

Open Market Operations in English Central Banking

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I.

The business of a central bank is to influence the behaviour of the country's financial institutions in the interest of the broad economic policy of the government. The most appropriate way for it to function depends upon the nature of the financial institutions it is called upon to influence, and the economic policy whose furtherance is its ultimate purpose. There is consequently no standard pattern of central banking: indeed it is scarcely an exaggeration to say that there are as many kinds of central banks as there are countries. I make no attempt to describe a common pattern; still less to suggest that there is some ideal form to which all central banks should strive to conform. My purpose is simply to describe and comment upon a certain part of the work of the British central bank, bearing in mind that this central bank works in a highly-developed financial system, and that here in Switzerland also there is a highly-developed financial system but no parallel operations by the central bank¹.

The system of which the Bank of England is the centre consists of a small group of giant banks, having branches more or less throughout the country, together with an extensive fringe of smaller banks. Of these fringe banks, some are confined to parts of the U. K. but most of them have their principal interests in other parts of the Sterling Area. At the centre, that is to say in London, is a unique band of institutions which compose the London Discount Market. Further important elements in the structure are the Accepting Houses and the Stock Exchange. The Accepting Houses have a wide range of business, the chief of which for our present purpose is the contribution they as guarantors of traders' credit make to the marketability of bills of exchange arising in the course of trade not only in Britain but all over the world. In the Stock Exchange a range of paper titles, including bonds, stocks and shares but excluding bills of exchange, are bought and sold; there operators dealing as principals are called the jobbers, while the intermediaries between these stock jobbers and the outside public are called the stockbrokers. Using the facilities offered by these various institutions are not only private individuals and ordinary business

¹ The substance of this paper was given as a lecture in the University of Zürich, under the auspices of the Schweizerisches Institut für Auslandforschung, on 23rd June, 1953.

corporations but also some very large concerns, such as insurance companies, investment trusts and building societies, which handle huge funds and are, together with the banks themselves, commonly referred to as «the institutional investors».

The open market operations of the central bank affect in some measure the business of all the parts of the market to which I have referred, but they usually impinge most directly upon the discount houses and the banks. The peculiar relations of these institutions which comprise the London discount market are well known. The clearing banks—the essentially domestic banks, who provide nearly all the bank credit for the country—hold cash reserves related strictly to their deposit liabilities by a conventional 8 per cent «cash ratio». Of these cash reserves, about half consists of till money, the other half being book entries at the Bank of England called «Bankers' Deposits». The banks lend, from day to day, large sums to the discount houses, who employ these funds up to the hilt, holding Treasury and other bills, and short bonds running up to 5 years' life. There is no margin of excess reserves, or spare cash, anywhere in the system: any surplus appearing is mopped up by the Bank of England, and if more is required at any time it has to be created by action of the Bank of England in adding to its assets.

This absence of any margin of excess reserves is the more important because government balances lie outside the structure of commercial bank reserves. Any appreciable net payments by the public to governmental bodies deplete the reserves of the banking system, while net receipts by the public from the government add to the reserves of the banking system. As the banks, striving to keep their cash ratio fixed at 8 per cent, sense the change in reserves, they try to adjust their positions by calling more or less money from the discount houses. These, having and wanting no margin, look to the Bank of England to enable them to meet the situation, and this gives the Bank important opportunities. Alternatively the Bank can itself create the opportunities. Whether the Bank takes the initiative or not, its action is referred to as an «open market operation» unless it insists upon helping the market only at the penal official Bank Rate.

II.

In the pre-1914 period the open market operations of the Bank of England normally took the form of borrowing in the market. The Bank employed a broker who took up call money or very shortdated money from the commercial banks, just as if that broker had been needing the money to finance his own holding of bills. The effect was to create in the Clearing a balance in favour of the Bank of England, and like any other such balance this was settled by Bank of England deduction from the balances standing in its books in favour of the banks who were short. That is to say, the Bank's open market operation enforced directly a reduction in Bankers' Deposits, the cash reserve of the commercial banks. The resulting tightness in the discount market prompted the firmness in the market rate of discount.

In this early period the hardening of the market rate of discount was the only immediate object of the Bank's initiative, and it was sought solely for the protection of the gold reserve. It was often referred to as the process of «making Bank Rate effective», though that phrase was also used more generally to refer to any market movement, whether at the initiative of the Bank or otherwise, which had the effect of pulling market rate up to a normal relationship with the official (and penal) Bank Rate.

