rates. This argument, which can be proved mathematically, has been set out in previous Bulletins. If the authorities persist with the policy of not allowing the term structure to alter and of resisting a change in the level, as they have since last July, there are bound from time to time to be periods of turmoil in the market, as there was in January.

Exchange rates

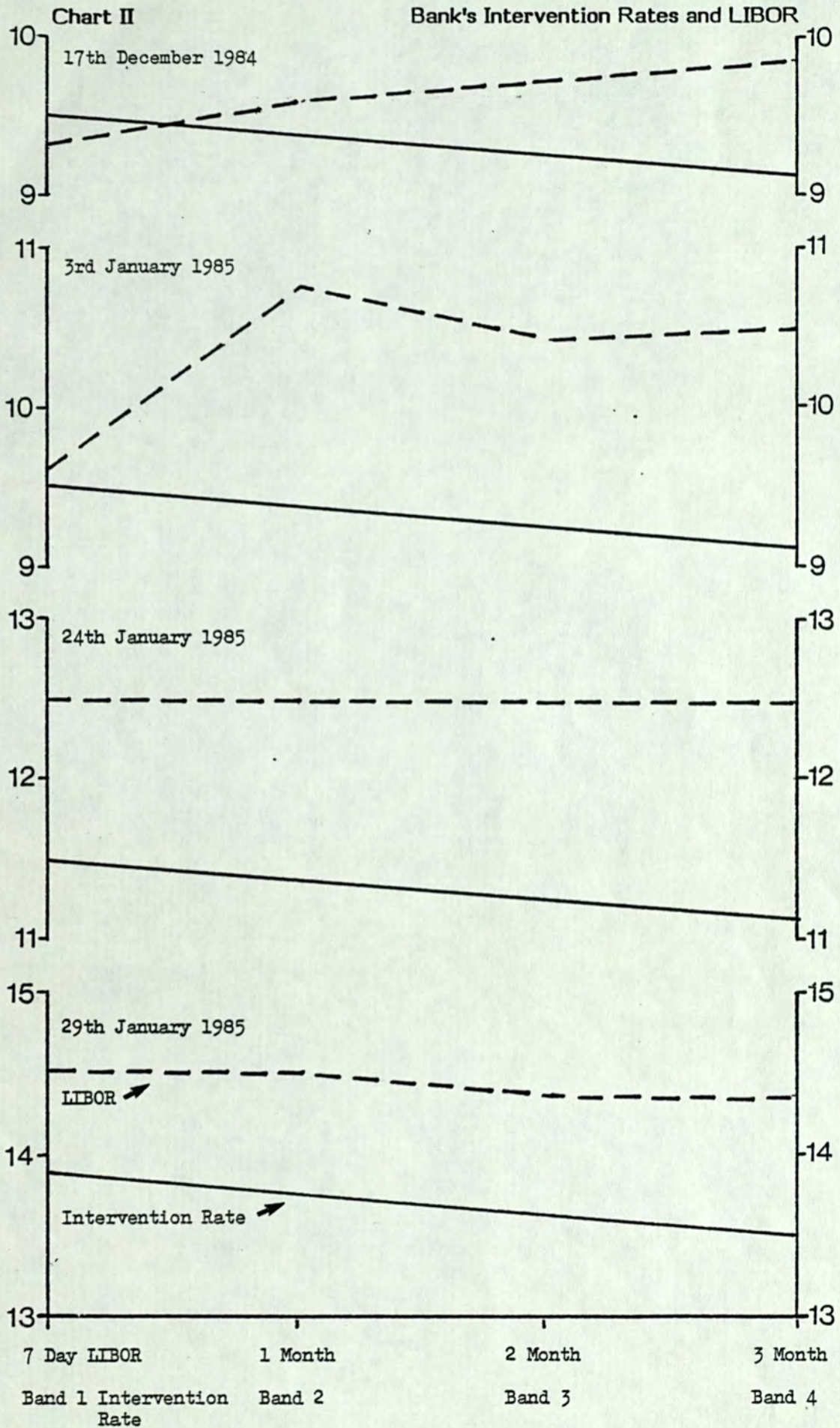
The final point to make is that the new mechanism was designed to control the money supply. In practice, the main cause of alterations in interest rates, certainly as far as timing is concerned, has been the behaviour of sterling. It should be noted that the new mechanism is less efficient than the old in this respect. Under the old mechanism, the authorities concentrated on pegging the three month rate, which allowed for short and sharp rises in overnight rates to help squeeze bears of sterling. Under the new mechanism, very short rates are also pegged, and bear squeezes are more difficult to organise.

