Monetary Control: Detailed Arrangements Consequent on the Publication of the Green Paper 1980

File FEU/2/6/09

PART 2

30/4/1980 – 8/10/1980

Pages 19 - 37

MR MIDDLETON

cc Mr Bridgeman OR
Mr Britton
Mr Riley
Mr Boote
Mr Pickford
Mr Shields
Mr Grice
Mr Williams

MONETARY CONTROL : CASH RATIO

I have had a further word with the Bank (Mr Gill) about the latest draft of the cash ratio paper.

2. The most important point is that my interpretation of paragraph 2.3 - i.e. that the clearers would still have to keep 1½% balances - turns out to be wrong. The draft does mean minima calculated to remunerate banking services, not existing balances where these are enforced for other reasons (as in the case of the clearers 1½%). Mr Gill says that he does not, in fact, know of any customer balances which would be likely to be above 1% of ELs but he will talk to the banking department to find out what information they may have.

3. Assuming that 1% or minimum banking balances, whichever is the greater, will turn out to mean 1% of ELs as near as makes no difference, then the stock of balances would be around £550 million (my minute of 2 March, copy attached) compared with £450 million from the clearers now. It is difficult to quantify the effect on the Banks' profits. It depends, above all, on the level of short interest rates but if the balances are used operationally then there will be additional costs to the Bank from carrying out the transactions.

4. Mr Gill recognises that one might distinguish the 1% cash ratio from operational balances but says he thinks the Bank would be very reluctant to do so. One main reason for this reluctance may well be that it raises immediately and acutely the problem whether interest should be paid on the 1% balances. If such interest were paid the

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banking department's profits would be substantially reduced but, again, it is impossible to say by how much since at least some part of the $1\frac{1}{2}\%$ balances must be held for operational reasons and so are, reasonably, held at no interest on that justification. These arguments do, again, raise the question whether the 1% should be justified in part ~~explicitly~~ as a return for supervision, and other central bank services not ~~separate from~~ specifically banking services, ~~supplied~~. I think we shall, in practice, find it very difficult to keep ourselves at arms-length from this argument even if we try.

R.G

MRS R E J GILMORE
6 May 1980

cc Mr Bridgeman
Mr Britton
Mr Riley
Mr Boote
Mr Grice

Mr Middleton

CASH RATIO : AMOUNT : ASSETS OR ELS?

. The short point about relative costs is that an assets based calculation benefits the Clearers and the Bank of England and falls harder on the rest; for this reason:-

£m 16 January 1980

	All UK Banks	Of which, Clearers
ELS	52,928	30,378
£ Assets	96,914	47,272

2. Thus (approximately worked on scant data) :-

£m average stock

	Bank of England	Clearers	The rest
1½% on London Clearers ELS (the present position)	+450	-450	Nil
1% on all ELS (? the previous Bank idea)	+530	-300	-230
1% on £ assets (the present draft § 4.10)	+ 970	-470	-500
1½% on £ assets (the FST's minute)	+ 1,450	-710	- 740

3. These figures show a substantial potential redistribution

of streams of income (17%, say Treasury Bill yield or so, is probably a reasonable proxy for the value of the stake at present).

I conclude that :-

i) we cannot publish the Consultation Document without a provisional view which % and/which base we prefer (compromises, eg $1\frac{1}{2}$% on ELS or $\frac{3}{4}$% on assets are possible);

ii) if we have such an idea I am not sure why we do not publish it as a question on which representations can be made;

iii) if we choose a high number we may need to legislate to enforce it (lower amounts can be justified as substituting for central bank charges, eg. for money transmission);

iv) if we choose a high number and legislate not all the proceeds should go into the Banking Department.

4. It still looks as if the minimum disruption is caused by 1% on ELS unless, as may be, the Bank is now attached to an assets based calculation. If so, we need to discuss their reasons.