Operations in the opposite direction simply occurred when money borrowed by the Bank's broker was paid off—but this was solely in termination of the initial absorption of funds as soon as the Bank considered that the occasion of its original intervention had passed. There were, as far as I know, no occasions when the Bank took the opposite initiative, of pumping funds into the market: if it was willing to see a lower Market Rate, it was always ready to reduce the official Bank Rate. Its predisposition always favoured a low rather than a high Bank Rate, because this official Rate affected lending rates throughout internal banking business, and the Bank's policy was always to create as favourable conditions as it could for home trade, consistently with the interest rates necessitated by the international capital situation. There were accordingly no occasions for open market operations to depress money market rates.

We have no certain knowledge, but there have been hints¹ that the Bank in those days also operated in the long-term market, not only for its own investment purposes but also to influence money market conditions. The principal security available in the gilt-edged group was the 2½ per cent Consols. These, being liable to considerable variations in price, were an unsuitable medium for open market operations designed primarily to effect short-lived alterations in money market conditions. The Bank did not then in its main operations look further afield than these ephemeral conditions; it did not seek direct effects upon long-term interest rates, to which operations in Consols would seem to have been appropriate. Nevertheless, apparently it did sometimes work this way and its action had an immediate automatic effect on bank reserves, since the people to whom the Bank sold Consols banked with the commercial banks. Operations in Consols were thus an alternative, if unattractive, way of creating tightness in the money market.

III.

In the inter-war period technical conditions were more favourable to open market operations, and central bankers were consciously pursuing more complex objectives. The three months' Treasury Bills had become available in hundreds of millions, and there was also a great volume of rather short government bonds. Through the first half of the period British policy was essentially a gold standard policy, even before the actual return to the gold standard in April 1925, but pursuance of this policy was qualified by a tenderness for home trade, more

¹ Cf. Committee on Finance and Industry, 1931. Minutes of Evidence. Qn. 401 (Sir Ernest Harvey).

constantly and in greater degree than before 1914. Policy was also more complex in that there was at times an important element of international co-operation which made gold standard management something very different from the blind, automatic action that had been standard, though not universal, behaviour before 1914. After September 1931 conditions were again different: international considerations were soon pushed into the background, and Bank of England policy became technical support of the government's cheap money policy. The difference between the earlier and the later half of the period was primarily in the underlying policy. The revolutionary change in this made little difference to the money market technique employed by the Bank, though the task of absorbing a great influx of foreign funds very greatly increased the scale of its open market operations, and the Bank also in this period came to take a much more direct interest in the long-term market.

In the 'twenties the Bank took advantage of the larger volume of Treasury Bills by using these as its normal medium for open market operations¹. To a central banker a bill is always more attractive than a bond, on account of the smaller range of capital depreciation. There were tens of millions of pounds' worth of these Bills maturing every week, and the market in them, at all stages in their 3 months' currency, was always active. The Bank of England itself always held a large volume, and the fact that it was constantly having to replace those maturing in its own portfolio would itself have been sufficient to give the Bank considerable influence in the day-by-day determination of the market rate of discount. In fact the Bank was more active than this, and was prepared to operate on either side of the market in pursuance of its general policy. To these operations the market was highly sensitive, very little swing in market resources being sufficient to influence the market rate of discount².

The more favourable technical conditions encouraged the Bank to embark upon these operations much more freely than it had done before 1914. In the pre-war period its restraint in open market operations had necessitated frequent movements of Bank Rate, as indications to the market of how market rate was to be moved in order to protect the gold reserve. During the 'twenties Bank Rate was unchanged for long periods, during which the Bank would by constant open market operations—operations in Treasury Bills—keep market rate at, but no higher than, the level necessary to protect the gold reserve. Detailed comparison between this period and pre-1914 shows the Bank as taking much greater care to offset seasonal variations, particularly the wide variations in the demand for cash in circulation. It was also trying, in its reaction to gold movements, to

¹ Committee on Finance and Industry, 1931. Minutes of Evidence. Qn. 401. «Do you generally, when you operate in the open market, operate through bills or through Government securities? — (Sir Ernest Harvey) Generally through bills. When I say 'generally' I do not wish it to be thought that we do not operate in Government securities. We may operate through Government securities, but, of course, at a time like this when the volume of bills is so much larger than in, let us say, pre-war times, owing largely to the great volume of Treasury Bills, the proportion of operations in bills is larger in comparison with securities than used to be the case.»