Excuse for failure

The most important excuse for failing to meet the stated objectives is the existence of the Bank's bill mountain. The huge volume of the consequent transactions in bills has meant that the Bank has dominated the whole spectrum of rates in the bill market.

Leaving aside the very important argument that the bill mountain is a by-product of the lack of secure foundations on which the present system of monetary control is built, inconsistencies between the administered term structure of bill rates and the term structure of interest rates in the inter-bank market have added greatly to the opportunity for arbitrage transactions.

Chart II, on page 4, illustrates the term structure of both sets of rates on four recent occasions. The solid lines show the rates at which the authorities have intervened in the bill market. The dashed lines show the rates in the inter-bank market. The differences in one graph relative to the other on the four occasions speak for themselves. Given the combination of this distortion and the bill mountain, it is no wonder that the broader aggregates are currently riddled with the effects of arbitrage transactions. It might be claimed that these are on a relatively small scale. Our reply is first that market participants gradually but powerfully become more aware of arbitrage possibilities and are likely to take increasing advantage of them. Secondly, everyone greatly underestimated the size of the distortions that had built up before the corset was scrapped in June 1980.



Conclusion

It is quite clear that the mechanism of monetary control which was introduced in August 1981 has not operated in anything like the way which was intended. Does this matter? The question can be answered from the narrow technical point of view or from a wider general perspective.

The Bank's bill mountain is a technical factor which is obviously quite absurd. The Bank has been a massive investor in commercial bills and has financed its investment by huge issues of gilt-edged stock. These issues have been so large that they would have financed almost two years' PSBR. The Bank's need to roll over the daily maturity of bills has reached more than £1,000m on quite a few occasions. Transactions of this size are bound to have caused massive distortions to the market.

A second technical factor is the way in which the term structure of bill rates has been wholly administered and, at times, inconsistent with expectations of rate changes in the market. This has been the cause of large arbitrage transactions and an important reason for turmoil in the market when a change in expectations has persisted, as in January.

The arbitrage transactions have distorted the broader money and credit aggregates. They are contributing significantly to the buoyancy of sterling M3. Even after allowing for this, the broader aggregates are currently expanding rapidly. In our judgement, however, this is substantially due to genuine savers being attracted into interest-bearing deposits by the high level of return, both in real and nominal terms, and by the pattern of relative interest rates. We are therefore more relaxed about the expansion of sterling M3 than many other commentators and see no immediate danger of a significant acceleration of inflation.

There is nevertheless no doubt that liquidity is accumulating in the economy. At some time in the future, people could decide to spend it. The control mechanism to prevent this from happening in the aggregate is not in place. Under the current system, equilibria tend to be unstable rather than stable - like a ball-bearing balanced on top of a large ball rather than in the trough of a saucer.

The fact that sterling M3 is becoming less intelligible is one reason why the authorities are currently focussing more and more attention on Mo. Under the present system of monetary control, however, they have even less ability to control Mo than sterling M3. The Bank's insistence on continuing to be an unlimited lender of first resort means that there is no supply-side control of Mo. Although Mo can be controlled from the demand-side - a change in interest rates will in due course affect Mo - the route is very indirect and there is a long lag before the influence materialises. According to a paper by the Treasury (The Demand for Non-Interest Bearing Money in the United Kingdom, R B Johnston, February 1984) the lag is about a year! We are, therefore, drifting into a situation where there is no short run mechanism for controlling the aggregate to which the authorities are now turning.

What is the solution? Some people will answer that the above analysis confirms their worst fears about monetarism and that the whole thing should be scrapped. Our answer is that we have consistently warned about the progressive build up of undesirable side effects from the demand-side system of monetary control which the authorities adopted ten years ago. This system was not the one that was recommended by the original advocates of monetary control. It was a variation on neo-Keynesian themes.

The events of this year are a clear warning that all is not well with the techniques of monetary policy. The Government would be wise to think it through again.

Monetary Growth in the Month to Mid-April

The seasonally adjusted data for the four weeks to 17th April are shown in Table I.

