6. Monetary Base Control III

14/11/1980 – 26/11/1980

2/A/0387

MR MONCK

cc Mr Burns
Mr Ryrie
Mr Middleton
Mr Unwin
Mrs Lomax
Mr Riley
Mr Culpin
Mr Grice
Mr Shields

THE RESERVE ASSETS RATIO AND PRUDENTIAL LIQUIDITY REQUIREMENTS

In the context of plans for the announcement in the week of 24 November, we have discussed the proposition that the simplest solution to the Reserve Assets Ratio problem would be to abolish it forthwith, leaving banks to take care of their own liquidity requirements. There is, I understand, now general agreement that abolition tout court would not be sensible from a prudential standpoint. But it may be helpful to set out some of the reasons for this view, and to comment on the possible way forward.

Prudential Requirements : Background and General Points

2. With all the other problems which a change in the system of monetary control presents, prudential requirements may seem a particularly tiresome obstacle. But I make no apology for stressing their obvious importance. This is greater than ever in a severe recession. The last thing we want is a banking crisis amid all the other problems, and we must ensure that any steps taken in the context of changes to the monetary control system do not increase the risk of one.

3. Besides this very obvious but important point, it would run against the trend of the last decade for the Bank, as supervisory authority, to give the impression that it was prepared to take a more relaxed view of prudential liquidity. The RAR has, willy nilly, come to play a significant prudential role for nearly 10 years. During that period, banking supervision has in the the first instance been put on a more intensive and systematic basis and has

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subsequently become a statutory duty of the Bank of England. At a time when this duty has been in force for little over a year, and the system is just settling down on a statutory basis, an apparent relaxation would seem very strange, and could not be defended if a banking collapse then took place, even if the two events were not directly connected. Moreover, the Bank's consultative paper on prudential liquidity was generally criticised for proposing a tightening of the requirements, and a relaxtion would look like the proverbial U-turn, which would damage the Bank's credibility as supervisory authority.

4. For all these reasons, straight abolition of the RAR before alternative prudential requirements were ready to replace it would not be acceptable. Reducing the RAR would also tend to give the wrong signal from a prudential point of view. It would be a move in the wrong direction if the eventual aim is a single, wider, prudential liquidity requirement expressed in terms of a larger percentage of assets. Assuming decisions on an evolutionary approach to the monetary control system with much of the detail remaining to be decided as we go along, it is important not to rush fences on the prudential side. Above all an impression of muddle or relaxation must be avoided, because this will give quite the wrong message to the banking system and to the public.

An Approach to the new Prudential Liquidity Requirement

5. The RAR still performs a useful function in prudential terms, but it impinges on monetary control. The present problems in the money markets arise because the RAR is biting as a monetary control in an undesired way. The steps taken to alleviate the problems (sale and repurchase agreements) are intended to prevent the RAR doing this. But they do not weaken prudential control because the Bank is, for the duration of the agreements, de facto extending the range of assets which are seen as primary liquidity (assets which can be turned into cash in all circumstances because they are eligible under the lender of last resort facility). They are thus implicitly underwriting banks' lending and ensuring the degree of prudential liquidity required by the RAR. The prudential liquidity requirement which replaces

it needs to combine two virtues : it should avoid weakening prudential control and it should interfere as little as possible with the chosen system of monetary control.

6. With a new approach to monetary control and the lender of last resort facility, it seems probable that the distinction previously drawn between primary and secondary liquidity will no longer be valid, so we will be thinking in terms of a general liquidity requirement embracing both categories, and making no subsidiary requirements about sub-categories within the total.

7. Given the shift towards lending to the private sector in the banks' asset distribution, their relative shortage of public sector assets, and the importance of such assets for prudential purposes, both to the banks themselves and for any normative ratio, one cannot rule out the possibility that a prudential requirement might put pressures on them which conflicted with requirements of monetary control. But a move away from the RAR and towards a wider single liquidity requirement would broaden the range of assets they would be seeking to hold for prudential purposes and make conflict much less likely. While a considerable proportion of assets held for prudential purposes would still consist of public sector debt, the particular problem caused by the RAR - of shortages of particular kinds of public sector debt - should not recur in the same way with a wider ratio.