² Committee on Finance and Industry. Minutes. Qn. 353.

distinguish between the purely ephemeral disturbance and the more deeply-seated movements—a distinction that was of some importance in a world of overgrown short capital movements. The Deputy Governor of the Bank, describing the system to the Macmillan Committee, said that the open market operations were aimed primarily at keeping the market rate of discount as high as the gold and foreign exchange position necessitated, and that subject to this overriding requirement the operations were aimed at avoiding disturbance to the cash position of the banking system¹. Actually the figures show that the Bank generally rather less than offset gold losses, and rather more than offset gold gains: it exerted, that is to say, a slight but steady pressure on the total of the Bankers Deposits that form the cash basis of the supply of bank money. As the largest bank was in this period reducing its cash ratio significantly, the broad upshot was that the supply of bank money was held almost stable.

Looking back, it does appear that this freer use of open market operations in the 'twenties was an important improvement over the pre-war system. The bill market and the banking system ceased to be subject to great seasonal strains; and the smoothing of the effect of gold movements at least gave a greater chance to the restored gold standard. It is of course possible to argue that the Bank of England ought to have followed a more deflationary policy, maintaining throughout a greater pressure on the cash basis; but that this pressure should have reflected the erratic character of actual gold movements is hardly arguable. At least one may assert that more erratic pressure on the domestic banking situation—that is, less of open market operations—would have aroused sharp criticism and rapidly made the gold standard policy unacceptable. The interest of a policy of foreign exchange stability is, that is to say, better served by intelligent central bankers having at their command open market operations, than by a blind exposure to every wind that blows.

To revert to the history of the Bank of England's technique. After the departure from the gold standard in September 1931 there was a period of about six months during which the Bank felt the foreign exchange position to be so weak that it was obliged to use its open market operations fully to support, in opposition to market tendencies, very dear money. Its first object was to accumulate sufficient foreign exchange to pay off the credits unavailingly used in the effort, in August and September 1931, to maintain the gold standard. Once these needs had been covered, the Bank switched its policy to an independent one of cheap money, primarily for the support of a gigantic conversion operation by the Treasury². In pursuit of this policy the Bank appears to have made an outstanding departure from its usual concentration on the Treasury Bill market: it is understood to have made large purchases of medium- and long-term bonds, in the successful effort to prepare the market for the War Loan conversion. It is necessary to emphasise that the circumstances in which this unusual step was taken were very extraordinary: market conditions (including the return of

¹ Committee on Finance and Industry, 1931. Qn. 345.

² For this 1932 switch in the Bank's operations, see *E. Nevin, The Origins of Cheap Money, 1931-32*, in *Economica*, February 1953.

foreign funds to London) were tending to push interest rates down, the Treasury was anxious to get a quarter of the National Debt converted to as low an interest rate as possible, and business and academic opinion was calling for cheap money to rescue trade from its extreme depression. The Bank's intervention in the long-term market could therefore be described as an attempt to hasten the natural and desirable market trend, in quite extraordinary circumstances of economic stress. It was not a technique the Bank was prepared to employ in any but the most unusual circumstances: certainly there was no sign of its employment when long-term interest rates tended to rise after 1935, even when trade slackened in 1938.

Through the remainder of the inter-war period the Bank reverted to its general practice of operating continuously in Treasury Bills. Its principal aim was, in conjunction with the Exchange Equalisation Account, to insulate the domestic banking situation from the colossal movements of short-term capital into and out of London. The cheap money policy was maintained, at least in the bill market, throughout the period, whichever way hot money was moving. In general the Bank left the market in government bonds to look after itself, though it intervened from time to time to smooth out the effect of new government bond issues. These temporary supporting operations tended to become more prominent as the years went by, not because the Bank was more favourably inclined to them but simply because rearmament brought a larger programme of government borrowing.

IV.

In a very broad way, the Bank's technique during the second war remained much the same as it had been during the rearmament period. The disinclination to go into the long-term market, otherwise than for purely temporary support, remained. Intervention in the bill market, on the other hand, not merely remained continuous but became automatic, as the Bank dropped all pretence of holding the initiative. The Bank's primary contribution to the policy of «the Three Per Cent War» was in fact to hold the Treasury Bill rate at 1 per cent, by standing ready at all times to operate either way in the market at that price.

