9. Monetary Base Control III

22/12/1980 – 16/1/1981

[illegible]

cc 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

INTERIM ADJUSTMENTS TO THE RESERVE ASSETS RATIO REQUIREMENT

In my minute of 19 December I said that the draft private secretary letter had not yet been cleared with the Bank. I now attach a revised draft version which incorporates the Bank's amendments.

2. I have not yet heard whether the Governor is content and, if the Chancellor is, you will want to check with his office before sending off the draft.

N MONCK
22 December 1980

1133/12

DRAFT LETTER TO:

P Lankester Esq
10 Downing Street

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 assostance 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 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 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.

MR MONCK.

MONETARY CONTROL

Mr Middleton is seeing Mr Fforde on Monday 19 January. This is a progress report on monetary control.

2. Some subjects can be left to one side:

i) the RAR has been reduced, and there is no need for further adjustments before it is abolished;

ii) we are pursuing at working level the legal implications of abolishing MLR and of changing Treasury bill arrangements;

iii) the Prime Minister has the Financial Secretary's paper on indexed gilts;

iv) Sir Douglas Wass is having a further meeting on funding techniques on Tuesday (20 January).

3. In ascending order of difficulty, that leaves:

v) M2;

vi) the cash ratio;

vii) the prudential arrangements to succeed the RAR;

viii) the new ground rules for money market operations;

ix) the future of the discount houses as market makers in bills. + LfLR

M2

4. On M2, the Bank have just written to the clearers, to ask what data could sensibly be collected. We cannot go firm on definitions until we know what is feasible. The Bank are hoping for a reply

within two weeks. We need to keep up the pressure.

The cash ratio

5. Sir Douglas Wass is seeing the Governor and/or the Deputy Governor today about alternatives to the cash ratio as sources of income for the Bank. We cannot get much further without a Bank appraisal of the options. Thereafter there will have to be negotiations with the banking system, probably as part of the package covering the items below.

6. Whether the cash ratio is the present $1\frac{1}{2}\%$, or zero, or something in between, it is clear that it should be a minimum instead of an average. If banks only have to meet it on average, as now, they have little incentive to manage their cash flows precisely. Among other things, this is an obstacle to observing their true demand for cash.

7. It is less clear that the cash ratio has to be abolished. Provided it is a minimum, we should probably be able to learn something from banks' chosen holdings of excess reserves. The case for and against abolition may turn largely on the costs and benefits of alternative ways of financing the Bank.

Prudential supervision

8. We have still not had a Bank paper on supervision. However, we expect the new prudential regime to be roughly as follows:-

a) an integrated liquidity test, as proposed in the Bank's consultative paper, will yield a consistent measure of maturity mismatch;

b) the rules of this test will be published;

c) representative calculations may be published for classes of institutions, yielding illustrative ranges of liquidity norms;

Who will know

d) the norms for individual institutions will be determined by type of business and will not be published;

What happens Ask Page

e) there will not be quantitative sub-norms for primary liquidity, but the supervisors will pay attention to the "quality" of each institution's liquidity.

Isn't this determined by dealing - particular assets

9. We need to keep nagging the Bank to write this down (corrected as necessary): they have again promised a paper. If the outline is roughly right, there is no reason in principle why the broad rules of the game should not be agreed by the Budget. But this will require further consultation with the banks, and they will probably be prepared to firm up prudential arrangements until the authorities can say more about the monetary control context, including the future of the cash ratio. In particular, (e) above turns on decisions about the Bank's operating practices and future support arrangements for the discount houses (the next two items below).

Money market operations

10. The Bank propose - in brief - that as the first move along a possible spectrum, to be tried for at least six months to a year:-

Agreed

i) the authorities should set a band for interest rates in much the same way as they currently set a point estimate for MLR;

How is the point determined

ii) the width of the band should be 2% - 1% either side of the point estimate;

iii) having set the band, the Bank should provide whatever cash the banks say they want, in much the same way as the Bank now provide whatever cash banks need to meet the cash ratio.

How do we make changes to the range?