Table I
Changes in the Month to April

	<u>£m</u>	<u>pa</u>
Mo	103	9%
Currency	17	2%
Retail M1	203	7%
M1	1,622	39%
Sterling M3	3,173	35%
PSL1	3,215	34%
PSL2	4,069	25%
Bank lending in sterling to private sector	2,627	26%

The sharp increase in the broader aggregates is very striking. The position over the longer term now becomes:-

Table II
Published Growth Rates

	<u>3 months</u>	<u>6 months</u>	<u>1 year</u>	<u>14 months*</u>
Narrow money: Mo	5	5	6	5 $\frac{3}{4}$
Currency	6	4	4	6
Retail M1	2	3	4	6
M1	22	15	15	17
M2	n.a.	n.a.	9	n.a.
Broad money: Sterling M3	19	15	12	12
PSL1	19	15	12	12
PSL2	18	17	16	16

* 1984/5 Target period

Overall our estimate for the underlying growth of the aggregates is given in Table III. The indications shown for the underlying growth of the three broad monetary aggregates are very tentative because of the uncertainty over the extent of the distortions in banking April.

Table III
Underlying Trends

	<u>Six months Published p.a.</u>	<u>Trend %</u>	<u>1985/6 Target Range % p.a.</u>	<u>Notes</u>
Narrow money: Mo	5.2	5 $\frac{1}{2}$	3-7	
Currency	5.8	5 $\frac{1}{2}$		
Retail M1	3.2	6		1
M1	14.9	9		2
M2	9.2	9		3
Broad money: Sterling M3	15.5	11?	5-9	4
PSL1	14.8	11?		4
PSL2	16.9	14?		5

- Notes
1. Revised upwards because of a switch from current accounts to high interest cheque accounts.
 2. Revised downwards not only because of roundtripping but also because of the newly available high interest cheque accounts and the greater use of overnight deposits by Other Financial Institutions.
 3. The published rate is for the last year rather than the last six months, because the series is too new for seasonal adjustments to be calculated. The downward adjustment is for a reclassification of certain building society deposits as estimated by the Bank.
 4. The downward adjustment is to allow for bill arbitraging and roundtripping and for the uncertain upward distortions to the figure for April.
 5. The downward adjustment is to allow for bill arbitraging and roundtripping, changes in term shares of building societies and for the uncertain upward distortions to the figure for April.

There is clearly a great divide between those aggregates which do and those which do not include some form of interest bearing deposits. None of the three narrowest aggregates include any interest bearing deposits. They all continue to grow only modestly. Indeed, the provisional indications are that M0 may actually have fallen very slightly in the banking month to mid-May. Its three, six and twelve month growth rates look set to decline to 4% pa, 4% pa and 5½% respectively, as compared to the 5% mid-point of the target range. The lagged effect of the rise in interest rates in January may be starting to materialise.

Turning to the other side of the great divide, the introduction in recent months of new high interest cheque accounts by three clearing banks is probably the major factor behind the £1,419m rise in interest-bearing sight deposits in the month to mid-April. Anecdotal evidence suggests that most of the money in these new deposits came from seven day and other term deposits, ie from deposits not included in M1. Up to a quarter may have come from current accounts. This latter switch has no effect on M1, but reduces retail M1. The underlying trends shown in Table III allow for this.

The very large increase in sterling M3 in the latest month to mid-April, and the sustained rise in bank lending, inevitably raise the question of whether monetary growth has become excessive. In our judgement this is not the case. These Bulletins have frequently argued that the growth of sterling M3, PSL1 and PSL2 have been boosted in the last four years by both the changing shape of the yield curve and the high level of real interest rates.

Chart III, at the top of page 8, shows the difference between three month money rates and yields on twenty year gilt-edged stocks. Since 1979, three month interest rates have been much higher relative to gilt-edged yields than during most of the 1970s; this is consistent with a switch of funds back into money related assets and, therefore, into sterling M3 and the broader aggregates. Chart IV, at the bottom of page 8, shows three month money rates in real terms. They too have been consistently very high over the last four years.

An analysis of the holders of bank deposits, given in Table IV, indicates that it is the deposits held by Other Financial Institutions that have grown most rapidly. During 1984 they accounted for over 40% of the total increase.