After the war came the *Dalton* episode, with the official attempt to get the long-term rate down to a $2\frac{1}{2}$ per cent basis. Whether the Bank itself, as well as Government Departments, joined in the heavy buying of medium- and long-term bonds, in this ultracheap money drive, has never been satisfactorily established. In any case, the episode was short-lived and there has not since the beginning of 1947 been any suspicion of sustained operations by the Bank in the long-term market. But the Bank did both during the brief *Dalton* episode and throughout the remainder of the Labour Government's life give full support to the cheap money policy along its more conventional lines of keeping rates at very low levels in the short-term market. Here it continued as in wartime to work automatically: Treasury bills were always discountable at $\frac{1}{2}$ per cent because any market operator short of funds could always get Treasury bills rediscounted by the Bank's own operator, at that fixed rate.

This brings us to 1951, and Mr. *Butler's* «new monetary policy». At first sight, the technical changes looked very great; but this has proved an illusion. The principal change, apart from the lifting of market rates, is that the Bank of England's action in the discount market has ceased to be purely automatic: it now reserves the right to choose the rate at which it will operate, even to the extent of forcing borrowers to pay its official penal rate. But technical circumstances in the market have made, and will continue to make, it necessary for the Bank to operate on a very large scale continually. The Bank is thus continually in a position to enforce, without effort, whatever rate it pleases. It has in fact used its power to hold the market rate of discount pretty well constant. Market operators have been allowed to approach the Bank's operator with almost the old assurance that funds will be available without disturbance of market rates; the occasions on which discount houses have been forced to go to the Bank's front door and pay the penal rate have appeared no more than sufficient to keep market operators aware of the procedure. The Bank has continued, that is to say, to rely almost entirely on its own operations in the market to keep market rates at very steady levels dictated by itself.

Before passing to more general matters brief reference must be made to certain technical details, market descriptions of which are a little confusing. Until 1939 the Bank of England did not ever operate by transactions directly with the commercial banks. The banks were—and are—lenders to the discount houses, and the Bank would relieve a shortage of funds in the market by buying bills from the discount houses. But the Bank, in the interest of not providing funds for unnecessarily long periods—it wants, we may say, «to keep the market on its toes»—is very particular about the dates of the bills it buys. In general it prefers those very close to maturity. When maturity comes, market operators are taking up the replacement bills, and they therefore, through the government account, have to pay the Bank of England the value of the maturing bills held by the Bank on its own account. The Bank has thus provided the market with funds only for the short remaining life of the bills it takes, reasserting its power as they mature. Exceptions to this general preference for short bills are made occasionally in favour of bills maturing on some date a month or so ahead when the Bank knows that some exceptional movement will be putting the market in funds. But in one way or the other the Bank's preferences are narrowly limited—to very short bills or to others of special dates—and it may be that the discount houses have not sufficient of these bills for selling to the Bank's operator. The tendency for the commercial banks to buy bills as these approach maturity indeed makes it unlikely that the discount houses will always have bills of just the dates the Bank is seeking. The Bank of England's operator—the «special buyer» is therefore prepared, if difficulties of this kind arise, to buy Treasury Bills from the commercial banks, who are then able to lend more freely to the discount houses. In this case the special buyer is said to have given «indirect help» to the market; the help being, on the other hand, described as «direct» when the Bank's operator buys bills from the discount houses themselves, when

these find themselves unable to borrow sufficient from the commercial banks but have in their portfolios bills of dates sought by the special buyer.

It will be appreciated that these technical terms, «indirect» and «direct help», are perverse in that the help provided by the Bank of England is really designed to protect the cash reserves of the commercial banks, so that one would expect official purchases of bills from these banks to be labelled «direct help». But the intervention of the discount houses is so ingrained in the English system that the terminology is based on the fabulous assumption that it is the liquidity of these discount houses that is the ultimate object of the central bank's concern.

In the last few years market operations by the Bank of England, whether of the direct or indirect form, have been almost continuous. This is due to the great swings of payments and receipts between government accounts (which are separate from the commercial bank's reserves) and private accounts, resulting from the greatly increased weight of government activity in the British economy. Efforts have been made to moderate these swings, with some success, but they remain considerable and as long as the authorities want the commercial banks to maintain stable cash ratios while official balances are outside these ratios, constant swings in the money market position are inevitable. The ease with which the central bank can offset them by its open market operations makes these swings harmless; and they enable the central bank to maintain continuous and perfect control of the rates of interest ruling in the short-term markets.

V.

