File FEA/0000000099, Part B – Monetary Base Control

Original reference FEA\C\650\1440\02 B

PART 8

15/4/1981 – 30/6/1981

Pages 136-154

Statistical changes

15 The present banking sector, as defined for the purposes of calculating the monetary aggregates, currently contains those institutions included in the "statistical list of banks". This list was drawn up prior to the Banking Act and is no longer appropriate to current circumstances. It excludes a number of recognised banks, many LDTs, and also the trustee savings banks[1] (who are evolving towards banking status and who will become subject to cash ratio and Special Deposit requirements when they cease to be exempt from the Banking Act).

16 A new monetary sector will therefore be defined, to include

(i) recognised banks and LDTs;

(ii) National Girobank;

(iii) /all banks in the Channel Islands and the Isle of Man, so long as the authorities in these islands institute broadly parallel arrangements for a cash ratio requirement upon banks within their jurisdiction;7

(iv) the trustee savings banks (TSBs)[1];

(v) the Banking Department of the Bank.

17 Although the population of the monetary sector will be considerabl larger than that of the "statistical list", the statistical effect will be comparatively modest since the present sterling business of many of the new contributors is relatively small. In total, the initial once-for-all adjustment to the stock of the main monetary aggregate, £M3, will probably be of the order of £8 billion (13%), of which the TSBs account for around £6 billion (9 1/2%).

18 Recognised banks and LDTs having either eligible liabilities totalling £10 million or more, or a balance sheet of £100 million or more, will be asked to supply the full range of statistics (comprising both the monthly and other returns); other recognised banks and LDTs will be asked to report only at end-calendar quarters.

---

[1] The Central Trustee Savings Bank (CTSB) is a recognised bank.

The timetable for change and the transitional arrangements

19 The provisions outlined above cannot be operated in full for some months. However, the authorities regard it as preferable to introduce the proposed changes by stages rather than to leave the present system in force until the new arrangements can be introduced in their entirety.

20 Consequently, the Bank will shortly specify an operative date when:

(i) the Reserve Asset Ratio will be abolished;

(ii) banks whose acceptances are eligible for sale to - or discount at - the Bank will begin to observe the requirements set out in para 11 above;

(iii) the agreement with the London clearers, whereby they keep an average of 1 1/2% of their ELs at the Bank, will lapse;

(iv) the Bank will receive the first deposits under the cash ratio requirement.

21 Because of the difficulty of obtaining the necessary statistics, the first deposits under the cash ratio requirement will be called only from institutions on the present statistical list of banks and from members of the LDMA. These deposits will relate to the average ELs of each institution over the /latest six-month period available/. For this period, ELs will be calculated as at present, except that offsets will be allowed in respect of all lending to the discount market and all secured money at call placed with money-brokers and gilt-edged jobbers and money-trading banks over the period.[1] The initial deposits will remain unchanged until /sufficient figures using the new definition of ELs are available/ (see para 22 below). The requirement thereafter will be adjusted every six months. The undertakings by eligible banks will commence on the same definition of ELs and in respect of their latest available ELs figures.

22 As soon as possible, currently reporting institutions will be asked to produce figures for one reporting date on the basis used

---

[1] The Bank can calculate these offsets from statistics already provided.

hitherto and on the basis of the enlarged list of institutions comprising the new Monetary Sector. Those seventy or so institutions which are not currently on the statistical list of banks and which are above the proposed cut-off points for full statistical reporting will be brought into the reporting network at the same time (and into the cash ratio requirement shortly thereafter).

23 Monetary aggregates will be calculated on both bases for the single reporting date; thereafter statistics will only be collected on the basis of the new Monetary Sector.

24 The remaining institutions not currently reporting and below the cut-off points set out in para 18 will be brought into the reporting network only when the current review of banking statistics has been completed.

cc Financial Secretary
Sir D Wass
Mr Burns
Sir K Couzens
Mr Ryrie
Mr Hancock
Mr Monck
Mr Kemp
Mrs Lomax
Mr Turnbull
Mr Ridley

MR MIDDLETON

MONETARY CONTROL

The Chancellor has seen the Prime Minister's personal minute of 4 June, and has commented that his conversation with Doctor Zijlstra certainly did not serve to fortify any intention to move to monetary base control.

2. Mr Lankester has suggested to me that the stock-taking Seminar should be arranged for the first week in August. I take it that this should present no difficulty?

JW

A J WIGGINS
8 June 1981

4.5.1.

8.6.81.