11. This would still be a purely accommodating policy in the provision of cash, given more or less administered interest rates. Monetary control would continue to turn on discretionary variation

of interest rates, and not on the supply of cash to the system. The change would not, therefore, introduce any new quantitative anchor. Nor would it teach us a great deal. At best (qualified by the next item) we would learn only about the banks' demand for cash in a world where they could get as much as they want, subject to increased price variability.

12. The main issues for the Treasury are:-

a) whether to argue from the start for a wider interest rate band;

b) whether to insist from the start that some independent target for the provision of cash should enter, in a specific way, into the determination of the band; and

c) whether to specify now what we think the next stage in a "gradual evolution" might be assuming that "Stage 1" does not fall flat: the Bank, for their part, say they simply cannot look beyond "Stage 1", which makes it harder to judge whether this would be a sensible first step.

wider bands

The bill market and the discount houses

13. Still more difficult questions arise on a new Bank proposal to shore up the discount houses as intermediaries in the bill market. This has only just reached us. The Bank argue that:-

i) to meet the specified objectives of giving the market more of a say in interest rates, and reducing reliance on discount window lending, they have undertaken to provide a greater proportion of their market assistance through open market operations, mainly in bills;

ii) to do this, they need the market in bills to remain broad and strong;

iii) they need price making intermediaries if they are to avoid one-on-one haggles with the clearers;

Is this realistic

iv) the discount houses fulfil that role;

What about new capitalisation

v) the Bank therefore want the discount houses to have a sufficient volume of liabilities to finance the necessary bill holdings; but

and she holds some

vi) the banks may have less reason to hold money at call when it loses its reserve asset status, with the abolition of the RAR; and

vii) the banks will have still less reason if the Bank implement another objective, which is to extend eligibility for rediscount to all bills accepted by recognised banks: at present, eligibility is limited to the Accepting Houses, the London and Scottish clearers, and a few others; this flatly and indefensibly discriminates against EC banks, American banks, and other recognised banks; it is also inconsistent with the monetary control objective of having a large enough supply of eligible bills to absorb bank interventions;

another [illegible]

viii) ending this discrimination would mean a considerable expansion in the stock of eligible bills, and for most practical purposes the newly eligible bills would be as good as call money for the banks;

ix) this would therefore threaten to dry up the supply of funds to finance the discount houses' holdings of bills;

x) in order to prop up the discount houses (in order to maintain the necessary market in bills), eligibility should be made conditional on banks keeping agreed amounts, on average, at call with the discount houses.

Surely not

14. The unattractiveness of conclusion (x) is obvious. It would look like a restrictive practice. If it changed banks' behaviour, it would be a distortion, and get in the way of observing the banks' demand for cash. If it did not, it would be redundant. In either case, it would give the discount houses a captive market, and

therefore no incentive to reduce their reliance on call money. Yet everyone agrees that the survival of call money would be incompatible with monetary base control.

why if this is so?

15. The Bank's answer is that conclusion (x) follows from premises (i) to (v). It would not be inconsistent with a gradual evolution to MBC, in the sense that no options would be closed off: nothing would be more difficult than it is now. The Bank reiterate that they cannot look beyond "Stage 1", so they cannot say how the support arrangements would be modified or dismantled. In principle, though, there is no reason why they should not be changed in any way whatever.

16. The alternative to the Bank's proposal is to run the unquantifiable risk that the supply of call money will dry up, that the bill mark will wither and die, and that the Bank will have to intervene instead in the interbank market. It would be difficult for the Treasury to force this on the Bank. It would mean overriding their operational judgment, and going back on the announcement (cleared by the Treasury) that they would conduct open market operations in bills, largely through the discount houses.

Not an announcement check papers

17. The Bank's substantive argument is that in the discount market they can, if they choose, be price takers. In the interbank market, they must negotiate interest rates with the four big clearers. In addition, the Bank can if need be take the upper hand in the discount market, because the discount houses depend on the authorities' good favour, and their day-to-day dealings are not collusive. In the interbank market, the clearers have the advantage, because they are the lenders of last resort to the rest of the system, and effectively collude with each other: they can engineer market conditions to their advantage, and force the Bank to show its hand.

