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University of Loughborough

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DEPARTMENT OF ECONOMICS
DAVID T. LLEWELLYN
Professor of Money and Banking

DTL/BM

30 July, 1981.

Mr. Middleton,
H.M. Treasury,
Whitehall,
London, SW1

Dear Mr Middleton

Some time ago you were kind enough to invite me to the Church House meeting though, as I had a commitment abroad, I was unable to attend.

You might be interested in the attached paper I wrote for Carr Sebag. I remain sceptical about monetary base control and every week that passes in the US reinforces my scepticism. In fact the paper was written in March.

It is some years since I was working in the Treasury and since then I spent a period at the IMF. If there were an opportunity, I would be very happy to renew contact.

With kind regards,

Yours sincerely

David T. Llewellyn

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1. MR MONCK

2. CHANCELLOR

cc PS/FST
Sir D Wass
Mr Burns
Sir K Couzens
Mr Ryrie o.r.
Mr Middleton
Mr Britton o.r.
Mr Cassell
Mr Evans o.r.
Mr Kemp
Mrs Lomax o.r.
Mr Pirie o.r.
Mr Riley
Mr Turnbull
Mr Davies

THE NEW MONETARY SECTOR: IMPLICATIONS FOR THE £M3 TARGET

One of the items covered in the Bank of England's paper on "Monetary Control - Provisions" is the replacement in the near future of the old statistical concept of a "banking sector" by a "monetary sector". This new sector will embrace a larger number of institutions than the old banking sector, primarily because of the addition of the larger Licensed Deposit-Takers, and the Trustee Savings Banks, and will result in a break in the current series for £M3. This submission seeks your approval of the date at which the changeover to the new sector will take place and the methodology for dealing with the break in the £M3 series within the context of the current target.

Background to the new "Monetary Sector"

2. The 1979 Banking Act, which came into effect in April 1980, created two classes of banking institutions: Recognised Banks and Licensed Deposit Takers (LDTs). The bulk of the second category is made up of institutions which had not previously been amongst the so-called "listed banks" which form the statistical base for the current banking sector. Deposits with these institutions tend however to be as money-like in nature as deposits with the current listed banks. Incorporation of these institutions into a broader "monetary sector" will therefore provide a more comprehensive coverage of monetary assets. For similar reasons, it has been though right to bring the Trustee Savings Banks within the scope of the enlarged

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sector. As before, National Giro, the Banking Department of the Bank of England and - subject to their approval - banks in the Channel Islands and the Ise of Man will continue to be included.

3. The Bank's paper suggests that the additional LDTs could add about 3½ per cent once-for-all to the level of £M3 and the TSBs a further 9½ per cent. There is no way of knowing what the implications might be for future rates of growth of the aggregates.

Possible changeover dates

4. There are strong arguments for making the changeover in statistical sectors as soon as possible after the new monetary control arrangements begin to take effect. Until the reporting procedures are revised, there will be deficiencies in the basis on which the existing listed banks will have to compute their eligible liabilities for the purpose of assessing their deposits under the new cash ratio requirements. And for the "new entries" to the monetary sector it is envisaged that two months' figures will be needed before they can be asked to start making cash deposits with the Bank of England. The maximum realistic gap between the start of the new control procedures and the change in reporting procedures is probably about four or five months. This would also mean that everything would be in place before next year's budget and announcement of a new monetary target.

5. Given the fact that it will take a little time for the Bank and banks to negotiate the new arrangements, the changeover date will probably have to be some time between November and January. Make-up days for December and January are likely to present some problems for the banks, so that the end of banking November (November 18) emerges as the best candidate. This is also the date mentioned tentatively in the Bank's paper on "Monetary Control - Provisions".

<u>Implications for monetary target</u>

6. The main drawback of a mid-November changeover date is that it comes midway in the current target period. It would provide an immense extra burden on the banks to collect data simultaneously on two bases between November and the end of the target period; backdating the new series to February 1981 would be even less feasible given the lack of information to date on the new entrants to the sector. The old and new series for £M3 will therefore have somehow to be spliced together using the November data as a link. This procedure was foreshadowed in paragraph 29 of the paper on "Monetary Control: The New Arrangements" for the Prime Minister's seminar on 31 July.