61

MR BRITTON

Mr Fallon
This seems OK
[illegible]

cc Mr Middleton
Mr Monck
Mr Riley
Mr Turnbull

A ROLE FOR THE NARROW AGGREGATES

At Friday's meeting of the Middleton-Fforde group I was commissioned to write a new paper on this subject. Following our chat, I have written the attached introduction, which gives some idea of the scope of the paper. I would hope it could be relatively short (not more than ten pages, say) with the minimum of supporting material (just a few charts showing the relationship between prices and Mo, M1 and £M3 and, possibly, velocity for the same three aggregates). Mr Bennett is doing some simulations which may help to inform the discussion of the compatibility of £M3 annual and medium term targets with short term targets for M1, and (maybe) Mo; but I would not plan to report them as such in the paper.

2. I would be grateful for any comments before I get too deeply into drafting. Given the relatively tight deadline, I do not want to waste time if this is not what is wanted.

RL.

RACHEL LOMAX
8 June 1981

Encl.

THE ROLE OF THE NARROW AGGREGATES

Introduction

This paper summarises and updates some of the work done before the Budget on the choice of target aggregate and considers whether there is a role for one of the narrower aggregates (M1 or some measure of the monetary base) either as a target in its own right, or as a less formal yardstick for taking short term interest rate decisions. The Budget reaffirmed this Government's commitment to £M3 as the target aggregate both for medium term (MTFS) and annual purposes. The paper discusses how far a role for one of the narrower aggregates would be compatible with this position. It concludes by reviewing the prospects for the different monetary aggregates in the next two years, as implied by the Budget forecast, and the internal forecast which is currently in the course of preparation, and describing how we might set about choosing a numerical target for a narrow aggregate, should we want to adopt one.

11.6.81

63

CHANCELLOR

cc Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr Ryrie
Mr Burns
Mr Middleton
Mr Britton
Mr Monck
Mrs Lomax
Mr Pirie
Mr Davies

MONETARY CONTROL

The Bank have shown us a draft text of the detailed provisions for the new monetary control arrangements. They want to finalise the text on Monday before circulating it to the banks and other institutions for final comments. As this will be more or less the last opportunity to make changes, the Bank would like confirmation that the Treasury are content.

2. The provisions cover a number of issues:

(i) the cash ratio requirement;

(ii) the definition of eligible liabilities;

(iii) eligibility of bills;

(iv) continuation of the power to call for special deposits;

(v) the undertakings by the banks to maintain funds with the discount houses, money brokers and gilt edged jobbers;

(vi) prudential arrangements;

(vii) statistical changes;

(viii) the timetable and transitional arrangements.

1.69/6

3. We have gone over the text with the Bank and are satisfied that it accurately reflects our understanding of how the new arrangements are to work. Our suggestions were therefore limited to points of drafting and clarification. A copy of the text in more or less the form the Bank wish to issue it is attached.

4. The text is drafted for the participants and does not provide its own commentary. It may therefore be helpful to you to have some explanation of the more arcane points.

(i) The Bank estimate that if the scheme were in force now the non-operational balances referred to in para 3 would be about £330 million. In addition, the clearers think their operational balances might be £150-200 million though they would hope with experience to reduce them. In recent months target balances have ranged from £500-530 million. A central estimate for total balances under the new system might be towards the lower end of this range.

(ii) The transitional arrangements in para 4 refer to those Finance Houses who will become licensed deposit takers (LDT's) and become subject to the cash ratio requirement for the first time. Much of their business is at fixed rates of interest, often for periods up to three years. This prevents them from passing on the extra costs generated by the cash ratio to existing business. They are therefore to be allowed to negotiate a transitional arrangements.

(iii) Para 5 discusses the new definition of EL's which will now be liabilities net of funds lent to institutions within the sector. This eliminates double counting and means that for the sector as a whole only liabilities to persons outside the sector are scored. The changes are necessary to take account of

(a) the enlargement of the monetary sector by the addition of LDT's and

(b) the abolition of the RAR - previously funds lent to other institutions and which were scored as reserve assets did not count as an offset but with the ending of reserve assets there is no longer any reason why they should not.

(iv) Para 6 makes an exception for the Discount Houses. Only their liabilities to outside the monetary sector will be eligible. This is part and parcel of the arrangements for securing an adequate size for the bill market. It would make no sense to set up the undertakings in para 11 to place funds with the discount houses and then impose an element of taxation on those funds.

(v) Para 8 retains the power to call for Special Deposits. We foresee only a limited role for them but we would not want to end the scheme altogether. The report on Monetary Control now being prepared for the Prime Minister's seminar will set out the circumstances in which Special Deposits might be useful. The differential scheme which is being allowed to lapse is a hidden form of inflow control. It has never been used and when the new provisions in the Finance Bill are enacted it will be superceded.

(vi) Paras 9 to 13 give force to the measures to support the discount and gilt edged markets.

(vii) Para 14 refers to the interim assurances on bank liquidity announced in the Budget Speech.

