Methods of monetary control

This background note was issued by the Bank on 24 November.

1 Since publication of the Green Paper on Monetary Control[1] the Treasury and the Bank have carried out extensive consultations and discussions on proposals for a change to a system of monetary base control and also on possible improvements to operational techniques within the existing framework.

2 From the consultations on monetary base control, two main types of proposal emerged, with an important distinction drawn between:

(i) non-mandatory systems in which banks are free to choose the amount of cash balances which they hold at the Bank of England; and

(ii) mandatory systems in which banks are required to hold a specified proportion of their liabilities as cash balances at the Bank of England.

3 Present arrangements do not allow firm judgments to be made about the desirability of moving to either kind of base control. In the case of a non-mandatory arrangement, it is not known whether the cash which the banks would choose to hold would be stably related to the money supply or to nominal income over an appropriate period. A mandatory system, on the other hand, particularly if related to a broad monetary aggregate, could prove vulnerable to the diversion of monetary flows outside the controlled area. In addition, and before fully moving to either system, time would be needed for adequate information and experience to be gained about the banks' demand for cash.

4 In this context, the Chancellor has announced in the House of Commons this afternoon that a number of improvements to the present system will be set in hand. These are desirable in their own right but they would also enable more to be learnt about the properties of a monetary base system and would be consistent with further evolution in either of the directions set out in paragraph 2 above.

5 The improvements to be set in hand within the existing framework are as follows:

(i) Once consultations with the banking system regarding adequate holdings of liquid assets have been completed, and appropriate norms agreed, the reserve asset ratio will be abolished. This was foreshadowed in the Green Paper.

(ii) Further consideration will be given to the future of the $1\frac{1}{2}\%$ cash ratio currently applying only to the London clearing banks, with a view to establishing arrangements that would be equitable within the banking system, and that could enable the authorities to monitor the development of the functional demand for cash balances at the Bank of England which could ultimately be associated with a non-mandatory system of monetary base control.

(iii) Discussions will take place with the banks regarding the collection of additional statistics on retail deposits, which would provide further information on monetary conditions and could, if that subsequently seemed appropriate, become the denominator of a cash ratio associated with a mandatory monetary base system.

(iv) Changes will be developed in the Bank of England's methods of intervention in the money market:

(a) It is envisaged that the Bank's intervention will place a greater emphasis on open market operations and less on discount window (lender of last resort) lending. It has been decided that these operations should continue to be conducted in the bill markets rather than through the inter-bank market, and in large part through the existing intermediaries, members of the London Discount Market Association, to whom discount window facilities would remain confined.

(b) Initially, the Bank's operational aim would be to keep very short-term interest rates within an unpublished band which would be determined by the authorities with a view to the achievement of their monetary objectives. The Bank would normally charge a rate on its discount window lending somewhat above comparable market rates but within the unpublished band. At an appropriate stage the Bank might cease to announce a minimum lending rate. These arrangements would allow market factors a greater role in determining the structure of short-term interest rates. It is accepted that this could lead to more flexible, market related, pricing of overdraft facilities.

(c) The Bank's operations would be broadly intended to offset daily cash flows between the Bank and the money markets. The present technique of creating initial shortages in the money markets which the Bank then acts to relieve would be abandoned. There would accordingly no longer be a deliberate over-issue of Treasury bills at the weekly tender.

(1) *Monetary Control* (HM Stationery Office, Cmnd. 7858).

6 The Bank will discuss the operational details of these changes with those institutions that will be affected as soon as practicable. It is intended that they will be put into effect next spring.

7 The Bank will also be putting forward proposals for changes in the institutional coverage of credit control and statistical reporting in the light of the Banking Act 1979.

8 Finally, in the light of the above changes, the Bank will examine further the possibilities of broadening the market for short-term central government debt as a means of providing greater flexibility to the government funding programme.