5. We also need to consider whether the cash deposit counts towards the liquidity norms once the RAR goes (almost certainly yes provided it is a lagged average requirement like the $1\frac{1}{2}$% deposits and so can be used) and, perhaps more difficult, the status of special deposits in the liquidity criteria (a problem implied, but not answered, in paragraph 4.9). RG 21iii

Monetary Control: detailed arrangements

Introduction

1.1 The Green Paper on "Monetary Control" explained that the Bank would issue a detailed paper, for discussion with those concerned, about the operation of the proposed cash requirement. The present document fulfils that undertaking.

1.2 The document discusses, first, in Part I proposals about the cash ratio and Special Deposits. Secondly, in Part II, there are proposals about the composition of the eligible liabilities against which the cash ratio and Special Deposits would be calculated. Finally Part III considers the institutional coverage of the credit control and statistical arrangements in the light of the Banking Act 1979.

1.3 The paper on "Monetary Control" also made it clear that the way would be left open for further developments, if after discussion there appeared on balance to be advantage in adopting either some form of Monetary Base Control or automatic adjustment of the Bank's lending rate to movements in the money stock. Where there are no substantive considerations pointing the other way, the Bank sees advantage in adopting at the present stage those arrangements least likely to require revision should further developments occur.

PART I

The Cash Ratio and Special Deposits

2.1 At present the London Clearing Banks are required to hold cash balances with the Bank, amounting to 1½% of their eligible liabilities. These balances are needed to facilitate clearing settlements, but the ratio is also used by the Bank as the fulcrum for influencing short-term interest rates through its money market operations. The Bank considers that, in the light of this second function, it would be more equitable if the cash requirement were in future applied in principle to all recognised banks and LDTs. [In addition the Bank considers that this would be a necessary element in any future use, for monetary control purposes, of the monetary base.]

2.2 The Bank proposes that the cash requirement, in the form of non-interest bearing balances with the Bank, should be 1% of each institution's eligible liabilities as defined in Part II of this paper. The cash requirement would be calculated from the mid-month statistical returns, for those recognised banks and LDTs on a monthly reporting basis (see paragraph 4.7) and would be adjusted each month. It should be noted that future development of the arrangements for monetary control (mentioned in paragraph 1.3) could require a reconsideration of the frequency with which the cash requirement was calculated and of the period over which the requirement had to be held.

2.3 The London Clearing Banks are at present required to observe the cash ratio on average during the ensuing month but not on each day because their balances can be affected by unforeseeable fluctuations in settlement of the clearing. This is a problem for other banks too, and it is proposed therefore that the cash requirement for all banks should in general be observed on average for each month in relation to targets related to eligible liabilities on the preceding make-up day. Banks which are already customers of the Bank would not be required under the cash ratio arrangements to open new accounts; and they would be expected to maintain either their current agreed average or minimum balances, calculated as a charge for services provid[ed] or 1% of eligible liabilities, whichever is the greater.

2.4 [Members of the London Discount Market Association, as recognised banks, would also be liable to maintain cash balances and Special

Deposits with the Bank but because of the specialised nature of their business the requirement would be based on their deposits other than tho from recognised banks and LDTs.7

2.5 The arrangements for Special Deposits would continue unchanged. As explained later in this paper (paragraph 4.7) liability to lodge Special Deposits would apply to all recognised banks and LDTs with eligible liabilities of at least £10 mn.

PART II

Eligible Liabilities

3.1 This Part considers the composition of the "eligible liabilities" against which the cash ratio and Special Deposits would be calculated. The Bank proposes that the broad concept of "eligible liabilities" should be retained as the basis for the cash ratio and for Special Deposits but that the opportunity should be taken to modify the present definition in certain respects.

3.2 Broadly speaking eligible liabilities, as used for the present credit control arrangements, comprise sterling deposit liabilities (excluding deposits with an original maturity of over two years), plus any sterling resources obtained by switching foreign currency into sterling. Inter-bank transactions and transactions with the discount market (other than money at call) and sterling CDs (held and issued) are taken into the calculation of individual banks' liabilities on a net basis, irrespective of term. Adjustments are also made for transit items.

