FINANCIAL INNOVATION EFFICIENCY AND DISEQUILIBRIUM

Problems of Monetary Management in the United Kingdom 1971–1981

PETER D. SPENCER

CLARENDON PRESS · OXFORD
1986

CONTENTS

I	Introduction: The British Monetary Experience since 1971	1
1	Financial innovation and the problem of structural change	1
2	The evolution of the monetary control mechanism	3
3	Developments in macroeconomic theory and policy	6
4	The evolution of a counter-inflationary macroeconomic	
	strategy	10
•	PART ONE	
	Competition, Credit Control,	
	and the Role of Banks in the Money-supply Process	
II	Portfolio Disequilibrium and the Role of Banks in the	
	Money-supply Process	13
1	The orthodox view of the money-supply process	16
2	The 'new view'	17
3	The disequilibrium-money approach	19
4	Portfolio disequilibrium and the interaction of real and	
	financial variables	23
5	A model of portfolio disequilibrium and the monetary	
	aggregates	26
6	Relationships between the demand for credit, money, and	
	other assets	27
III	The Experience of Competition and Credit Control	31
ı	The development of the banking sector and money markets	-
•	during the 1960s	31
2	The initial Competition and Credit Control arrangements	35
3	The control mechanism envisaged by the authorities	36
4	The early operational experience	38
5	The use of short-term market instruments in the later CCC	
	period	44
6	The effect of the CCC reforms on the structure of	
	clearing-bank deposit liabilities	46
IV	The Behaviour of Bank Rates and Lending to the Private	
	Sector	51
1	A theoretical perspective	52
2	The empirical relationship between administered and market	_
	rates	55
3	A possible rationalization	58
4	Empirical models of the loan market	60

x Contents

5	An empirical model of bank lending to industrial and	
	commercial companies	62
6	Bank lending to other financial institutions	66
7	A disequilibrium model of bank lending to persons	67
8	The pressures on bank lending in the initial CCC period	69
V	Bank Portfolio Behaviour and the Wholesale Money Markets	70
1	The banks' balance sheet	71
2	The original CCC conventions	74
3	Excess reserves and the net money-market position	74
4	Supplementary Special Deposits	75
5	The incidence of the control requirements in the wholesale	~ ~
c	markets	77
6 7	An empirical model of bank-portfolio behaviour The effect of the SSD scheme on the structure of bank	79
′	portfolios	86
	portionos	00
VI	Monetary Control and the Problem of Bank liability-	
	management-some Policy-simulation Results	88
1	The model and policy assumptions	89
2	The effect of different reserve-asset supply policies on the	
_	stability of the early CCC system	90
3	The effect of a Special Deposit call on the late 1970s system	95
4	Disintermediation and the effect of the Supplementary	^^
_	Special Deposit scheme	98
5	Conclusions: bank liability-management and the problem of	100
	monetary control	103
	PART TWO	
	Monetary Targets, the Exchange rate, and the role of Expectations in an Open Economy	
VII	The Experience of Monetary Targets	109
1	The uncapping of sterling in October 1977	110
2	The PSBR and funding arrangements	112
3	Wage inflation and the collapse of the incomes policy	114
4	The Medium Term Financial Strategy	115
5	Alternative explanations of the rise in sterling	116
6	The 1981 budget strategy	120
VIII	The Gilt-edged Market and the Speculative Demand for	
	•	122
1	The PSBR, financial-asset accumulation, and the demand	
	for money	123

Contents	xi

Gill-edged expectations and the specthative demand for	
money	124
The McCallum substitution technique	127
An empirical model of gilt-market expectations	128
An empirical model of the non-bank demand for gilts	130
Implications for the demand for sterling M3	133
Monetary Theory and Policy in an Open Economy	137
The monetary theory of the exchange rate	138
Two-sector models of the open economy	139
The International Monetarist model	142
The Dornbusch model and the effect of price rigidities on the	
operation of monetary policy in an open economy	143
The effect of oil discoveries in the Dornbusch model	147
The implications of imperfections in international capital	
markets	150
The Effect of Monetary Pressures and Oil Production on the	1e
UK Economy-Some Consistent-expectations Simulation	
Results	153
Open-economy aspects of the model	155
Monetary-policy assumptions	156
Simulating the effect of monetary pressures on the exchange	
rate	158
Simulating the effect of North Sea oil production	165
The Monetary-control Debate: a Conclusion	174
The monetary-control debate	174
Portfolio disequilibrium and the monetary base	176
The August 1981 arrangements and their effect on the	
composition of bank balance sheets	178
Competition and innovation in loan and deposit markets	179
TECHNICAL APPENDICES	
Powefalio theory and the demand for money	184
	101
· · · · · · · · · · · · · · · · · · ·	194
	131
	203
	203
index of algebraic symbols employed	403
ography	213
Index	
	The McCallum substitution technique An empirical model of gilt-market expectations An empirical model of the non-bank demand for gilts Implications for the demand for sterling M3 Monetary Theory and Policy in an Open Economy The monetary theory of the exchange rate Two-sector models of the open economy The International Monetarist model The Dornbusch model and the effect of price rigidities on the operation of monetary policy in an open economy The effect of oil discoveries in the Dornbusch model The implications of imperfections in international capital markets The Effect of Monetary Pressures and Oil Production on the UK Economy—Some Consistent-expectations Simulation Results Open-economy aspects of the model Monetary-policy assumptions Simulating the effect of monetary pressures on the exchange rate Simulating the effect of North Sea oil production The Monetary-control Debate: a Conclusion The monetary-control debate Portfolio disequilibrium and the monetary base The August 1981 arrangements and their effect on the composition of bank balance sheets Competition and innovation in loan and deposit markets TECHNICAL APPENDICES Portfolio theory and the demand for money An analysis of the stability and comparative-static properties of the money-market system Financial policy and the determination of prices in an open economy Index of algebraic symbols employed