(viii) Paras 15 to 18 cover the statistical changes which will follow from enlargement of the monetary sector. The stock of £M3 will increase by about £8 billion or 13 per cent, mainly on account of the TSR's. We do not expect this change to affect the trend rate of growth of money. In making comparisons which straddle the changeover date, it will of course be necessary to correct for the statistical break.

(ix) Paras 19-24 cover the transitional arrangements. Some of the changes, e.g. the introduction of the new statistical definition of the monetary sector probably cannot be introduced until the end of the year but rather than wait, the Bank propose to move in stages. In practice most of the important changes can be made earlier. The Bank would like to be able to introduce the core of the new arrangements by mid August.

5. The Bank would like you to confirm that you are satisfied with these provisions so that they can finalise the text for circulation to the banks and institutions. We recommend that you agree. We would like to be able to inform the Bank of this on Monday morning.

6. There remains the question of the appropriate stage to inform the Prime Minister. We are preparing a reply to her letter of 4 June suggesting a seminar on monetary control before the Recess. We suggest that a final version of the document, in the form in which it is circulated to the banks etc, could conveniently be appended to your reply which will be sent next week.

AT

A TURNBULL
11 June 1981

MONETARY CONTROL - DRAFT PROVISIONS

<u>Introduction</u>

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 more detailed proposals on a number of the subjects covered in the Background Note were sent to all recognised banks and licensed deposit-takers (LDT's). The Bank has since discussed these proposals with the various associations, as well as with a number of individual institutions, and has reached agreement on the following provisions, which will begin to take effect on a date to be announced.

<u>The cash ratio requirement</u>

2. A substantial part of the Bank's resources and income in recent years has been provided by the average of 1½ per cent of Eligible Liabilities (EL's) maintained by the London clearing banks in non-interest-bearing accounts at the Bank. This sum has also served as a fulcrum the money market management. The Bank's paper in March proposed that this should in future be provided by the volume of operational funds which the London clearing banks would retain at the Bank for clearing purposes, and that the Bank's resources and income should be secured primarily by a uniform requirement on all banks and LDT's to hold non-operational, non-interest-bearing deposits with the Bank. The provisions set out in this section have been designed to provide broadly the same total of non-interest-bearing funds initially as did the previous arrangements with the London clearing banks.

3. This non-operational requirement will be a ½ per cent of an institution's EL's and will apply to recognised banks and LDT's (and National Girobank) having EL's which average £10 million or more in the latest period over which the requirement is calculated. The level of an institution's [illegible]

to its average EL's in the previous six months(1).

4. The Bank accepts that, for institutions not on the present statistical list of banks whose business mainly comprises the provision of fixed rate finance for periods in excess of one year, the cash ratio requirement described above may create transitional problems. The Bank will be prepared to consider individual representations from such institutions for some temporary alleviation of the requirement.

5. EL's are to be redefined to reflect the changes set out in this paper, so that offsets will be allowed in the calculation of EL's in respect of:

(i) funds lent by an institution in the newly defined monetary sector(2) to any other;

(ii) secured money at call placed with money brokers and jobbers in the Stock Exchange;

(iii) clearing balances and Special Deposits held at the Bank.

6. EL's will be calculated in uniform fashion for all reporting institutions(3) except members of the London Discount Market Association (LDMA). Reflecting the particular structure of the balance sheets of LDMA members, their EL's will be calculated as the total of deposits other than from institutions within the Monetary Sector.

7. It would be contrary to the objective of these agreed arrangements for any institution to reduce its EL's deliberately or artificially on reporting dates. The Bank

---

(1) A requirement due in, say, March would relate to the [illegible]

(2) See para 15 below.

(3) [illegible] reporting arrangements for finance houses [illegible]

accordingly reserves the right to make a spot check on the level of an institution's EL's on days when it would not normally report. [Should these checks or any other evidence suggest deliberate or systematic avoidance, consideration would need to be given to resetting the cash ratio requirement on a more frequently reported average of EL's (say weekly), despite the increased statistical burden involved.]

Special Deposits

8. The Special Deposits scheme remains in place and is to apply to all institutions with EL's - calculated on the basis set out in para 3 above - of £10 million or more (4). As hitherto, calls will be set as a percentage of EL's. The scheme for Differential Special Deposits (5) [will lpase when ....]

Eligibility

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

(i) does the applicant have and maintain a broadly based and substantial acceptance business in the United Kingdom?

(ii) Does it command the finest rates in the market for ineligible bills?

---

(4) Hitherto only banks on the statistical list (other than members of the LDMA) have been subject to Special Deposits.

(5) The scheme was devised and agreed with banks in [illegible] but [illegible] (i) [illegible] and (ii) [illegible]. Details [illegible] Bank of England Quarterly Bulletin [illegible]

(iii) In the case of foreign-owned banks, do British banks enjoy reciprocal arrangements in the foreign owners' domestic markets?