What does all this mean in monetary terms

18. There may in practice be a halfway-house between reliance on bill operations in the discount market, backed up by gentlemen's agreements, and reliance on the interbank market. This could consist of smaller reliance on discount market intervention, or direct dealing with banks in bills, and some intervention in the interbank market. However, there can be no guarantee that this option will be open. It would depend on the banks' placing sufficient money at call for

the discount houses to maintain the bill market that was a bit narrower but still broad enough to accommodate Bank interventions.

19. It is difficult for the Treasury to judge the balance of risks. However, we have to decide whether to recommend Ministers to let the Bank put conclusion (x) to the banks, or to hold it up while we try to work up an alternative.

Timetable

20. Before the operators can talk to the banks, they need agreed negotiating instructions on the ground rules for money market operations, the proposal to make the eligibility of bank bills conditional on banks holding call money with the discount market, and arrangements for financing the Bank. From the time the negotiating instructions are agreed, they expect to need at least two months to finalise arrangements. The supervisors will have to continue parallel discussions on liquidity.

Conclusion

21. The prospects are pretty bleak. They offer some greater flexibility in interest rates, and this may be moderately sensible in itself. But nothing so far proposed is likely to produce substantial gains in monetary control. It will be difficult to say convincingly that the Bank's proposals are a clear step towards anything else, or even that they will teach us much of relevance to MBC. They will take months to negotiate. They threaten to introduce a new distortion to shore up a feature of the system - call money - which we believe to be incompatible with MBC. There is no telling when or how we could remove this distortion, or make any other progress. It may not be obvious to outsiders what we gain by substituting a call money ratio for a reserve asset and/or a cash ratio.

22. For all these reasons, we may have to reopen some of the issues which were apparently settled in November. But as yet we have only msgivings, not counter-proposals.

pp [signature]

ROBERT CULPIN

16 January 1981

PRUDENTIAL AND MONETARY CONTROL CONSIDERATIONS AFTER THE ABOLITION OF THE RESERVE ASSET RATIO

The aim

1 The Bank's Background Note of 24 November set out a number of changes to be made "within the existing framework". These explicitly envisaged continued use - largely through the intermediation of the discount houses - of the bill markets rather than the inter-bank market for the conduct of open market operations. The reasons for this approach were explained in the Bank's paper to the Prime Minister last September and related primarily to the wish to avoid dealing directly with a small number of powerful banks and in a form which would result in a negotiated interest rate rather than one which reflected more fully market factors.

2 The changes implicitly envisaged the introduction, over time, of a greater measure of flexibility in short-term interest rates. This intention put considerable emphasis on the need to have markets strong and deep enough for market operations to be possible on the required scale - at least £2-3 billion in a relatively short period of time. Consequently there is a need to ensure the continued ability of the principal market makers - currently the discount houses - to provide the required conditions. It also gave emphasis to the point that, while it might be appropriate to define some set of assets as offering "primary liquidity", the price at which - and, if desired in due course the extent to which - these assets could be encashed by their holders was in our hands.

3 It was also agreed that we should avoid doing anything which foreclosed the possibility of significant future moves towards some form of monetary base control (MBC). The question of how far the existing institutional framework - particularly the discount houses in their role as intermediary - could adapt to such further moves was not raised, because it could only be addressed sensibly after seeing how well the houses could respond to the changes explicitly foreshadowed and after a decision had been reached about the desired form of MBC.

4 This note takes as our immediate aim the abolition of the present minimum reserve asset ratio requirement and its replacement by prudential guidelines and monetary control arrangements which are consistent with each other and which do not foreclose future options on MBC. It does not consider subjects, such as the future cash ratio requirement (if any), which the banks may wish to consider as part of a package with the topics covered here.

Prudential needs

5 The supervisors' concern is with the viability of the British banking system in both its domestic and currency business. As such, their needs go well beyond topics of concern in this paper. Their position in respect of the issues here can be summarised by saying that (i) they require liquidity in the banking system (taken as a whole) that is adequate for the total and nature of the business undertaken by that system and (ii) their perception of the need for such liquidity, and of the contribution to that need made by particular assets, will depend significantly upon the form of our monetary control operations.

