MONETARY POLICY SINCE 1971
Conduct and Performance

Also by Maximilian Hall

The Framework of United Kingdom Monetary Policy 1971-81
(with G. E. J. Dennis, D. T. Llewellyn and J. G. Nellis)

Monetary Policy Since 1971

Conduct and Performance

Maximilian Hall

Department of Economics, Loughborough University

M

© Maximilian J. B. Hall 1983
Softcover reprint of the hardcover 1st edition 1983

All rights reserved. No part of this publication may be reproduced or transmitted, in any form or by any means, without permission.

First published 1983 by
THE MACMILLAN PRESS LTD
London and Basingstoke
Companies and representatives throughout the world

ISBN 978-0-333-33142-2
DOI 10.1007/978-1-349-17111-8

ISBN 978-1-349-17111-8 (eBook)

Typeset in Great Britain by
Multiplex Techniques Limited, Orpington, Kent

The paperback edition of this book is sold subject to the condition that it shall not, by way of trade or otherwise, be lent, re-sold, hired out, or otherwise circulated without the publisher's prior consent in any form of binding or cover other than that in which it is published and without a similar condition including this condition being imposed on the subsequent purchaser.

To my Wife and Parents

Contents

PREFACE	ix
LIST OF TABLES	xi
GLOSSARY	xii
ABBREVIATIONS	xv
1 THE ADVENT OF COMPETITION AND CREDIT CONTROL	1
Competition	1
Credit control	4
Control of the money stock	5
2 ARRANGEMENTS UNDER CCC	7
Competition	7
Reserve requirements	7
Control of the money stock	8
Appendix: reserve 'creation'	11
3 CCC IN OPERATION: PERIOD 1 (OCTOBER 1971-DECEMBER 1973)	14
4 CCC IN OPERATION: PERIOD 2 (JANUARY 1974-APRIL 1979)	20
Background	20
Monetary instruments	23
Lending guidelines	23
Minimum Lending Rate	24
The special deposit scheme	24
Official transactions in the gilt-edged market	26
The 'corset'	30
Monetary targets: June 1976-June 1979	43
5 THE MONETARY REFORM DEBATE	55
Why monetary reform was necessary	55
Reform proposals	58
Monetary base control	58
Indicator systems	66
Negotiable entitlements	67
'Other'	68

6	THE TORIES' FIRST YEAR IN OFFICE (MAY 1979-MARCH 1980)	70
	Targeting experience	71
	The PSBR	73
	Inflation	73
	The abolition of exchange controls	74
	Portfolio diversification	76
	Disintermediation through the Eurosterling market	81
	UK banks' 'switching-out' operations	83
	UK banks' foreign currency lending to domestic residents	85
	The build-up of resident-owned foreign currency deposits	86
	The return of sterling to a reserve currency role	86
7	THE MEDIUM-TERM FINANCIAL STRATEGY	88
8	THE MEDIUM-TERM FINANCIAL STRATEGY IN OPERATION	101
	Control of the money supply	101
	PSBR control	109
	1980-1: 'blown off course'	109
	1981-2: 'attempts to get back on course'	110
	The 'costs' of the MTFs	114
9	THE 'NEW' MONETARY ARRANGEMENTS	122
	Changes in the techniques of monetary control	122
	REFLECTIONS	131
	APPENDICES	133
	A. Reserve availability	133
	B. Official transactions in the money markets	137
	C. Official transactions in the gilt-edged market	138
	D. The 'direct' monetary effects of the balance of payments	139
	Accounting identities	139
	'Fixed' exchange rates	141
	'Floating' exchange rates	144
	E. The abolition of exchange controls	150
	Implications for monetary control through observance of £M ₃ targets	150
	Implications for monetary control through the 'corset'	152
	POSTSCRIPT: THE MARCH 1982 BUDGET	154
	END-NOTES	156
	REFERENCES	175
	INDEX	181

Preface

This book has resulted from a series of research papers written during my first three years as a lecturer in the field of monetary economics and reflects a personal bias towards the institutional framework within which monetary policy is conducted. Accordingly, the dependence of the efficacy of monetary instruments on the response of economic agents, notably the banks, to policy manoeuvres is stressed, reflecting the importance of the regulatory environment within which financial transactions are conducted. Apart from the establishment of the theoretical rationale for the adoption of individual instruments, emphasis is given to an assessment of the 'success' of policy action from the points of view of both the ability of the prevailing administration to meet its stated policy (especially financial) objectives and the overall effect on broader macroeconomic goals.

