1. Monetary Base Control III

23/12/80

NM

cc Mr Britton
Mrs Lomax
Mr Pirie
Mr Riley
Mr Culpin

2/6/03G

H M Treasury

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N J Monck
Under Secretary

23 December 1980

E A George Esq
Bank of England
Threadneedle Street
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Mr Middleton
You may like to see this.
Clearly time is short
but I hope we can avoid a 'progress report' to the FST or the PM before we have some progress and in particular before we have (a).
NM 6 Jan

Dear Mr George

MONETARY CONTROL WORKING GROUP

We are planning to take two papers at the next meeting of the Group on 15 January:

a. prudential guidelines to follow the reserve assets ratio; and

b. a revised version of the paper on Money Market Management.

I think it is important that we should look at both together. This is the letter I said I would write setting out some enquiries and some Treasury concerns relevant to those papers.

2. The enquiries about your proposals can, I hope, be conveniently answered in the first paper. We are not clear at present on the following:

a. why the assets in which the Bank proposes to trade are confined to bills and exclude other "safe" assets such as gilts;

b. whether within the prudential norms for total liquidity the proportion of more liquid assets in which the Bank will trade will itself have the status of a norm or near-norm and whether it will be defined numerically;

c. whether you see any non-prudential reason for having guidelines or norms about the proportion of such assets to be held eg to ensure that there is a sufficiently broad market for you to carry out your market operations.

3. When we discussed your paper on Money Market Management on 15 December, you stressed that it covered only the first of a possible series of changes and did not look beyond 1981. This is clearly the right way to start. But if we are to be able to assure Ministers that "Stage 1" is fully "consistent with a gradual evolution towards a monetary base system" we shall need to look a little further ahead. The points which concern us are related to this and you may like to keep them in mind in preparing the papers mentioned in paragraph 1. They are all variants of the vexed question how we could reach the long run - a major structural change - out of a series of practicable short runs.

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4. The first concerns the interactions between the Bank's operating policy in the money markets and the prudentialguidelines. So long as you are operating either the present system or "Stage 1", both operators and supervisors must be concerned with the volume of assets outstanding in which the Bank will normally trade. However, if a move were made to the other end of the spectrum, we do not see how guidelines about the volume of such assets could co-exist with monetary base control. We do not of course know whether or when we shall make such a move; but we do know that we should keep the option open. It is therefore important that, while the supervisors must follow the operators' policy in "Stage 1", they should not establish guidelines which would constrain later changes. In practical terms, this implies that the main emphasis should be on guidance for total liquidity, with only a subsidiary and changeable role for that part of liquidity which comprises the assets in which the Bank will normally trade. This view will clearly influence our reaction to the answers to the enquiries in paragraph 2 above but I hope that it will not present insuperable problems for the supervisors.

5. The second point is that during Stage 1, our experience would tell us only about the banks' demand for cash in a world where they could get as much as they want, subject to increased price variability. Information will be difficult to interpret: if, for example, the banks' demand goes up, we shall not know immediately whether this suggests the interest rate band is too low, or whether banks are increasing their holdings of precautionary excess reserves. Before we embark on the first learning phase, therefore, it would be helpful to have some idea of where we might go from there, if Ministers decide to proceed to a second stage. The most obvious extension would be to widen the band for interest rates. But would you also see scope for introducing any element of supply constraint into the provision of cash?

6. The third point concerns the mechanisms for the Bank's market interventions. Under Stage 1, you will presumably use the existing discount market intermediaries to maintain markets which can absorb your interventions fairly readily. However, to look - again - at the other end of the spectrum, it wouldbe impossible for these intermediaries to continue with their present balance sheet structures in a system in which the only primary liquidity was cash. If the authorities' market assistance were designed to achieve a target for the base, the discount houses could no longer make call money the virtual equivalent of cash for the rest of the banking system. Tony Coleby said at the meeting that the houses have already proved very adaptable, and need not remain dependent on call money forever, but we did not have time to go into that in any detail. The point which concerns us most is that it would not be sensible or realistic to build up dependence on the present market structure during the learning period only to have to run it down to get from there to monetary base control. I think it would be helpful, therefore, if the next version of your paper could suggest how you think the secondary market institutions might develop over a succession of moves towards MBC, and could review the case for and against developing over time a somewhat greater reliance on direct dealings between the Bank and the banks.

7. There are two more mundane matters which I should also like to take at the next meeting - or, if it would be possible, in correspondence before then. First, I hope that you will be able to let us know soon about the

legal implications of abolishing MLR. Once we have a concrete proposal - for example, to publish some average of short-term interest rates as a Son of MLR for contractual purposes - we shall have to check that this would be acceptable to other Departments whose legislation mentions MLR or bank rate. This will take time. Although it is unlikely, it is conceivable that we might have to amend existing legislation perhaps by means of the Finance Act, and we need enough time for consultations before the Budget.

8. Secondly, I hope we can start thinking about arrangements for providing the Treasury with the information we shall need for advising Ministers about the working of Stage 1 generally as well as about particular decisions during it. To get the most out of the learning process, our present view is that we should ideally like daily returns on the following:-

i. the banks' stated demand for cash;

ii. your target provision of cash to the system, taking account of i. and of projected transactions between the central government and the market;

iii. the outturn for ii;

iv. the quantity and price of cash provided through open market operations: how many bills were traded, of what maturity, at what price, in what relation to average market prices on the day; and

v. the quantity and price of assistance through the discount window, and the relation between this price and both average market rates (already recorded under iv.) and inter-bank rates.

Needless to say, it would also be helpful to have whatever commentaries you felt able to offer. This may sound a tall order, and we shall no doubt need to discuss it; but the information should be fairly readily available in the Bank, and we might well be able to do without some of the returns which we get at present. At any rate, I thought it sensible to give you some sort of shopping list to be considering.