3.3 It is suggested that the basic definition of eligible liabilities should remain unchanged. Eligible liabilities should continue to include deposit liabilities (including CDs and other negotiable paper issued) but not other liabilities eg., capital. Overseas deposits and any net liability in foreign currency would still be included.

3.4 The following sections discuss certain elements of eligible liabilities where the Bank considers changes might be made.

3.4 Term of deposits

At present eligible liabilities include deposits of all maturities from UK banks or overseas offices of the reporting bank but only deposits of an original maturity of 2 years or less from other sources. The 2 year dividing line is inevitably somewhat arbitrary and is intended to draw a distinction between short-term deposits and deposits having more of the character of loan capital. The Bank would like

to discuss the possibility of changing the definition in one of two ways. Either the definition of deposits included in eligible liabilities could be brought into line with the definition used for the purposes of £M3: all deposits would then be included regardless of term. Alternatively, since the proposals in the Bank's consultative paper "Measurement of Liquidity" mean that information will be provided on the residual life of deposits, the Bank is prepared to envisage the possibility of including in eligible liabilities (and in the monetary aggregates) only deposits with a residual life of under one year.

3.6 Offset Arrangements

The Bank suggests that the present practice of allowing reporting institutions to net-out inter-bank positions should be continued but that the definition of inter-bank deposits and loans should include all other institutions within the Monetary Institutions Sector. (See para.4.3) The justification for the offset arrangements remains ie, that the institution which ultimately uses the funds to lend outside the sector should bear the increase in eligible liabilities rather than the institution which draws the funds from outside the sector. All deposit placed with members of the LDMA (instead of as at present only money not at call) would qualify as inter-bank deposits by the lender, [as would deposits placed with certain discount brokers, Stock Exchange money brokers and gilt-edged jobbing firms].

3.7 Deposits from Overseas

In the present definition of eligible liabilities banks are allowed to balance sterling claims on offices overseas against sterling liabilities to such offices (but no deduction is allowed if claims exceed liabilitie The Bank proposes to discontinue this concession; the abolition of exchange control and the inclusion in eligible liabilities of other overseas deposits on a gross basis could cause it to be abused if it were maintained.

3.8 Working Capital for UK Branches

Hitherto the Bank has allowed certain sterling deposits by overseas banks with UK branches which have been invested in fixed assets to be excluded from eligible liabilities. There are practical problems in

operating this concession, and, in the absence of any supervisory requi
ments on the capitalisation of branches, the Bank proposes to discontinue it.

3.9 Northern Ireland

Banks in Northern Ireland observe the reserve asset ratio and it is proposed that they should observe the cash ratio. They have been exempted from calls for Special Deposits (although formally within the scheme) in recognition of the particular economic circumstances of the province. For the time being the Bank proposes to continue this arrangement.

PART III

Coverage of the new arrangements

4.1 The Banking Act 1979 provides, with effect from 1 April 1980, for two categories of deposit-taking institutions: recognised banks and licensed deposit-taking institutions (LDTs). The Bank is responsible for the supervision of both categories and it has been officially agreed that the Bank should also undertake the collection and analysis of financial statistics from both categories.

4.2 In the Bank's view, there would seem to be a clear case in equity for including all deposit-taking institutions, whether recognised banks or LDTs, within the proposed arrangements for a cash ratio and for Special Deposits. Furthermore, the effectiveness of these arrangements would be impaired if the requirements could readily be avoided by channelling business through associates which lay just outside their coverage. The Bank also considers that it would be wrong to preserve the existing "statistical" list of banks, once complete lists of recognised banks and LDTs have become available under the Banking Act. The Bank therefore proposes that the new arrangements should in principle include all recognised banks and LDTs.