8. Gordon Pepper has suggested that the range should be widened straight away by increasing the percentage of commercial bills which can be included. There must be some doubt about this when the assets of a banks needs to hold, and which they offer in the sale and repurchase arrangements, are gilts of over 1 year's maturity. If this idea were being pursued it might seem more logical, given the slightly greater element of risk associated with commercial bills, particularly in a recession, to choose gilts up to 5 years rather than bills.

9. The Bank's consultation paper of March 1980 proposed that a liquidity requirement should be expressed as a <u>norm</u>, not a <u>minimum</u> (as the RAR now is). It would be possible to introduce this change as part of a transition towards new monetary control and prudential arrangements.

A C PIRIE
14 November 1980

BB- Middleton

2/101/8312

NOTE OF A MEETING HELD IN THE CHANCELLOR OF THE EXCHEQUER'S ROOM, H.M TREASURY AT 8.45 AM ON FRIDAY 14TH NOVEMBER, 1980

Present:

Chancellor of the Exchequer (in the Chair)	Governor of the Bank of England
Financial Secretary	Deputy Governor
Sir Douglas Wass	Mr. Fforde
Mr. Burns	Mr. Coleby
Mr. Ryrie	Mr. George
Mr. Middleton	Mr. Goodhart
Mr. Britton	
Mr. Monck	

MONETARY CONTROL : THE NOVEMBER STATEMENT

The meeting had before it the note of the issues which might be covered in the November statement on monetary control submitted by Mr. Britton on 13 November. This note embodied the results of discussions with the Bank during the preceding week aimed at defining the area of agreement and clarifying the differences of view between the Treasury and the Bank.

2. Sir Douglas Wass defined the differences in view between the Treasury and the Bank on the following lines. The Bank were anxious to avoid multiple targeting, and would not wish to operate a system which involved short-run targets for the monetary base and somewhat longer term targets for sterling M3. They were willing to move to a more flexible system of determining short-term interest rates, which would involve limiting access to the discount window; but they would want to operate by reference to a variety of economic factors, while the Treasury would like the guiding light to be a relatively narrow monetary aggregate - ideally this might be M_2, but there was no statistical series available, so perhaps in the interim M_o might be used instead. For the time being sterling M3

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would remain the broad aggregate to which attention was paid, but over time the main focus might move towards M_o. On the determination of short-term interest rates, the question was whether the mark should have greater influence by reference to the path of M_o. On th marketing of long-term debt, if short-term rates were related to M_o, there would be a need for more flexible arrangements for debt sales so as to achieve the objective for sterling M3; this might involve some combination of more aggressive marketing, some use of the auction technique, and perhaps the issue of RIGs. The attraction of the RIG was that it would make it possible for debt to be sold in market conditions when no-one would buy conventional gilts. For their part, however, the Bank did not believe that conventional gilts could be sold more aggressively - this they thought would have a perverse and damaging effect on the financial markets.

3. Sir Douglas Wass confirmed that the Treasury were no longer contemplating a move to a mandatory Monetary Base Control (MBC) system directed towards M_2, which would involve a cash requirement far above 1½ per cent of eligible liabilities; experience with such a system would not tell us how a non-mandatory MBC system would work. The Treasury now envisaged using the system which would emerge from the abolition of the reserve asset ratio (RAR) and the more flexible management of short-term interest rates as a half-way house which might in time lead to a non-mandatory MBC system; but there was no question of taking a decision now whether or not to take this further step. It was to be noted that the interim stage would only yield useful information about M_o as an eventual possible target if the banks were left to set their own cash holdings - and this meant that the requirement for the clearing banks to hold 1½ per cent of their eligible liabilities in the form of interest-free deposits with the Bank of England would have to be removed. However, abolition left the major problem that this would call into question a substantial part of the Bank of England's present income; it seemed quite probable that the

banks, left to themselves, would hold significantly less than 1½ per cent of eligible liabilities in the form of deposits with the Bank, so that if the change were to be made, some alternative means of guaranteeing the Bank's income would have to be found.