9. Finally, could I ask you to specify in the next draft of your paper what changes Stage 1 is intended to bring about and the measures by which you propose to judge, compared with some past figures, whether they have come about. One example would be the intended increase in the variability of the terms at which the banks have access to cash.

Yours sincerely

N MONCK

Financial Secretary
Sir Douglas Wass
Mr Ryrie
Mr Burns
Mr Middleton
Mr Britton
Mr Pirie
Mr Riley
Mrs Lomax
Mr Turnbull
Mr Davies
Mr Culpin
Mr Monck

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Treasury Chambers, Parliament Street, SW1P 3AG
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23 December 1980

T P Lankester Esq
Private Secretary
Prime Minister's Office
No.10 Downing Street
LONDON SW1

Dear Tim,

THE BANKS' RESERVE ASSETS RATIO

At the Prime Minister's meeting on 18 November, it was agreed that the reserve assets ratio (RAR) could not be abolished until new prudential guidelines had been established, and that this could not be done before the Budget. However, it was also agreed that it would be desirable to consider an interim change to avoid, if possible, the need for special Bank assistance to the market in the first quarter of 1981, when the central government surplus will drain cash out of the system.

The Chancellor and the Governor have concluded that such a change could indeed be made. A reduction in the ratio from 12½% to 10% of banks' eligible liabilities should just enable the banking system to get through the revenue quarter without further sale and repurchase operations in gilts. It accords with the approach to the new prudential system of recognising that liquid assets are there to be run down at times of pressure. No prudential risks would be created. The reduction would not prejudge decisions on future monetary controls or future prudential guidelines. The Chancellor and the Governor therefore propose to announce the reduction early in January, when the central government goes into surplus.

The scale of the problem is as follows. On present projections, the Government surplus is likely to take the cumulative cash shortage in the market from nearly £900 million at the end of banking December to about £3.2 billion by the end of banking April. (The shortage could be smaller if the Government's first quarter surplus falls short of the forecast or larger if sales of Government debt are higher than is projected.) The Bank must meet

/this shortage by

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this shortage by converting other assets into cash, unless short term interest rates are to rise in a way entirely inconsistent with the reduction in MLR and unhelpful to monetary control (because the increase in market interest rates would simply encourage round-tripping).

The additional cash shortage in the first quarter will be of roughly the same order of magnitude as in the revenue quarter last year; but the problem of alleviating it will be more difficult for two reasons. First, there are no special deposits to release, as there were in the first quarter of 1981. Second, we start 1981, unlike 1980, with the Bank already providing nearly £900 million of assistance, mainly through purchases of commercial bills. Nonetheless, the problem should be manageable provided the RAR is reduced.

A reduction from 12½% to 10% will release something over £1½ billion of reserves to be converted into cash. The amount by which the Bank's need to buy in commercial bills will be reduced may well be somewhat smaller. It depends how far the banking system is prepared to run down its holdings of reserve asset claims on the public sector (ie Treasury Bills and local authority bills). The Bank judges that the reduction in such assets might not exceed £1 billion, but that it is right to make room for a somewhat larger reduction in case it proves possible.

If the reduction amounts to £1 billion, some £2 billion will remain to be provided by purchase of other assets. The Bank will aim to do so by buying in commercial bills and, to a lesser extent, swapping the banks' foreign currency holdings into sterling. This should be just possible without recourse to special arrangements.

To reduce the RAR below 10% would not reduce the need for the Bank to buy in commercial bills because the ability of the banking system to run down its holdings of reserve asset claims on the public sector would be already exhausted - if not more than exhausted - by the reduction to 10%. Nor would it help to allow more private sector assets to count as reserves, for the same reason. Nor would it help to bring in gilts over one year (the present boundary), because this would make them more attractive to banks, and so could conflict with the objective of broadening the market in central government debt of this maturity.

/The Chancellor and

UNITED KINGDOM TREASURY AND SUPPLY DELEGATION
BRITISH EMBASSY
WASHINGTON, D.C. 20008

December 23, 1980

P.E. Middleton Esq
HM Treasury
London, England

Dear Peter,

MONETARY CONTROL IN THE US AND UK

I enclose a copy of a paper by Warren Coats, a Senior Economist in the IMF Central Banking Department, on recent monetary policy strategies in the United States. Coats wrote this paper on the basis of research done when he was a visiting economist at the Fed. The paper examines the efficacy of the reserve strategy followed by the Fed since October 1979, as compared with the strategy pursued before then.

Alan Walters mentioned this paper to me the other day, and has since sent me a note pointing out the relevance to the UK. He suggested that it would be very useful if Coats could use his experience and carry out a similar analysis for Britain, and he wondered whether I would consider the possibility of asking the Fund to make Coats available for such a study.

I could, of course, only do this if people in London wanted to have Coats, and are prepared to meet any costs involved in making him available. I should be grateful, therefore, for your reactions and those of the Bank of England to the suggestion which Alan Walters has made.

Meanwhile, I have told Alan Walters that I am sending the paper to you seeking instructions on his suggestion.

I am copying this letter and enclosure to Charles Goodhart, and to Andrew Turnbull and Ron Gilchrist without enclosure.

Yours ever,

John

John Anson

cc: Mr. C.A.E. Goodhart (B of E)
Mr. R.H. Gilchrist (B of E)
Mr. A. Turnbull (HMT)

The Chancellor and the Governor are satisfied that to reduce the RAR to 10% is the right course to follow in the circumstances. If the Prime Minister is content, the Bank of England will announce the change on or about 5 January.

I am copying this letter to Tim Allen at the Bank of England.

Yours

John

A J WIGGINS
Principal Private Secretary