Monetary control needs

6 The question here is whether the discount houses will be able, in an unconstrained environment, to obtain a sufficient volume of funds to support the market conditions we desire. They will continue to benefit from the fact that the liquidity provided by easily realisable assets held with discount houses, like holdings of types of bills dealt in by the Bank as part of its open market operations, will be greater than that provided by otherwise closely comparable assets. (This will be recognised by the supervisors in assessing the quality of liquid assets held by a particular bank.) They will also continue to benefit from the fact that a bank's holding of call money is capital certain, whereas its holding of bills is not. It is also the case that, over time, the houses may be able to change the structure of their own balance sheet in ways which will help, in particular reducing their current dependence on call money (which has recently been providing over 90% of their total borrowed sterling funds).

7 However it is not possible to predict with any degree of accuracy how banks might adjust their portfolio of liquid assets under a new set of prudential guidelines and what, if any, would be the basis on which the discount houses could expect to attract sufficient funds on a regular and profitable basis. It is therefore, unclear whether the banks would hold funds with the discount market on a large and regular enough scale to assure the strength and depth of bill markets necessary for monetary control purposes, in the absence of a requirement to do so.

8 In part, the outcome will depend upon the liquidity ascribed to eligible bank bills and the quantity of these bills in the system and this subject is taken up below; but our preferred solution to the eligibility of bills issue might leave the discount houses in a weaker position under the new arrangements than would continuance of the present treatment of these bills. It follows that, in the first instance at least, other measures might be needed to ensure a sufficiency of funds for the discount market.

The question of eligible bank bills

9 The present position of bills is that only those accepted by a limited group of banks (notably members of the Accepting Houses Committee and the clearers) are eligible for rediscount at the Bank and can count towards the 2% of the present reserve asset ratio which can be held in the form of commercial bills. For both these reasons, eligible bills tend to command a higher price than ineligible bills, although if the latter have been accepted by, say, a major American bank it is difficult to argue that they carry any greater credit risk.

10 The Bank have been under pressure - notably from EEC and American banks - for some time to widen the definition of eligibility and it would seem increasingly awkward, on these grounds alone, to continue present practice. In addition, now, the intention to reduce the emphasis on regular use of discount window lending, relying on more complete offsetting of cash flows through open-market

operations in bills, means that there is a good monetary control reason for wishing to expand the supply of eligible bank bills, by widening the eligibility criteria.

11 The problem is that the more eligible bills are held by banks the less will these banks be interested in placing liquid funds with the discount market, given that their overall liquidity needs are unaltered. The less funds that are placed with the houses, the less bills can the houses hold with which to make the markets on which our monetary intervention techniques will depend.

12 The question then is whether there should be any limit on the quantity of bills held by banks - either by an arbitrary control (similar to the 2% maximum imposed under the present reserve ratio) or by an attempt to restrict eligibility according to some general criterion which could effectively - if indirectly - limit banks' total holdings.

13 Our preliminary conclusions are that any arbitrary control would be an undesirable feature of a new system and presentationally difficult to defend. On the question of restrictive criteria, we can think of nothing which would limit banks' holdings without also limiting the total supply of bills. Thus, the only obvious possibility - the restriction of eligibility to bills financing certain types of transactions (some form of "real bills" doctrine) - is ruled out, although we understand it is practiced in the United States, because it would be likely to restrict the total supply of bills, while doing nothing to encourage the holding of the available/bills by the discount houses rather than by banks. (It would also have unacceptable implications for the creation and monitoring of documents to support the bills.)

The implications of the above

14 Without an arbitrary control on banks' holdings of eligible bills, there would seem to be only two ways of providing assurance that the banks would continue to place liquid funds with the discount market on a scale sufficient for the monetary control arrangements envisaged.