4.3 So far as statistical treatment is concerned, it is proposed that both recognised banks and LDTs should in principle be included in the same sector. This enlarged sector would also include institutions exempted from the scope of the Banking Act and would be designated "the Monetary Institutions Sector". Deposits of UK non-bank residents with members of the sector would then be included in the monetary aggregates

4.4 Trustee Savings Banks, which are among the institutions exempted from the scope of the Banking Act, are not included within the existing banking sector. Although their range of business is widening steadily, they are still subject to some special statutory controls. For the sake of completeness the Bank would propose to include them within the Monetary Institutions Sector from the outset for statistical reporting, but not to apply the cash ratio and Special Deposits until the TSBs cease to be exempted from the scope of the Banking Act.

4.5 The application of the various proposals in this paper to banks in the Channel Islands and the Isle of Man will need to be discussed with

the respective Monetary authorities. These banks are outside the scope of the Banking Act, which applies only to Great Britain and Northern Ireland. But they are included within the existing credit control arrangements and many are subsidiaries of UK banks; moreover, they are part of the United Kingdom for national accounts purposes; and there would seem to be no reason in principle why these arrangements should be changed. For statistical purposes these banks would also be included within the Monetary Institutions Sector.

4.6 Taken together the above proposals mean that while the population of the Monetary Institutions Sector will be considerably increased, the statistical effect will be relatively modest. In the first place, many of the larger LDTs are already contributing to the existing banking statistics and indeed are within the present credit control arrangements and, secondly, many of the new LDT contributors are relatively small. In total, the initial once-for-all adjustment to the stock of the main monetary aggregate, £M3, arising from the inclusion of LDTs is estimated to be an addition of the order of £3 bn. (5%), the inclusion of TSBs, however, would bring it up to £9 bn. (14%).

4.7 The Bank proposes that only those recognised banks and LDTs having eligible liabilities totalling £10 mn. or more should be included within the Special Deposit Scheme and cash ratio requirement. With this in mind, it should be practicable also to alleviate the burden of statistical reporting on the smaller institutions by exempting them, in general, from the provision of the monthly balance sheet and associated returns. Only recognised banks and LDTs having eligible liabilities totalling £10 mn. or more would be asked to supply the full range of statistics, comprising both monthly and quarterly returns; other recognised banks and LDTs would be asked to complete the quarterly statistical returns and may be asked to complete certain other returns, eg., in relation to foreign currency activities. Institutions reaching the £10 mn. cut-off point would thereafter become subject to the Special Deposit and cash ratio arrangements and to the full monthly reporting procedure.

Can I have a meeting
MR MIDDLETON   about this. AJB
Ch. Shields. Grace.

cc Mr Bridgeman
Mr Riley
Mr Shields

Mr Goodhart (Bank of Engla

MONETARY CONTROL AFTER THE GREEN PAPER

1. I had quite a long talk with Charles Goodhart yesterday afternoon about the various alternative ways in which the debate which we provoked by publishing the Green Paper could be brought to a satisfactory conclusion later this year. The ideas which follow are largely my own and I would not like to commit Charles to them in any way.

2. Although the authorities introduced the idea of the indicator scheme into the debate, they did so with little enthusiasm. Public opinion does not seem to have received the idea with much enthusiasm either and it is unlikely that the debate will lead to the conclusion that it should be implemented. In fact, the issue of rules versus discretion has not been the dominant one in the debate so far. In my view, the authorities should not throw away their discretion unless there is an overwhelming wish amongst political or market opinion that a more automatic procedure should be adopted.

3. The Green Paper expressed great reservations about any form of monetary base control. It does not seem to me that the debate has shown a balance of opinion so strongly in its favour that we need to change our point of view. Nevertheless, there is a widespread wish to see the issue of interest rates "de-politicised". There is, in fact, no reason why this wish should be satisfied by monetary base control as such; what is required is rather that market tactics should be conducted in terms of quantity and not of prices. The monetary base is one such quantity, but not the only possible one. When discussing the indicator scheme, we concluded that the monetary base was a redundant step in the argument which really ran from interest rates to the money supply; in a quantitative scheme of control, the monetary base could similarly be redundant and the sequence could run straight from sales of Government debt instruments to the target path for £M3.