[A provisional list of eligible banks is attached.] (6)

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.

Undertakings by eligible banks

11. From a date to be announced, each eligible bank undertakes to maintain secured money with members of the LDMA and secured call money with money brokers and gilt-edged jobbers (7) - all at market rates appropriate to the nature of the lending - such that:

(i) the total funds so held average [6%] of that bank's EL's;

(ii) the amount held in the form of secured money with members of the LDMA does not normally fall below [4%] of EL's on any day.

12. Reflecting the possibility that its liquidity may be subject to considerable seasonal fluctuation, each eligible bank will undertake

(i) to aim to meet the daily average requirement over six or twelve month periods;

---

(6) i.e. will be attached to the final provisions.

(7) The Bank's concern with the adequate availability of funds for the continuous functioning of the gilt edged market was noted in [illegible] Control - the next steps. There are six recognised money brokers, James Capel & Co, Cazenove & Co, [illegible] & Co, [illegible] are - and will continue to be - limited by the Bank in the amount of secured money at call which they can take. Security may be provided by money-brokers or jobbers in the form of gilt-edged stock, Treasury bills, local authority bills and eligible bank bills.

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 discuss such action with the Bank when the relevant monthly return is made.

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

Prudential considerations

14. The Bank has received the assurances mentioned in the Chancellor's Budget Speech and requested in its paper of 12 March, "The liquidity of banks", that those institutions to whom the reserve asset ratio has applied will discuss with the Bank in advance in the course of the normal process of prudential supervision changes in their policies for the management of their liquidity and its composition. Discussions on the development of prudential supervision are continuing and a separate paper on liquidity will be issued by the Bank in due course.

Statistical changes

15. The present banking sector, as defined for the purposes of calculating the monetary aggregates, currently contains those institutions included in the "statistical list of banks". This list was drawn up prior to the Banking Act and is no longer appropriate to current circumstances. It excludes a number of recognised banks, many LDTs, and also the trustee savings banks(8) (who are evolving towards banking status and

(8) The Central Trustee Savings Bank (CTSB) is a recognised bank.

who will become subject to cash ratio and Special Deposit requirements when they cease to be exempt from the Banking Act).

16. A new monetary sector will therefore be defined, to include

(i) recognised banks and LDT's;

(ii) National Girobank;

(iii) [all banks in the Channel Islands and the Isle of Man, so long as the authorities in these islands institute broadly parallel arrangements for a cash ratio requirement upon banks within their jurisdiction;]

(iv) the trustee savings banks (TSBs)

(v) the Banking Department of the Bank.

17. Although the population of the monetary sector will be considerably larger than that of the "statistical list", the statistical effect will be comparatively modest since the present sterling business of many of the new contributors is relatively small. In total, the initial once-for-all adjustment to the stock of the main monetary aggregate, £M3, will probably be of the order of £8 billion (12%), of which the TSBs account for around £6 billion (9½%).

18. Recognised banks and LDT's having either eligible liabilities totalling £40 million or more, or a balance sheet of £400 million or more, will be asked to supply the full range of statistics (comprising both the monthly and [illegible] the other recognised banks and LDT's will be asked to report only at end-calendar quarters.

__The [illegible] for change and the transitional arrangements__

19. The essential features of the new arrangements can be brought rapidly into effect but there are a number of difficulties, primarily statistical, which mean that the provisions cannot be operated in full for some months. This section deals with the sequence of developments.

20. The Bank will shortly specify an operative date when:

(i) the Reserve Asset Ratio will be abolished;

(ii) banks whose acceptances are eligible for sale to - or discount at - the Bank will begin to observe the requirements set out in para 11 above;

(iii) the agreement with the London clearers, whereby they keep an average of 1½% of their EL's at the Bank, will lapse;

(iv) the Bank will receive the first deposits under the cash ratio requirement.

21. Because of the difficulty of obtaining the necessary statistics, the first deposits under the cash ratio requirement will be called only from institutions on the present statistical list of banks and from members of the LDMA. These deposits will relate to the average EL's of each institution over the [latest six-month period available]. For this period, EL's will be calculated as at present, except that offsets will be allowed in respect of all lending to the discount market and all secured money at call placed with [illegible] and gilt-edged jobbers and money-trading banks over the period.(9) The initial deposits will remain [illegible] the new definition[illegible]

(9) [illegible] calculate these offsets from statistics [illegible].

of EL's are available_7 (see para 22 below). The requirement thereafter will be adjusted every six months. The undertakings by eligible banks will commence on the same definition of EL's and in respect of their latest available EL's figures.

22. As soon as possible, currently reporting institutions will be asked to produce figures for one reporting date on the basis used hitherto and on the basis of the enlarged list of institutions comprising the new Monetary Sector. There