4. The Deputy Governor agreed generally with Sir Douglas Wass' statement of the differences in approach between the Treasury and the Bank. The Bank were concerned that a situation might develop in which short-term interest rates were directed towards an M_o objective, while fiscal policy was directed towards sterling M3; this would leave bank lending to the private sector - usually the largest counterpart to monetary growth - in a sort of limbo. Insofar as instruments were available to influence bank lending, the most important was short-term interest rates, and it would therefore be a mistake to try to compartmentalise particular instruments and policy objectives. The Bank agreed that any mandatory ratio imposed on the banking system could lead to disintermediation; nor was it possible for the time being to avoid the problem by distinguishing between wholesale and retail deposits in setting monetary targets. So far as debt sales were concerned, the Bank did not believe that changes in technique would make it possible for the authorities to achieve a significant increase in the take-up of gilts; fundamental problems could not be solved by technical devices. More generally Mr. McMahon suggested that the statement of the issues should make clearer what the immediate position reached would be; if we were to concentrate on that, the theoretical differences of approach between the Treasury and the Bank would matter much less.

5. Given that policy would continue to be directed towards a broad monetary aggregate, the discussion focused on the position created in the money markets by the abolition of the reserve asset ratio and the more flexible regime for determining short-term rates, and on arrangements for selling Government debt.

Money markets

6. The following main points were made in relation to the money markets:-

(i) The Governor could not agree to the announcement of the disappearance of the present 1½ per cent cash ratio unless it was clear how the Bank's income was to be assured. This was an issue which he would have to discuss with the Court.

(ii) A zero cash ratio would have the advantage that it removed an inducement to the growth of the euro-sterling market.

(iii) Greater flexibility in short-term interest rates, which would tend to "de-politicise" MLR, was desirable in its own right; that - if the cash ratio were abolished - it should be possible to learn about the possible scope for operating in future by reference to an M_2 target was a useful by-product.

(iv) Although the changes envisaged should be presented as not ruling out a subsequent move to non-mandatory MBC, there should be no presumption that this step would be taken - until some experience was gained in operating a system with a zero cash ratio, it was not possible to say whether or not a clear relationship between the monetary base, the price level and the level of activity would emerge.

Debt sales

7. The following main points were made about sales of public sector debt outside the banking system:-

(i) During the interim period when there was no question of using short-term rates to hit an M_0 target, the authorities would in practice be able to make discretionary changes in the level of short-term interest rates as a means of stimulating gilt sales in exactly the same way as they have done hitherto.

(ii) It was common ground that present debt marketing methods did not make it possible to achieve precise control of sterling M3 in the short run. The Bank were confident, however, that they would be able to achieve realistic objectives for total debt sales over a period through the use of existing marketing techniques, although actual sales were likely to diverge from desired sales in particular months. It should in any event be made clear that the authorities were not trying to control sterling M3 in the short run.

(iii) The authorities had recently been relying on gilt sales to "over-fund" the PSBR, in order to offset the impact of high bank lending to the private sector on the monetary aggregates. However, this could not continue indefinitely, since it implied a steady deterioration in the quality of banks' balance sheets.

(iv) Work would continue on possible ways of making debt marketing more flexible, but there was no question of decisions being reached in time for a statement during the week beginning 24 November. Among the possibilities under consideration were more aggressive use of the part-payment technique, and the issue of nationalised industry stocks (which the Government would guarantee) by auction.

(v) The Financial Secretary saw the particular advantage of the RIG as being that it would enable the authorities to achieve a continuing flow of debt sales despite adverse conditions in the market for conventional gilts. This would be particularly important if the system evolved to a point where short-term rates were directed towards M_o, while the Government still set an objective for sterling M3 in the medium term.

(vi) The Governor said the Bank would be prepared to sell RIGs if the Government so decided. However, his personal view remained against taking this step, which he thought would give the impression that the Government were surrendering to inflation. Moreover, he thought that once RIGs began to be issued, there could well be undesired pauses in conventional funding as some of the market operators sought to manoeuvre the authorities into a position where they had to offer more RIGs. Although the announcement of the early issue of a tranche of RIGs would fit in with the general approach to be outlined in the Chancellor's statement about monetary control, the statement could be perfectly coherent and consistent without it.