15 One would be to consider the imposition across the banking system of a liquidity norm designed to achieve this effect. The other would be to link the extension of the eligibility criterion to the question of how to ensure adequate liquid funds for the discount market. This approach would envisage arrangements whereby a bank's bills would acquire eligible status only if that bank contributed, on some agreed basis, to the provision of sufficient liquidity to the discount market to fulfil the role envisaged for it. This would be attractive only to those wishing to maintain a significant bill business, would not be restrictive in any clearly objectionable sense and would probably be wide enough for the clearers to feel that any burdens were being shared among the major rivals in the domestic banking system. It would, further, have the desirable feature that if it appeared that pressure on discount market funds in the absence of the agreement would be less than had been feared, or if the intermediating role of the discount market became less important, the scale of the arrangements could be reduced progressively and easily, as seemed fit.

The effect on possible forms of MBC

16 Nothing in the ideas considered above would imply any difficulty for the supervisors in responding, given time, to a series of staged moves towards MBC, if made. Insofar as these moves affected the liquidity of particular assets, the supervisors would have to take account of the change. Any change in the relative attractions of near-cash assets or in the relation between cash and previously close substitutes for cash would be the consequence of deliberate monetary control changes and an inevitable part of a staged move to some form of MBC. What would be avoided would be any significant risk of disturbances (to the informational content of banks' cash balances during the various stages of transition to MBC) arising from the interaction of prudential and monetary control considerations.

Conclusions

17 We think it possible to quantify very broadly the stock of liquid assets necessary for the monetary control arrangements

envisaged and, within that, to identify a minimum for the funds placed with the discount market.

18 It is possible that this minimum would be available without further action by the authorities. But, if it is agreed that insurance is needed against this not being the case, we should prefer to obtain that "insurance" via the second route set out in para 14 above. Progress in this direction would need the agreement of higher authority together with further consideration of the exact nature of the "agreed basis" for the arrangements. The next step thereafter would be to produce a paper for discussion with the clearers. Failing this "preferred" route, consideration would have to be given once more to the imposition across the banking system of some appropriate liquidity norm, to achieve the same effect.

35/09 Mrs
Mr
Mr
Mr Grice

TREASURY
5 JAN
H.F.C.S.

Mr H Davies
Mr J Davies
Mr Pickford
Mr Shields

MONEY MARKET MANAGEMENT

This note first describes how we envisage conducting our day-to-day money market operations under the proposed new arrangements - assuming for the purpose circumstances in which we are not seeking to influence short-term interest rates in either direction. It then discusses the procedures we envisage for managing the general level of short-term rates.

I Day-to-day operations

As set out in the Bank's background note it is intended that we should operate in the money market primarily through purchases or sales of bills (Treasury bills, corporation bills or eligible bank bills), conducted in large part through the specialist discount market, with the aim of keeping very short-term rates within an unpublished band. We would seek to minimise discount window lending to the discount houses, and where we did lend it would normally be at rates somewhat higher than comparable market rates.

- Whats this mean
- how much penalty

(i) Informational requirements

As now, these arrangements would require daily estimates of the banking system's net cash shortage/surplus, which we would then aim to offset by matching bill transactions. To avoid undue recourse to the discount window, and strengthen our control over very short-term rates, it will be important that these estimates are as accurate as possible, which requires action in two areas:

Sue

Can I have my 'parliamentary' letter to EG, after Thursday before Christmas?

NM

MONETARY CONTROL WORKING GROUP

NOTE OF A MEETING ON 15 DECEMBER 1980

Those present: Mr Monck (in the Chair)

Mr George Mr Coleby Mr Goodhart Mr Foot	Bank	Mr Riley Mrs Lomax Mr Pirie Mr Culpin	Treasury

There were three papers for the meeting:-

i) Mr Monck's letter to Mr George of 28 November;

ii) Mr Foot's note of 11 December on interim adjustments to the reserve asset ratio requirement; and

iii) the Bank paper of 12 December on money market management.

In addition, there was a brief reference to Mr Goodhart's letter of 9 December about M2: the Treasury undertook to reply to this in writing (letter of 18 December).

