MONETARY BASE CONTROL: A USEFUL ALTERNATIVE FOR THE NETHERLANDS?

BY

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I INTRODUCTION AND BACKGROUND

Monetary policy in the Netherlands is aimed at control of the liquidity ratio, \textit{i.e.} the money supply as a percentage of net national income. Liquidity here means $M_2$. The liquidity ratio is viewed as a global measure or informative signal of the liquidity of the economy. This policy of controlling the liquidity ratio may easily be translated into a policy of a desired growth rate of the money supply, taking into account (unavoidable) price increases, the expected growth in real income and cyclical fluctuations in the demand for liquidity.

Control of the money supply in the Netherlands is traditionally exercised at the sources of liquidity creation, \textit{viz.} public sector finance, the balance of payments and net credit expansion of the banking sector. Although the Netherlands Bank has in some way or other the power to influence each of these sources, emphasis is given to controlling bank lending. The Bank does control net credit expansion of the banking sector as a whole by imposing ceilings on bank credit expansion. These are derived from the liquidity ratio target, while making allowances for the expected or normative impact of the public sector and the balance of payments on the money supply.

The Bank's strategy seems to be in sharp contrast to the monetarist view on controlling the money supply. Monetarists often contend that monetary control should be exercised through control of the monetary base. Present-day adherents of this view very often derive their preference from the literature. This literature seems to be biased in that neither a comparison between, nor a thorough evaluation of, the advocated strategy and other methods have been undertaken. Another factor not to be ignored is that this literature is based on

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monetary practices in the United States. Little attention, however, is paid to the question whether an approach suited to American circumstances is also applicable to the much more open economies of Western Europe.

The major aim of this paper is to find out whether monetary management through control of the monetary base is feasible in the Netherlands and the extent to which this approach differs from the monetary strategy pursued at present in the Netherlands. To that end the following questions are analysed: First, what is base money in the case of the Netherlands and how is it measured? Second, which specific problems arise from the openness of the Netherlands economy with regard to the definition and measurement of base money? Third, to what extent is the operational framework required to control the money supply via the monetary base stable? The result of this analysis enables us to answer the question of whether the line of policy thinking prevalent in the Netherlands and control of the monetary base in practice are clearly discernible, and which approach is most suited to the actual circumstances in the Netherlands.

2 MEASUREMENT

The literature defines base money as those liabilities on the balance sheet of the monetary authorities which are liquid assets to the private sector or money-creating institutions. The relevant liabilities can be listed as follows:
- notes and coin held by the general public;
- notes and coin in the hands of the banks;
- deposits at the central bank; and
- drawing rights on the central bank (notably credit facilities open to the banks, which ensue from the central bank's function as lender of last resort).

Although the above listing seems adequate for analytical purposes, a concrete enumeration of the specific liabilities is called for if a satisfactory statistical description and an appropriate measurement are required. The balance sheet of the central bank, amended to include the public authorities' function as an issuer of coin, seems to be an appropriate starting point. This summary balance sheet as of October 15, 1979 is given in Table 1. It shows that the assets side is dominated by items which together form the gold and foreign exchange reserves, while the liabilities side is dominated, apart from items due to revaluation, largely by bank notes. This is even more evident when we summarize the balance sheet into a monetary-analytical enumeration (amended to include the public authorities' function as an issuer of coin) as presented in Table 2.

1 Although this concerns only a relatively unimportant amount for the Netherlands, it is included for the sake of completeness.