Conclusion

8. The Chancellor, concluding the discussion, said his instinct remained favourable towards gradual rather than quick and radical change. He asked Treasury and Bank officials to revise the note on the issues for immediate submission to the Prime Minister, together with an annotated agenda for the Prime Minister's meeting on 18 November. Treasury officials should meanwhile be preparing a first draft of the sort of statement he might make, in the light of the discussion.

JW

A.J. WIGGINS
18 November 1980

Distribution:			
	Chief Secretary	Sir Kenneth Couzens	Mr. Monck
	Financial Secretary	Sir Anthony Rawlinson	Mr. Unwin
PS/Governor, B/E	Sir Douglas Wass	Mr. Ryrie	Mrs Lomax
	Mr. Burns	Mr. Middleton	Mr. Riley
		Mr. Britton	Mr. Ridley
		Mr. Lavelle	

BACKGROUND NOTE ON METHODS OF MONETARY CONTROL

1 Since publication of the Green Paper on Monetary Control the Treasury and the Bank have carried out extensive consultations and discussions on proposals for a change to a system of monetary base control and also on possible improvements to operational techniques within the existing framework.

2 From the consultations on MBC, two main types of proposal emerged, with an important distinction drawn between:

(i) non-mandatory systems in which banks are free to choose the amount of cash balances which they hold at the Bank of England; and

(ii) mandatory systems in which banks are required to hold a specified proportion of their liabilities as cash balances at the Bank of England.

3 Present arrangements do not allow firm judgments to be made about the desirability of moving to either kind of base control. In the case of a non-mandatory arrangement, it is not known whether the cash which the banks would choose to hold would be stably related to the money supply or to nominal income over an appropriate period. A mandatory system, on the other hand, particularly if related to a broad monetary aggregate, could prove vulnerable to the diversion of monetary flows outside the controlled area. In addition, and before fully moving to either system, time would be needed for adequate information and experience to be gained about the banks' demand for cash.

4 In this context, the Chancellor has announced in the House of Commons this afternoon that a number of improvements to the present system will be set in hand. These are desirable in their own right but they would also enable more to be learnt about the properties of a monetary base system and would be consistent with further evolution in either of the directions set out in paragraph 2 above.

5 The improvements to be set in hand within the existing framework are as follows:-

(i) Once consultations with the banking system regarding adequate holdings of liquid assets have been completed, and appropriate norms agreed, the Reserve Asset Ratio will be abolished. This was foreshadowed in the Green Paper.

(ii) Further consideration will be given to the future of the 1½% cash ratio currently applying only to the London Clearing Banks, with a view to establishing arrangements that would be equitable within the banking system, and that could enable the authorities to monitor the development of the functional demand for cash balances at the Bank of England which could ultimately be associated with a non-mandatory system of monetary base control.

(iii) Discussions will take place with the banks regarding the collection of additional statistics on retail deposits, which would provide further information on monetary conditions and could, if that subsequently seemed appropriate, become the denominator of a cash ratio associated with a mandatory monetary base system.

(iv) Changes will be developed in the Bank of England's methods of intervention in the money market:

(a) It is envisaged that the Bank's intervention will place a greater emphasis on open market operations and less on discount window (lender of last resort) lending. It has been decided that these operations should continue to be conducted in the bill markets rather than through the interbank market, and in large part through the existing intermediaries, members of the LDMA, to whom discount window facilities would remain confined.

(b) Initially, the Bank's operational aim would be to keep very short-term interest rates within an unpublished band which would be determined by the authorities with a view to the achievement of their monetary objectives. The Bank would normally charge a rate on its discount window lending somewhat above comparable market rates but within the unpublished band. At an appropriate stage the Bank might cease to announce a Minimum Lending Rate. These arrangements would allow market factors a greater role in determining the structure of short-term interest rates. It is accepted that this could lead to more flexible, market-related, pricing of overdraft facilities.