General issues

2. The discussion started with a general overview of the interactions between the Bank's operating policy in the money markets and the prudential guidelines which would have to replace the reserve assets ratio. It was agreed that the Bank's operating policy would be a major determinant of the liquidity of different assets, in the sense that those assets in which it would normally trade would be more liquid than those in which it would not. In taking account of this distinction, the Bank's supervisors would necessarily follow the operators' policy. Logically, therefore, decisions on money market intervention (and the cash ratio) must come first, and a judgment on appropriate prudential guidelines second.

3. The Bank representatives said that this judgment would have two parts. For the system as a whole, it would be necessary to

ensure that there was a sufficient volume of assets outstanding in which the Bank would normally trade. This would be required not only for prudential reasons but also to enable the Bank to conduct with reasonable facility its money market operations for purposes of monetary control. For an individual bank, the Bank envisaged that both the size of its overall norm for total liquid assets and (within that norm) the proportion of "primary" liquidity (assets in which the Bank would conduct its open-market operations) it should hold, either directly or indirectly, would depend on the nature of its business. The clearing banks, for instance, would tend to need more of such assets than licensed deposit-takers, because the clearers tended to be the lenders of last resort for the rest of the banking system.

4. The fact that there would continue to be a distinction between assets in which the Bank would normally trade and those in which it would not need imply little about the terms on which it would trade. It did not mean that the Bank would encash any assets at entirely predictable prices. In principle, the Bank already had discretion to vary its prices; that discretion would be used more fully in future.

5. As to procedure the Bank would need consultations between operators and supervisors before putting proposals to the Treasury. Thereafter, they would probably talk to the clearers in advance of other institutions, probably raising the subject of the cash ratio at the same time. At present, it looked as if the Bank's consultation paper on liquidity would need relatively little revision in its discussion of total liquidity, but might need substantial revision in its discussion of primary liquidity.

Reserve Assets Ratio

6. The Bank agreed to expand their paper on interim adjustments to the reserve assets ratio before the end of the week.

Money Market Management

7. To supplement the paper on money market management, the Bank agreed to show the Treasury papers describing the changes which

have recently been introduced in money market operations.

8. In discussion of the paper of 12 December, the following points on the Bank's proposals were made more explicit:-

i) The Bank's paper dealt only with the first move along a possible spectrum of changes. This would have to be tried for, say, six months or so before it would be sensible to consider whether to make a further move.

ii) During the initial period, the authorities would set a band for interest rates in much the same way as they currently set MLR. The Bank would then accommodate whatever demand for cash emerged from the banking system, in much the same way as they now provide whatever cash banks need to meet the cash ratio. Monetary control would continue to turn on discretionary variation of interest rates, and not on the supply of cash to the system. The main changes would be that interest rates would be more variable, and the required cash ratio would be a minimum instead of an average. (This would hold whether the ratio were $1\frac{1}{2}\%$, or zero, or something in between.)

iii) So long as interest rates remained within the band, the Bank would not try to manoeuvre them except for tactical reasons - for example, to obscure the limits of the band.

iv) Fluctuations in interest rates would reflect informational errors and changes in expectations.

v) However, the Bank would not want the cost of informational errors which were not the 'fault' of the market to fall entirely on interest rates. To some extent, the Bank would be prepared to correct them through the discount window at its least penal rates. The object would be to let errors cause interest rates to fluctuate more than now, but not to such an extent that noise obscured signals, or that secondary markets were damaged.

vi) During the initial period, the Bank's objective would be to reduce the predictability of the price at which it would convert assets into cash, but not to sharpen further the dividing line between cash and near-cash assets.

vii) Looking to the longer term, the sharpening of this dividing line would not necessarily cause massive institutional disruption if it could be managed gradually. In particular, it was probable that the discount houses would be able to adjust to changes in their environment. They had proved adaptable in the recent past, were not completely dependent on call money, and could manage their assets as well as their liabilities.

Next steps

9. The Bank representatives undertook to revise their paper on money market management in the light of the discussion. They also said that they would submit as soon as possible a paper on the prudential guidelines to follow the reserve assets ratio. The next meeting will be on Thursday, 15 January at 3.30pm.

pp R CULPIN
22 December 1980

Distribution:

Those present.
Mr Turnbull
Mr Grice
Mr H Davies
Mr S Davies
Mr Pickford
Mr Shields