In general the Bank of England confines its substantial open market operations to the short money market. Upon occasion it has made important interventions also in the Stock Exchange markets for medium- and long-term government securities. Such was the episode of 1932, referred to earlier. Through the remainder of the 'thirties the Bank confined its operations in this market to a minor grooming of the market when new bond issues or conversion offers were in train. It is commonly believed that in the *Dalton* drive for ultra-cheap money in 1946 the Bank of England threw its weight into the market, in support of the Chancellor's policy, but this has never been authoritatively admitted. Since that occasion the Bank is understood to have confined itself to smoothing operations, notably in steadying a demoralised market in the autumn of 1949.

This unwillingness normally to operate in the long-term market is contrary to the recommendation of the Macmillan Committee in 1931. At that time economists stressed the long-term rate of interest as an important weapon of contra-cyclical policy, and the monetary authorities' control of short rates was thought important largely for the sake of its influence upon the long rates. In these circumstances there was much to be said for intervention by the central bank in the long-term market. Since then, however, economists have rather lost faith in the long-term interest rate as a weapon of monetary policy, and the central bankers themselves seem to have been sceptical.

Against substantial intervention in the long-term market, there is the argument that the relation between short and long rates is determined by public preferences for various degrees of liquidity: that the gap between, say, the Treasury Bill rate and the yield on Consols is determined at any moment by these preferences and that the Bank can therefore push the long rate about as it likes by, and only by, moving the short rate. If it attempts to alter the long rate without moving the short rate, it will simply be inundated with bonds (if it tries to push the long rate down) or with cash or short paper (if it tries to push the long rate up). This argument is alleged to have the support of the post-war experience of the American Federal Reserve System, which was faced by disbelief in the permanence of the rigid structure of interest rates inherited from the war period. But account must be taken of the fact that the entire supply of bonds is not at any one time held by a uniform body of investors who all take identical views of the interest rate structure: much of the National Debt will on the contrary be held tightly, and the remainder will be spread among holders whose views and preferences will ordinarily vary considerably. If the central bank is prepared to sell or to buy an appreciable proportion of the total National Debt, it should be able to make an appreciable impression on the difference between short and long rates. In support of their efforts, the monetary authorities can always alter any bonds already in their possession to bills (if, when trying to raise long rates, they run short of ammunition); or alter any bills in their possession to bonds (if they are trying to depress long rates). This elasticity of the supply of ammunition is important: especially if, as in Britain and elsewhere, it is thought proper that securities held as «backing» for the note-issue should be very short-term paper.

In Britain the proportion of the National Debt held by the central bank is appreciable—something like one-twelfth—and altogether nearly a quarter is in the hands of government departments and other bodies more or less under central control. Whether this is a proportion large enough to enable the central bank by open market operations of the most venturesome kind to force upon the market a great alteration in the structure of interest rates is doubtful. Certainly it would be altogether too risky a business to attempt to freeze a precise pattern of rates, an attempt in which the Americans ultimately failed although they had comparatively large resources at their disposal. But there may well be room for rather more venturesomeness than has become conventional. The market may often be ready to be led, and, as the Macmillan Committee suggested long ago, the central bank could sometimes by judicious operations in the long-term market, not amounting to a pegging of prices, accentuate market tendencies that it thought desirable and counter movements in the wrong direction.

VI.

The upshot of all this is that, though operations in the long-term market might be employed rather more freely than is nowadays the practice in England, central bankers should review the technical conditions for such operations very

carefully before they embark upon them; and in any case they should beware of over-ambitious efforts of this kind. Unless technical conditions are exceptionally favourable, it is much easier for the central bank to exert its influence by pushing short rates up or down, relying upon a normal public reaction—perhaps helped by a readiness to explain the policy—to bring about a desired movement in long-term rates. In controlling the short-term rates themselves, the central bank can, as the British example shows, employ open market operations to great effect. Technical circumstances are, admittedly, highly favourable to such operations in London. The most important of these conditions is not the existence of independent bill dealers, which other centres have found so elusive, but the great variability in the cash available to the commercial banks, a variability imposed by the separate accounts of the government in the Bank of England. The conventional fixity of the cash ratio has to be protected against this variability of the cash automatically available; this need gives the central bank the opportunity to impose, in its open market operations, the short-term interest rates it deems appropriate. The way to ensure reality for Bank Rate policy is, thus, to ensure that the central bank is continually operating in the money market; and conditions for success in this can easily be created in an active financial centre. The conditions for successful operations in the long-term market are more elusive, and perhaps central bankers are wise in their conventional shyness of these more ambitious open market operations.