(c) The Bank's operations would be broadly intended to offset daily cash flows between the Bank and the money markets. The present technique of creating initial shortages in the money markets which the Bank then acts to relieve would be abandoned. There would accordingly no longer be a deliberate overissue of Treasury Bills at the weekly Tender.

6 The Bank will discuss the operational details of these changes with those institutions that will be affected as soon as practicable. It is intended that they will be put into effect next Spring.

7 The Bank will also be putting forward proposals for changes in the institutional coverage of credit control and statistical reporting in the light of the Banking Act 1979.

8 Finally, in the light of the above changes, the Bank will examine further the possibilities of broadening the market for short-term central government debt as a means of providing greater flexibility to the government funding programme.

Bank of England
24 November 1980

2/6/1038

MR MIDDLETON

cc Mr Britton
Mr Monck
Mr Riley
Mr Culpin

Mr Shields
Mr Bennett

M2

You asked what the next steps should be on this.

2. Mr Grice has been in touch with the Bank and reports that Graham Kentfield has been told to give this job top priority and to open negotiations with the banks immediately on the basis of the size criterion. Graham Kentfield expressed himself anxious for an early meeting with us, so I am fixing up for them to come over here early next week, to talk to us and Peter Stibbard from the CSO. We may get some inkling about possible timetables then, though I doubt it. I will keep you in touch with progress. The FST expressed some interest at an early stage. It might be a good idea to send him a note before ideas get set in concrete.

RL

RACHEL LOMAX
21 November 1980

1080/11

2/6/03G

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7 The Bank will also be putting forward proposals for changes in the institutional coverage of credit control and statistical reporting in the light of the Banking Act 1979.

8 Finally, in the light of the above changes, the Bank will examine further the possibilities of broadening the market for short-term central government debt as a means of providing greater flexibility to the government funding programme.

Bank of England
24 November 1980

FEU/N2/46/83/6

MR MIDDLETON

cc Mr Burns
Mr Britton
Mrs Lomax
Mr Pirie
Mr Riley
Mr Boote
Mr Culpin
Mr Davies
Mr Grice
Mr Pickford
Mr Shields

IMPROVEMENTS IN MONETARY CONTROL: FOLLOW-UP

Mr Britton and I discussed with others in HF and FEU yesterday afternoon how to follow-up the changes announced by the Chancellor and the Bank and the unannounced remits on the RIG and debt sales generally.

2. It is obviously important to get this right for a number of reasons:

a. much of what was announced is still extremely badly defined;

b. several of the changes interact awkwardly with each other, notably the reserve asset ratio, new prudential arrangements and the new policy on discount window lending. Also connected with this complex are proposals for "broadening the market for short term central government debt";

c. we want to make the maximum possible progress by the Budget that is consistent with avoiding blunders;

d. the Bank may get rapidly involved in discussions with City institutions which may pre-empt some of the options if we do not stake out the ground clearly in advance.

3. We aimed in each case to reach a view about:

timing;
a broad Treasury line;

papers to be prepared for discussion or internal purposes; and

next steps including the level at which the different subjects should be pursued.

Reserve Asset Ratio and Prudential Arrangements

4. We want to make rapid progress onthis, subject to the interaction mentioned in paragraph 2b. above. Our aims are:

i. to avoid or minimise special assistance in the first quarter of 1981;

ii. to abolish the RAR by the Budget and substitute new prudential arrangements that are, and are seen to be, adequate;

iii. and to ensure that these new arrangements are compatible with a move to MBC and with getting the information needed for a decision on this.

5. The next step would be a letter to the Bank recording these aims and asking the Bank to outline their proposals so that we can have a discussion with them before they get committed to specific propositions in their consultations. If necessary, we can use as a peg for this the Bank's agreement to delete from their background note the reference to "primary" liquid assets on the basis that the question of substance would need discussion later.

6. Meanwhile, Mrs Lomax and Mr Pirie will prepare an internal paper setting out more detail about the questions that need answering and the tests the Treasury should apply to the Bank's proposals. In some cases they may need to make specific Treasury proposals.