The starting-point of the text is a review of the recommendations of the National Board for Prices and Incomes (Report No. 34 on *Bank Charges*) and the Monopolies Commission (*Barclays Bank Ltd., Lloyds Bank Ltd. and Martins Bank Ltd., A Report on the Proposed Merger*) which, towards the end of the 1960s, inquired into various aspects of monetary policy, and reported critically on the harmful effects of 'direct' controls, such as lending ceilings and interest-rate agreements, for competition between 'like' institutions and within the financial sector more generally. In apparent acceptance of many of these criticisms a new monetary control regime was instituted in 1971 under the name of *competition and credit control* (CCC), which represented an attempt to improve the competitive environment in the financial field and to tighten control over credit and monetary aggregate growth through a respecification of balance-sheet ratio control and a revision of the Government Broker's dealing tactics in the gilt-edged market. By December 1973, however, with the appearance of the 'corset', all faith in the willingness of the monetary authorities to adhere to the principles of CCC had vanished. The reasons for this and the need for a new form of 'direct' control are closely documented, as are the *modus operandi* of the 'corset' and its extensive effects on the financial system.

Chapter 5 provides a review of the monetary reform debate (including a detailed analysis of the case for monetary base control, MBC) that arose as a result of dissatisfaction with the conduct of

policy that persisted with the 'corset' scheme, and leads, in chronological fashion, to the Tories' first year in office (1979). The pervasive, free-market philosophy embraced by the new administration first appears in the abolition of exchange control, and the monetary implications of this move, both in theory and practice, are carefully elaborated. Chapters 7 and 8, respectively, cover the theoretical case for, and 'real-world' implications of, the Tories' full financial plans unveiled in the guise of the *medium term financial strategy* (MTFS) in March 1980. The evidence presented to and views expressed by the Treasury and Civil Service Committee inquiring into the conduct of monetary policy are analysed within this context.

The final chapters cover the 'new' monetary arrangements introduced in August 1981 and early experience with the changed control techniques. The series of appendices is designed to clarify for the more discerning reader those, mainly theoretical, topics that are given only cursory treatment in the text.

The book is intended for second- and third-year undergraduate courses in monetary/financial economics and should also appeal to students undertaking the Institute of Bankers' Examinations in Applied Economics and those generally involved or interested in the financial sector of the UK economy.

Finally, I would like to thank my colleagues at Loughborough and Nottingham Universities who provided helpful comments, suggestions and insights, especially Brian Tew, who enthusiastically undertook the daunting task of reading the whole script in draft form and provided much helpful advice and clarification. Last, but by no means least, I would like to express my sincere thanks to Su Spencer for all the patience shown and hard work involved in typing the entire script.

Loughborough
November 1982

MAXIMILIAN HALL

List of Tables

	<i>Page</i>
4.1 Duke of York operations	28
4.2 Application of the corset	31
4.3 Corset effects in practice	38
4.4 Destruction of IBELs relative to £M_3 through the discount market	40
4.5 Reserve asset 'pressure' during the operation of the corset	41
4.6 Interest-rate effects of the corset	44
4.7 The relative advantages of different monetary aggregates as intermediate targets	49
4.8 Early UK targeting experience	52
6.1 Data illustrating the effects of the abolition of exchange controls	80
7.1 The direct monetary effects of financing the PSBR	91
7.2 The PSBR/ £M_3 relationship 1973-80	95
8.1 Targets' experience post-May 1979	101
8.2 The demise of the corset: expectations fulfilled	102
8.3 Indicators of economic 'performance' (April 1979-December 1981)	116
 <i>Appendices</i>	
A1 'Residual' supply of Treasury bills to banks and finance houses	134
A2 Fixed exchange rates: summary of results	147
A3 Floating exchange rates: summary of results	148

Glossary

Definitions of money

M_0 (monetary base): notes and coin in circulation with the non-bank public plus banks' balances at the Bank of England.

M_1 : notes and coin in circulation with the non-bank public plus UK non-bank private-sector-owned sterling sight deposits (interest and non-interest-bearing) held with monetary sector institutions. (An adjustment is made for items in transit - *see* eligible liabilities.)

M_2 : M_1 + clearing banks' 7-day time deposits.

M_3 : notes and coin in circulation with the non-bank public, plus UK-owned (non-bank private and public sector) sterling deposits held with monetary sector institutions, plus all UK-resident-owned foreign currency deposits. (An adjustment is made for items in transit - *see* eligible liabilities.)

£ M_3 : the *sterling* component of M_3 .

DCE: defined on p.50.

PSL_1 : notes and coin in circulation with the non-bank public plus UK non-bank private-sector-owned sterling time (excl. deposits of an original maturity of over two years) and sight deposits (including certificates of deposit), certificates of tax deposit (*gross*), and Treasury bills, bank bills and local authority temporary debt (all *net*).