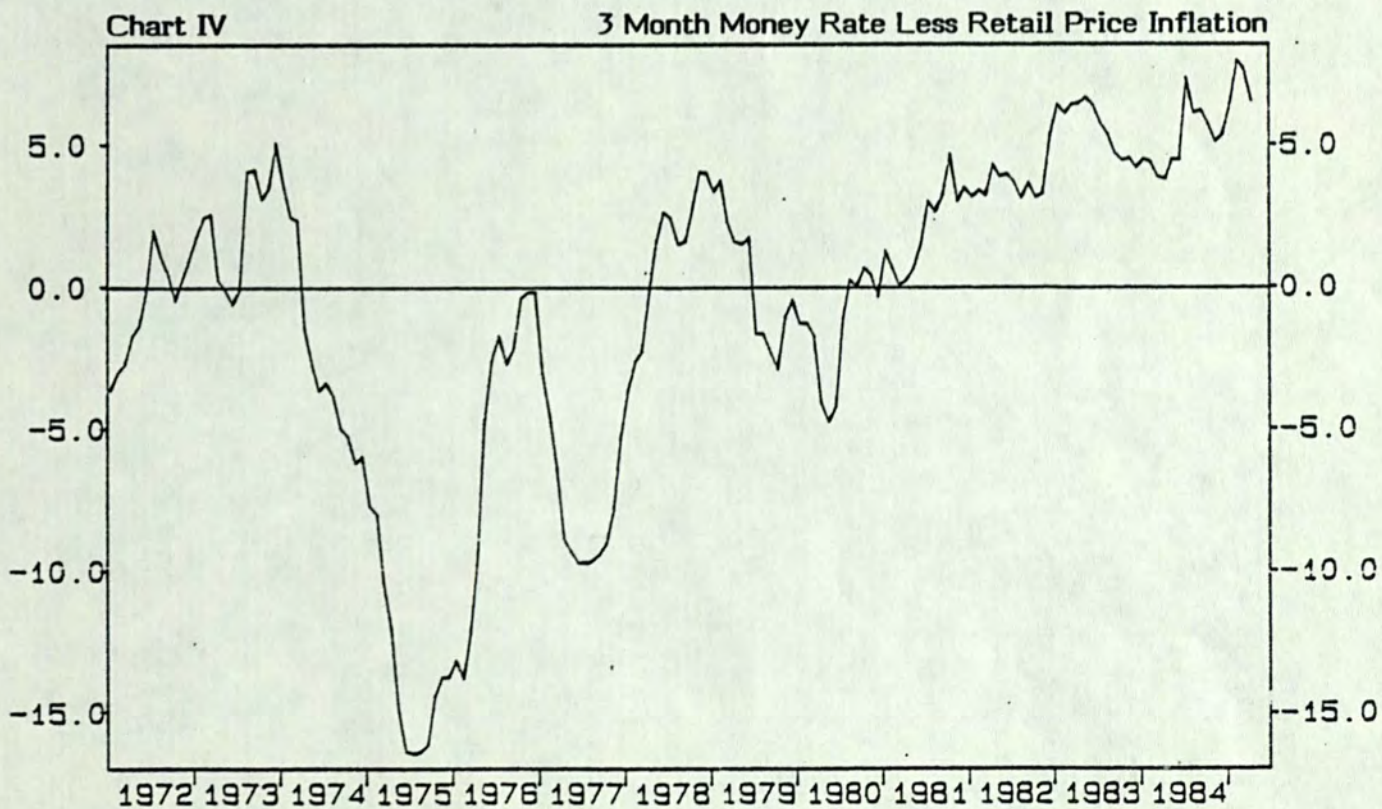
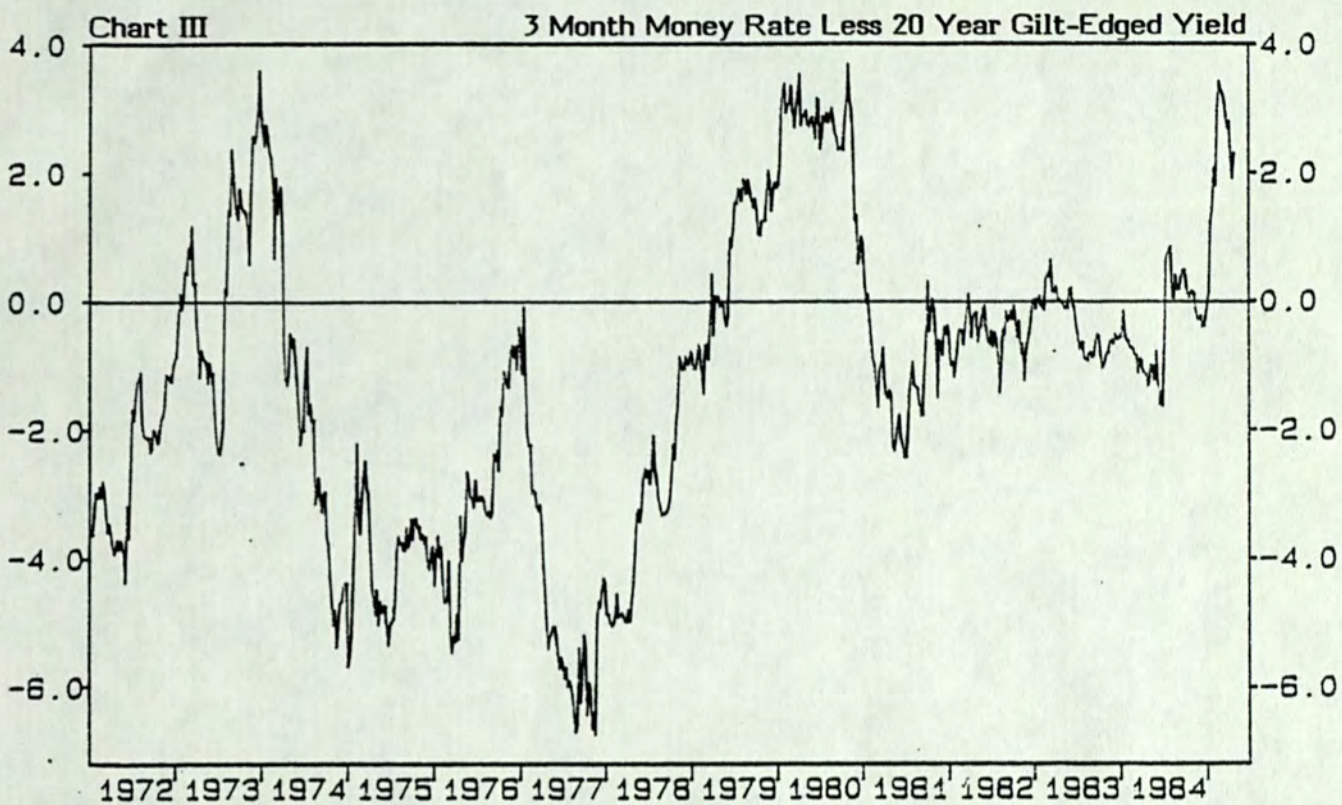