Money Market Operations and Discount Window Lending

7. Although we do not need to be in a great hurry to allow the market to play its announced "greater role" in determining interest rates, we do need an early definition of the discount window proposals for prudential purposes. A lot of work also needs to be done on the content of the guidelines for the Bank's operations and on the procedure and criteria for settling them.

8. A useful peg for this in Mr Fforde's argument at your meeting last week that it would be useful for the Bank to prepare for discussion with us a possible outline of initial guidelines. We propose that the letter mentioned in paragraph 5 above should also ask the Bank for such a note and draw attention to the need for early definition of the discount window proposals.

9. Meanwhile for internal consumption Mrs Lomax and HF3 will produce a note setting out questions that need to be answered and suggesting a Treasury line on them. This will cover such questions as the width of the band, the possible need for inner and outter bands (partly to avoid increasing the effective discretion of the Bank and to ensure that Ministers exert at least their present influence) the extent to which quantity changes in various monetary aggregates on the one hand and other factors such as exchange rate movements (the Bank's favourite) should be treated as criteria for setting or shifting the band etc.

The Cash Ratio and Alternative Sources of Income

10. The Treasury interest is in getting rid of the obligatory cash ratio so that we can get information about the banks' prudential demand for balances with the Bank in conditions not too far from those of a non-mandatory MBC system. We are not yet clear whether the post-Budget regime can be expected to meet this requirement, notably in its prudential arrangements and discount window lending. But it is clear that the Bank will need alternative sources of income and that the preferable form for these would be a fee.

11. You already have the paper I sent you on 18 November (since slightly amended). This paper, perhaps supplemented by briefing, would be a suitable basis for an approach by Sir Douglas Wass to the Governor. There is probably little to be gained from exchanges on this subject at a lower level.

M2

12. Mrs Lomax and HF3 are discussing this with the Bank who appear to be co-operating fully. We shall say that the aim is to be able to say that the new figures are being collected by the time of the Budget.

Debt

13. There is agreement on the case for selling more short term central government debt (up to 4 years) and that experiments with auctioning such debt are desirable. The letter mentioned above would also ask the Bank about the timing and content of their proposals and for comment on the interaction with abolishing the RAR, the question whether particular assets will be designated as the basis for discount window lending, and possible changes in the source and status of local authority borrowing.

14. HF3 are preparing a paper on the principle of the RIG and on the eligibility problem in consultation with the Bank and the Department of Trade.

15. This leaves methods of selling other debt. We are not hopeful of finding a new approach to this subject that offers a prospect of earlier progress than we might make by extending experiments from the short end. It is seems worthwhile, however, to ask the Bank to prepare a paper abou what their views would be if the jobbers had already disappeared. This subject seems suitable for a reconvened seminar type discussion chaired by Sir Douglas Wass with a Bank team led by Mr McMahon. The next step on this might be for us to prepare a draft letter for Sir Douglas Wass, followed by an internal paper or at least a brief while the Bank are producing theirs.

Conclusion

16. It would be helpful to know if you agree with these proposals. I envisage that the letter mentioned in paragraphs 5, 8 and 13 could go from me and then be discussed at under secretary level unless you prefer to do it yourself.

17. It would be highly desirable to have an early Ministerial steer on how seriously they take the case for clearing the way for MBC.

NM

N MONCK
25 November 1980

Mr Monck

cc Mr Burns
Mr Britton
Mrs Lomax
Mr Pirie
Mr Riley
Mr Boote
Mr Culpin
Mr Davies
Mr Grice
Mr Pickford
Mr Shields

IMPROVEMENTS IN MONETARY CONTROL: FOLLOW-UP

Thank you for your timely minute of 25 November, with which I agree. I had a very brief word about this with Mr Fforde yesterday. We agreed that the best way to proceed would be to bring the follow up work together in a group under your chairmanship. You could then report to Mr Fforde and myself when you get to appropriate points in the work.

It will clearly be necessary in much of this to get the Bank to put down their proposals so I should be grateful if you would write to the Bank as you suggest. But first, it might be as well to have a word with Mr George to make sure that he is agreed on this method of proceeding.

PEM.

P E MIDDLETON
26 November 1980