7. We have discussed with the Bank various possible ways of producing a spliced series for £M3 which will cover the whole of the current target period. Information is already available (and published) on the Trustee Savings Banks. This can probably be used as a basis for estimating what their contributions to £M3 would have been in February of this year. For the other new entrants to the sector, we propose to estimate a grossing-up factor which can be applied to the recorded level of £M3 in February. This factor will be equal to the relative size of the new entrants to the listed banks in November. Since the new entrants are thought likely only to contribute about 3½% to £M3 any errors due to differences in rates of growth between February and November should be very small.

8. This procedure will result in a fairly easily-understood "new" £M3 for February 1981. Growth in the target period can then be calculated using values of the new recorded £M3 series subsequent to November 1981. Intervening months can be readily interpolated.

9. An alternative way of avoiding the problem created by a break in the middle of the target period would be to rebase the target formally in mid-November. It was decided last

autumn that a rollover of the target in the middle of the financial year would not then be appropriate. This is clearly not a suitable moment to reopen the issue for this financial year, but - notwithstanding uncertainty about the after-effects of the Civil Service strike - it remains a possible option.

Conclusions

12. Subject to your views, we propose to

(i) Agree that the Bank start consultations as soon as possible with institutions in the new "Monetary Sector" with a view to obtaining monetary data on the new definitions from mid-November onwards.

(ii) Agree that the joint returns obtained in November should be used in the preparation of an estimate of the mid-February 1981 level of £M3 for the purposes of assessing growth in the current target period. The Bank would announce their methodology for doing this in advance, preferably near to the publication of the final version of the Monetary Control document in early August.

Jon Shields

JON SHIELDS
31 July 1981

As you know from the seminar paper on the New Arrangements (see para 6 above), there will be a once and for all addition of about 13 per cent to £M3 when the new enlarged "monetary sector" comes into statistical existence. This submission deals with the date for that change and with the method of estimating, for the new £M3 series, a February figure as a base for the current target period. November is a convenient date. On the method of estimat[ing] a new base Mr Shields has persuaded the Bank to change their origina[l] suggestion, which would have exaggerated the growth rate of £M3 a little. I agree with Mr Shields' advice on both points.

NM

N MONCK

MR MONCK

cc Mr Middleton
Mr Turnbull
Mr Lennon

SUSPENSION OF MINIMUM LENDING RATE

This minute records what I told you on Friday about the practical implications of suspending MLR.

2. You will recall that our trawl of Departments earlier this year threw up no insuperable difficulties and we concluded that we would probably be able to go ahead with suspension with fairly minimum notice to Departments. Subsequently the Law Society advised the Bank of a number of items of legislation which we had not discovered in our trawl which they claimed would require amendment. They also of course drew attention to the frequent use of MLR in contracts.

3. As for legislation, I am now convinced that there is nothing which could prevent us from suspending MLR on 20 August. It transpires from discussions with the Bank and a number of other Departments that most of the items of legislation put forward by the Law Society are either not in force or can in due course be amended without significant transitional problems. I will not burden you with the details, but there are only three cases in which amending orders need to be laid. In one, a piece of MAFF legislation the amending order has already been prepared. In another case since the legislation provides for a maximum interest rate of 13% or MLR plus 1% if interest rates move up considerably in the next few months it may be necessary to propose an amending order, but there is no urgency. In a third case involving insurance brokers the Department will need to consult the insurance brokers council but say that this would take a period of months and they would not require advance notification of the suspension of MLR. I have told the Bank of England. They are content and will so inform the Law Society.