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4. All this suggests that the conclusion of the debate should be that there is no need for radical change in our methods of monetary control. We may, nevertheless, wish to add one or two qualifications to that general conclusion and use the opportunity to introduce any minor innovations which we think appropriate. If any changes of this sort are to be presented at the conclusion of the debate, it would be well to introduce them into public discussion before the debate is formally brought to a close. The meeting we are ourselves organising after the summer holidays provides the obvious occasion.

5. The sort of innovation which I have in mind would introduce some element of quantity setting, rather than price setting, into our operations at the short end of the market. Inevitably, this means, I think, some form of auction. There are a variety of short term instruments one might contemplate (variations on national savings deposits or on tax reserve certificates), but such innovations in themselves, though perhaps desirable in their own right, would not assist monetary control in the way I have in mind unless they were put out to competitive tender.

6. If the auction were designed to sell a fixed quantity of debt to the non-bank public, it would be necessary to limit the attractiveness of the assets in question to the banks and also to overseas residents. The attraction to banks would be substantially reduced if the assets were not treated as part of their primary liquidity - I suppose it would not be too difficult to make this condition when issuing a new asset, clearly distinguished from existing Treasury Bills etc. The problem of overseas holdings is more worrying, and might point to some special tax treatment.

7. Perhaps I might anticipate one criticism of this idea. It may be said that we are creating something very like a public sector CD, and then saying that we will exclude this from our target aggregate. If the asset is too like a CD, it could be claimed that our control method was purely cosmetic. As you know, I am not as averse as some to a certain amount of cosmetics, provided that no substantive damage to medium term monetary control is taking place under cover. If the asset in question had a maturity of, say, 12 months, I think we could respond to critics by saying that an asset with such a long life bears little or no resemblance to money as understood by economic theory. Indeed, we might counter-attack by removing CDs beyond a certain maturity from the definition of £M3.

8. If it were decided that an instrument of this kind had a useful role to play, the first stage would be to experiment with it on a relatively small scale. The attitude of the Bank could well be that there is no large domestic non-bank market for a short term marketable asset of any kind. The only way to find out is to try it out. However, since the experiment would initially be conducted on a very limited scale, we could do no more than suggest that it could have a certain role to play in monetary control under certain conditions. We would not, of course, wish to over-sell it initially as making a substantial change to the degree of short run precision with which monetary targets could be hit.

9. I also gathered from conversation with Charles that the Bank is becoming quite enthusiastic about the idea of an extension of the issue of Granny Bonds. The argument for doing so is not essentially one of monetary control, but rather a strategic one: they see a need to tap small savings at the retail level. I suspect we shall be hearing more of this quite soon. In the context of monetary control, the argument is that a progressive relaxation of the limits on the size of permitted holdings could be a quite flexible instrument for monetary control over the next year or so. In other words, when we are faced with a gilts pause, we would respond by an announcement that the limits on Granny Bonds had gone up by the odd thousand or two with fair confidence that the public would respond with alacrity.

10. I think we need to consider carefully the case for (and against) a wider use of Granny Bonds. In the context of the monetary control and the Green Paper, however, I do not see it as especially relevant. For that purpose, the kind of innovation that would be most helpful would be the sort of longish-bill described above. It may be that the idea has been floated in the Treasury before; in any case, I would welcome comments.

Pauline Hogg

pp A J C BRITTON
26 June 1980

MR BRITTON

cc Mr Middleton
Mr Bridgeman
Mr Grice
Mr Shields
Mr Williams

MONETARY CONTROL AFTER THE GREEN PAPER

Your minute of 26 June.

2. It is not wholly surprising to hear that the Bank wish to increase the role of National Savings in the context of monetary control. Neither is it surprising that improvements in gilt marketing techniques are generally not mentioned. However it is my view that the latter should be given much greater attention than the former, simply because the scope for substantial improvement in monetary control is much greater in that case. A number of commentators have noted that the omission of a discussion of gilt marketing techniques from the Green Paper was strange in view of its importance in terms of monetary control.