Table IV
Components of Growth of Sterling M3

£m(%)	Sterling M3	Notes & Coin	Bank Deposits	Bank Deposits				
				OFI	Ind & Com Cos	Persons	Other Personal Sector*	Residual Error
1981	9296 (13.6)	585	8711	2107 (29)	2966 (22)	2222 (8)	1466 (17)	-50
1982	7522 (9.3)	462	7060	2920 (30)	501 (3)	2409 (7)	1236 (12)	-6
1983	9466 (10.6)	672	8794	2065 (18)	3580 (20)	2199 (6)	1036 (9)	-86
1984	9773 (10.2)	309	9464	4037 (27)	2839 (13)	1939 (5)	1144 (9)	-495

* Mainly unincorporated businesses

Deposits held by Other Financial Institutions are relatively sensitive to the interest rate differential between bank deposits and gilt-edged stock. They are also much less likely to be directly transferred into transaction balances than are other deposits. A nagging worry does remain, however, because of the authorities' current techniques of money market intervention, as explained earlier.

The extent of the distortions to sterling M3 and the other broader aggregates can also be analysed in terms of the counterparts. Bank lending was clearly distorted upwards by a surge of some £1bn in leasing finance ahead of the reduction in capital allowances at the beginning of April. Direct investment by business will also have been accelerated by the change in allowances, and is likely to have contributed at least a further £½bn to bank lending. Once most of the invoices are paid, which may not be for another month, bank lending should be sharply lower for some months.

The other main source of the rapid growth of sterling M3 came from the exceptionally unfavourable impact of the banking sector adjustments. These comprise banks' net foreign currency positions, together with their net sterling transactions with non-residents (whose deposits are excluded from the definition of sterling M3) and the increases in their capital from both issues and retained profits. Together, these elements increased sterling M3 by £940m in banking April, compared with an average reduction of almost £300m in the previous five months. In future months, the net impact of these adjustments should largely reverse. The data for banking May will be favourably affected by the proceeds from Barclay's £500m rights issue. Special factors will also favourably affect the data for banking June and July; will be a benefit from the proceeds received from the dollar perpetual floating rate notes issued recently by Lloyds, Midland, National Westminster and Standard & Chartered. Because of associated changes in the banks' net foreign currency positions, however, the net impact on sterling M3 from these dollar dominated issues, may be no more than a quarter of their total proceeds of \$2,900m, say £500m.

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