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4. This leaves the problem of contracts. The Bank accept that there is no overriding reason for us to reach agreement with the Law Society but think it would be helpful if we do so. As you know the Law Society initially proposed legislation which the Bank rejected. The problem turns essentially on whether the Law Society will agree to recommend a rate based on interbank rates as an acceptable alternative to MLR. The Bank know that this is our preferred solution and that we are very doubtful about publishing an alternative rate based on the rates at which the Bank have dealt in the market. You are discussing this further with Mr Somerset today.

Howard Davies

H J DAVIES
3 August 1981

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1. MR MIDDLETON
2. CHANCELLOR OF THE EXCHEQUER

c c PS/FST
Sir Douglas Wass
Mr Burns
Sir Kenneth Couzens
Mr Ryrie
Mr Middleton
Mr Britton
Mr Cassell
Mr Evans
Mr Kemp
Mr Lomax
Mr Piry
Mr Riley
Mr Turnbull
Mr Davies
Mr Ridley

NEW MONETARY SECTOR : IMPLICATIONS FOR THE £M3 TARGET

I understand that you want to consider further the proposals in Mr Shield's submission of 31 July that a new £M3 series should be collected from November and that the February base for the monetary target should be adjusted accordingly.

2. There is no need to settle this finally today. The Bank's paper on the new provisions mentions November, but in a non-committa way.

3. Para 22 says that as soon as possible after 20 August ".... (probably in respect of make up day in banking November) currently reporting institutions will be asked to produce figures for one reporting date both on the basis used hitherto and on the basis of the enlarged list of institutions comprising the new monetary secto For completeness I enclose a copy of this document for you.

4. There is no reference in the Bank's press notice or notes to editors to the date of the transition and Bank briefing will be ver low key and stress that no final commitment has been made.

5. All this means that the Bank accept that the message which is recorded in manuscript on your copy of the submission that they "would like the ok first thing" today was not really necessary. O own submission did not ask for such a rapid decision and I am sorry you felt you were being rushed.

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6. We have discussed with the Bank your suggestion of continuing with the present series, base and figures until the end of this monetary year with the other series being collected in parallel but not necessarily published. But I am afraid there would be a number of difficulties :

(a) The Bank consider that there is no chance of persuading the banks to collect figures on two different bases for more than one month. For technical reasons this would be complicated even for members of the existing "banking sector" : the definitions of the statistics required vary with the definition of the sector. The reason for this is that in order to avoid double counting banks have to report figures for their liabilities net of "offsets" for funds lent to other institutions within the sector. The definition of the sector obviously affects the size of the offsets. Hence the need for two sets of figures.

(b) There is the problem that the statistical changes are tied up with the new and extended ½ per cent cash ratio. There will be a protest if the statistical change is delayed unnecessarily. Institutions which are members of the existing banking sector will have to deposit ½ a per cent of their eligible liabilities with the Bank from 20 August, but the new institutions will not have to deposit their ½ per cent until the new figures are available. Those who have to start paying in August will argue strongly that this delay is inequitable or causes unfair competition. They will also claim that statistics on which their cash ratio is based are not correct while they do not allow for offsets for funds deposited with new entrants and that this should be put right as soon as possible.

7. Moreover, we do not think that the switch in series is as "important" as you fear. The annex by Mr Shields explains why the quantitative effects, if they occur at all, are likely to be small compared with what the improved series would have shown if it had been available in February. This is not the same as comparing the likely movement of the old and new series. But our judgment is tha if anything the new series is likely to show a slightly slower growt

8. For these reasons I hope that on consideration you will feel able to agree with the proposed date for the statistical switch and with the method of arriving at the new February base.

NM

N MONCK
5 August 1981

1. MR MONCK

2. CHANCELLOR

cc PS/FST
Sir D Wass
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NM

N MONCK

ANNEX

QUANTITATIVE EFFECTS OF STATISTICAL SWITCH

The extension of the banking sector to include all Licensed Deposit-Takers and the Trustee Savings Banks will result in a more comprehensive coverage of money-like assets within £M3. The market is expecting this change (it was in the Bank's earlier documents). The change to the new monetary sector should **be of benefit to** monetary policy.