3. I would welcome a meeting on this subject.

CJR

C J RILEY
30 June 1980

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1. Mr Ryrie

2. Chancellor of the Exchequer

8.10.8

cc Financial Secretary
Chief Secretary
Minister of State (L)
Minister of State (C)
Sir Douglas Wass
Mr Burns
Sir Kenneth Couzens
Sir Anthony Rawlinson
Mr Unwin
Mr Monck
Mr Britton
Mrs Lomax ✓
Mr Riley
Mr Culpin
Mr Grice
Mr Shields
Mr Ridley
Mr Cropper

Monetary control (box)

MONETARY CONTROL

1. I attach a series of papers on monetary control. They are long and detailed - but the changes considered are fundamental with widespread implications. The analysis and comments are the responsibility of the Treasury alone.

2. It would be quite wrong to consider these papers as a response to the situation which has arisen since the removal of the corset. When submitting (13 July 1979) the Treasury paper for the seminar which the Prime Minister held last year I said that the present system of control seemed to be existing increasingly unhappily alongside a tight monetary target regime. This has become more obvious. Since monetary targets were first introduced in 1975 we have not succeeded in achieving any sustained reduction in the rate of growth of the money stock as measured by £M3; if anything there has been an acceleration. The more Government policy has become predicated on tight monetary policy the less we have succeeded.

3. The reason is that we operate a system where unforeseen or even foreseen events - eg the PSBR overshooting, bank lending running at three times the targeted growth for the money supply - come in the first instance into the money supply. We then start a long and often painful process of trying to recover the position.

4. The alternative is to make the private sector, through the

market, take these disturbances. The various monetary base, flexible interest rate regimes do this to varying degrees. Shocks feed through on to interest rates rather than money. The price you pay is in fluctuating interest rates. The recent surge in the money supply would have brought about much higher interest rates. This applies to all interest rates; you cannot fix one rate such as the mortgage rate or base rates and expect a monetary base system to work.

5. The choice is therefore a fundamental one. Do you want a system which will automatically give short run control and bring you back towards your target, irrespective of the consequences?

6. If you do, an effective monetary base regime is the direction in which to move. If the PSBR gets out of hand, or if fiscal policy is imbalanced, interest rates will go up until you do something about it. The banks will not be able to lend as readily as happens at present; they would generate higher interest rates while adjusting their assets to the available base. The regime for interest rates would be very similar to that for the exchange rate. So it would become very important indeed to get the monetary targets right.

7. If you do not, and you want the money supply to act as the shock absorber in the economy in the short term - a position taken by the great majority of those involved in our consultations - then you must be prepared to pursue monetary targets in a longer term sense. That means relying on making changes aimed at getting rid of the source of the disturbance but accommodating swings in monetary growth in the short term and perhaps in the longer term if measures are inadequate or insufficient.

8. It is easier said than done to manage without short term control. You have to somehow get the balance between the target, fiscal policy and external policy to generate the level of interest rates you are willing to live with. Yet almost any move to improve short term control will involve institutional changes. These include tightening up on lender of last resort facilities, with implications for the discount market, encouraging the banks to move away from the overdraft system,

widening the range of debt instruments and directing techniques towards ironing out surges in monetary growth, more flexible mortgage rates, and the highest possible degree of smoothing of the PSBR. But bringing about these changes can have unpredictable effects - not only on the money supply but on the banks and industry. To try to do them all, quickly, as would be involved in a sudden move to monetary base control could lead to disruption and difficulty in setting and meeting the £M3 targets - we just cannot be sure.

9. If you wish to take this further, there is not much else the Treasury can do on its own. So far as monetary base is concerned the illustrative scheme could be used as a possible basis for further consultations with the institutions.

10. There are also a number of issues on which the markets will be expecting us to pronounce which cannot be settled until decisions have been taken on monetary control. The prudential liquidity of the system and the Bank's taxation of the banking system to provide itself with revenue are two. But the most pressing is the future of the Reserve Asset Ratio which we are all agreed cannot continue to exist in its present form.

P E MIDDLETON
8 October 1980

Encs