PSL_2 : PSL_1 (*minus* certificates of tax deposit (*gross*)) plus UK non-bank private-sector-owned certificates of tax deposit (*net*) and savings deposits (with building societies and the National Savings Bank) and securities (premium bonds, British Savings Bonds, National Savings stamps and gift tokens) (all *net*).

demand-for-money function

mathematical representation of the relationship between the demand for money (however defined) and its major determinants (e.g. income, wealth, yields).

disintermediation

financial transactions that bypass the banks, usually as a result of the imposition of *direct* controls on certain banking activities which are not extended to other types of financial institution or activity.

eligible liabilities

sterling deposits of the banking system as a whole, excluding deposits having an original maturity of over two years, *plus* any resources obtained by switching foreign currencies into sterling, *plus net* inter-bank deposit liabilities, *plus net* sterling certificate of deposit liabilities, *plus* the banks' *net* sterling deposit liabilities to their overseas offices. An adjustment was made for items in transit by subtracting 60 per cent of their net debit value.

eligible reserve assets

comprising: bankers' balances (excl. special deposits) at the Bank of England; money at call with the 'Discount Market'; British government and Northern Ireland Treasury bills; British government (and government-guaranteed nationalised industries') stock of less than one year to maturity; 'eligible' local authority bills; 'eligible' commercial bills (up to a maximum of 2 per cent of eligible liabilities); and company tax reserve certificates.

Eurosterling market

sterling liabilities and claims of banks located outside the United Kingdom.

gradualist approach (to curing inflation)

a 'medium-term' cure for inflation (in recognition of the significant short-run 'costs' of a sharp deflation) involving a progressive reduction in monetary aggregate growth as a means of favourably influencing inflation expectations.

'hard' arbitrage ('round-tripping')

the practice of borrowing from banks at 'base-related' rates of interest and redepositing (e.g. through the purchase of bank certificates of deposit) at 'market-related' rates whenever profitable opportunities arise.

'natural' rate of unemployment

defined on p.169.

Phillips curve

graphical presentation of the time-series relationship between inflation (originally wage inflation) and the level of unemployment.

public sector borrowing requirement (PSBR)

the difference between the expenditure and receipts arising from the various activities of the public sector as a whole (central government, local authorities and public corporations).

reintermediation

the reflux of business to the banks, usually as a result of the removal of distortive, *direct*, controls.

Abbreviations

<i>BEQB</i>	<i>Bank of England Quarterly Bulletin</i>
BIS	Bank for International Settlements
BL	British Leyland
BSC	British Steel Corporation
CB	Commercial Bill
CCC	Competition and Credit Control
CD	Certificate of Deposit
CEPG	Cambridge Economic Policy Group
CGBR	Central Government Borrowing Requirement
DCE	Domestic Credit Expansion
DM	Discount Market
ECF	External and Foreign Currency Finance
ECGD	Export Credit Guarantee Department
ECU	European Currency Unit
EEA	Exchange Equalisation Account
EFL	External Financing Limit
ELs	Eligible Liabilities
EMS	European Monetary System
ER	Exchange Rate
GDFCF	Gross Domestic Fixed Capital Formation
GDP	Gross Domestic Product
IBELs	Interest-Bearing Eligible Liabilities
(IB)ELs	Eligible Liabilities <i>and possibly</i> Interest-Bearing Eligible Liabilities
ICL	International Computers Ltd
IMF	International Monetary Fund
LA	Local Authority
LDMA	London Discount Market Association
LDT	Licensed Deposit-Taking Institution
LIBOR	London Inter-Bank Offered Rate
MBC	Monetary Base Control
MC	Monopolies Commission
MLR	Minimum Lending Rate
MTFS	Medium Term Financial Strategy
NBPS	Non-Bank Private Sector
NIBELs	Non-Interest-Bearing Eligible Liabilities
NIESR	National Institute of Economic and Social Research

NIS	National Insurance Surcharge
OPEC	Organisation of Petroleum-Exporting Countries
PIB	National Board for Prices and Incomes
PRT	Petroleum Revenue Tax
PSD	Public-Sector Debt
PSFD	Public-Sector Financial Deficit
RAs	Reserve Assets
RPI	Retail Price Index
SDs	Special Deposits
SDR	Special Drawing Right
SSDs	Supplementary Special Deposits
TB	Treasury Bill
TCSC	Treasury and Civil Service Committee
TPI	Tax and Price Index
TSB	Trustee Savings Bank
TUC	Trades Union Congress
VAT	Value Added Tax