2. The only problem is the resulting statistical "break" being made in the £M3 series within the target period. If the splicing technique adopted to overcome this break were to result in a false reading of monetary growth during the period, the implications could be awkward.

3. In practice, because of the expected relatively small contributi[on] of the additional LDTs to the £M3 series any error resulting from a poor splicing technique is likely to be extremely small. To demonstr[ate] this it is perhaps easiest to consider the <u>maximum</u> divergence that might occur between 'old' and 'new' banks and hence estimate the maximum potential size of error. In normal circumstances such divergences would be very unlikely to open up.

4. The Bank's proposed methodology effectively assumes that the growth in eligible deposits of the 'new' institutions will be the sam[e] as those included in the old banking sector between the period mid-February and mid-November 1981. In this period 'old' £M3 could grow by as much as 13% (before adjustment for the strike). The minimum conceivable growth of the deposits of the new institutions in this period is probably about 5%. Should that prove to be the case, the Bank's methodology would result in an overstatement of £M3 growth of less than ¼% for the period. In this case, £M3 growth for the 14 months of the target period would be over-stated by about 0.2% at an annual rate or roughly one-twentieth of the width of the range within which it is intended to constrain £M3.

5. The problem might have been much worse if the Bank had followed their original intention of using their "grossing-up" procedures for

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the TSBs as well. This could have taken the maximum error up to 1% of £M3. Now that the intention is to use direct data from the TSBs for February to November as well as thereafter, there should be little problem about getting a "true" reading from this source.

MONETARY CONTROL - PROVISIONS

Introduction

1 On 24 November 1980, the Bank published a Background Note describing a number of improvements to be made to the existing framework of monetary control. On 12 March this year, in a paper entitled "Monetary control: next steps", more detailed proposals on a number of the subjects covered in the Background Note were sent to all recognised banks and licensed deposit-takers (LDTs). The present paper sets out the provisions resulting from discussions since then with the various associations, as well as with a number of individual institutions.

The cash ratio

2 A substantial part of the Bank's resources and income in recent years has been provided by the average of 1 1/2% of Eligible Liabilities (ELs) maintained by the London clearing banks in non-interest-bearing accounts at the Bank. This sum has also served as a fulcrum for money market management. The Bank's paper in March proposed that this latter purpose should in future be served by the volume of operational funds which the London clearing banks would retain voluntarily at the Bank for clearing purposes, while the Bank's resources and income should additionally be secured primarily by a uniform requirement on all banks and LDTs to hold non-operational, non-interest-bearing deposits with the Bank. The provisions set out in this section have accordingly been designed to provide, in aggregate, broadly the same amount of non-interest-bearing funds initially as did the previous arrangements with the London clearing banks alone.

3 This non-operational requirement will be 1/2% of an institution's ELs and will apply to institutions covered in paragraph 16(i)-(iii) below having ELs which average £10 million or more in the latest period over which the requirement is calculated. The level of an institution's non-operational balance will be set twice a year in relation to its average ELs in the previous six months[1].

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[1] A deposit calculated in, say, May would relate to the monthly average of ELs from November to April inclusive.

4 For institutions not on the present statistical list of banks and whose business mainly comprises the provision of fixed rate finance for periods in excess of one year, the Bank accepts that the introduction of the 1/2% cash ratio may present a special transitional problem. The Bank will be prepared to consider individual representations from such institutions for some temporary alleviation of the requirement. In addition, in recognition of the special conditions in Northern Ireland, the Bank has reduced to 1/4% the cash ratio to be observed by institutions for which Northern Ireland is the principal place of business in the United Kingdom. This concession will apply in respect only of the ELs of their Northern Ireland offices and will run for two years, when it will be reviewed.

5 ELs are to be redefined to reflect the changes set out in this paper. In future, offsets will be allowed in the calculation of ELs in respect of:

(i) funds (other than cash ratio deposits or Special Deposits placed with the Bank) lent by one institution in the newly defined monetary sector[1] to any other;

(ii) money at call placed with money brokers and gilt-edged jobbers in the Stock Exchange, and secured on gilt-edged stocks, Treasury bills, local authority bills and eligible bank bills.

6 ELs will be calculated in uniform fashion for all reporting institutions[2] except:

(i) members of the London Discount Market Association (LDMA), whose ELs will be calculated as the total of sterling deposits other than from institutions within the monetary sector and from money-brokers and gilt-edged jobbers in the Stock Exchange.

(ii) certain banks with money trading departments, who will be allowed to omit from their ELs secured money at call placed by other banks with these departments, up to a limit set by the Bank.[3]

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(1) See paragraph 16 below.

(2) The present arrangements for those finance houses which have observed a 10% reserve asset ratio since 1971 will lapse accordingly.

(3) The banks concerned are: Algemene Bank Nederland, Banque Belge, Charterhouse Japhet, Leopold Joseph and Samuel Montagu. Hitherto, funds placed on this basis, up to a limit set by

7 It would be contrary to the objective of these agreed arrangement for any institution to reduce its ELs deliberately or artificially on reporting dates. The Bank accordingly reserves the right to make a spot check on the level of an institution's ELs on days when it would not normally report.

Special Deposits

8 The Special Deposits scheme remains in place and will apply to all institutions with ELs of £10 million or more at the latest make-up day for which figures are available[1]. As hitherto, calls will be set as a percentage of ELs. The scheme for Differential Special Deposits[2] has lapsed.

Eligibility

9 As set out in its March paper the Bank has judged applications, by recognised banks wishing their acceptances to become eligible for discount at the Bank, according to the following criteria:

(i) whether the applicant has and maintains a broadly based and substantial acceptance business in the United Kingdom;

(ii) whether its acceptances command the finest rates in the market for ineligible bills;

(iii) whether, in the case of foreign-owned banks, British banks enjoy reciprocal opportunities in the foreign owners' domestic market.

A first list of eligible banks is attached.

10 A bank may apply for eligibility at any time. An eligible bank which wishes to renounce its eligibility is free to do so on giving notice to the Bank.

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(1) Hitherto only banks on the statistical list and finance houses observing a reserve asset ratio have been subject to Special Deposits.

(2) Details can be found in the Bank's Quarterly Bulletin for March 1973.

Undertakings by eligible banks

11 From 20 August 1981, each eligible bank undertakes to maintain secured money with members of the LDMA and/or secured call money with money brokers and gilt-edged jobbers[1] - all at market rates appropriate to the nature of the lending - such that:

(i) the total funds so held normally average 6% of that bank's ELs (as defined in paragraph 5);

(ii) the amount held in the form of secured money with members of the LDMA does not normally fall below 4% of ELs (as defined in paragraph 5) on any day.

12 In relation to the above undertaking, each eligible bank will

(i) aim to meet the daily average ratio over either six or twelve month periods (having first notified the Bank of its choice of period), the ratio on any particular day in a banking month being calculated as a proportion of ELs at the last but one make-up day.[2]

and

(ii) to provide monthly returns of its daily figures, which the Bank will use to assess the bank's performance relative to its long-term commitment.

A bank will go below the minimum only in exceptional circumstances and will be ready to explain such action to the Bank when the relevan[t] monthly return is made.

13 The Bank will be prepared to review these undertakings, in consultation with eligible banks and the LDMA, when sufficient experience of the operation of the arrangements has been gained, covering at least a year. The Bank will also be prepared to discuss particular difficulties, as they arise, with any party to the arrangements.

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(1) The Bank's concern with the adequate availability of funds for the efficient functioning of the gilt-edged market was noted in "Monetary control: next steps". There are six recognis[ed] money-brokers - James Capel & Co, Cazenove & Co, Hoare Govett (Moneybroking) Limited, Laurie Milbank & Co, Rowe & Pitman Money Broking and Sheppards and Chase. Secured call money with these firms has hitherto counted as a reserve asset. The amount of such money which these firms can take will continue to be limite[d] by the Bank.

(2) For example, the relevant ELs figure for each day in banking September will be those as at make-up day in banking July.