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PART 12

15/4/1981 – 30/6/1981

Pages 211-230

FORECAST, ACTUAL AND ERROR FROM EQUATION-BASED FORECASTS

Notes and Coin (% pts pa)

Forecast date	Q1			Q2			Q3			Q4		
	F/C	A	E	F/C	A	E	F/C	A	E	F/C	A	E
Revised February 1975	9.0	14.2	5.2	14.3	11.5	2.8	14.9	12.1	2.8	14.7	15.3	0.6
Post-Budget 1975	20.5	8.8	11.7	18.5	11.0	7.5	17.4	15.7	1.7	16.3	14.7	1.6
Autumn 1975	20.5	13.2	7.3	17.6	19.2	1.6	15.4	16.6	1.2	13.9	15.5	1.6
March 1978	7.8	11.5	3.7	8.8	11.9	3.1	10.0	13.6	3.6	9.8	8.9	0.9
Summer 1976	10.3	12.2	1.9	12.3	14.7	2.4	11.3	8.1	3.2	10.8	11.2	0.4
Autumn 1976	14.4	17.2	2.8	13.0	6.1	6.9	12.3	10.9	1.4	11.9	12.0	0.1
Post 1976 cuts	10.7	-4.1	14.8	10.8	7.9	2.9	10.6	10.3	0.3	10.0	11.4	1.4
Post budget 1977	9.9	15.3	5.4	10.5	15.0	4.5	8.0	14.3	6.3	8.8	16.4	7.6
Summer 1977	8.1	14.8	6.7	6.3	13.8	7.5	8.9	16.8	7.9	9.8	16.8	7.0
July 1978	3.6	17.0	13.4	7.9	17.2	9.3	8.8	13.4	4.6	9.2	16.4	7.2
Autumn 1978	4.7	6.3	1.6	6.9	15.6	8.7	9.6	10.9	1.3	9.9	11.8	1.9
Autumn 1979	17.5	7.0	10.5	15.0	5.6	9.4	13.5	5.9	7.6	12.4	5.7	6.7
Winter 1979	19.9	4.3	15.6	17.6	5.3	12.3	15.1	5.3	9.8	13.1	6.9	6.2
Summer 1980	22.7	5.4	17.3	18.3	8.5	9.8	15.4	5.8	9.6	14.7	n/a	
Autumn 1980	20.4	11.8	8.6	15.7	5.9	9.8	14.8	n/a		13.5	n/a	
Spring 1981	18.2	n/a		15.4	n/a		13.4	n/a		12.9	n/a	

APPENDIX 1b

M1 (% pts pa)

Forecast date	Q1			Q2			Q3			Q4		
	F/C	A	E	F/C	A	E	F/C	A	E	F/C	A	E
Revised February 1975	10.2	14.6	-4.4	16.7	14.2	2.5	16.7	15.5	2.2	17.1	13.5	3.6
Post Budget 1975	23.8	13.8	10.0	21.8	16.0	5.8	21.5	13.1	8.4	21.3	15.2	6.1
Autumn 1975	20.0	18.3	1.7	18.8	12.8	6.0	17.8	15.7	2.1	15.7	15.2	0.5
March 1976	15.5	21.7	-6.2	16.0	17.7	-1.7	17.5	16.1	1.4	16.3	11.1	5.2
Summer 1976	12.8	13.8	-1.0	16.0	13.4	2.6	13.6	7.8	5.8	10.6	8.9	1.7
Autumn 1976	13.5	12.9	0.6	6.8	4.9	1.9	7.6	7.3	0.3	7.4	10.8	-3.4
Post 1976 cuts	2.7	-2.5	5.2	6.2	4.7	2.5	7.0	7.5	-0.5	8.5	15.3	-6.8
Post Budget 1977	16.5	21.9	-5.4	17.3	27.0	-9.7	16.2	25.6	-9.4	16.2	24.6	-8.4
Summer 1977	22.5	32.3	-9.8	19.7	27.5	-7.8	16.9	25.5	-8.6	16.5	22.2	-5.7
July 1978	11.1	12.7	-1.6	13.7	14.1	-0.4	13.2	11.0	2.2	12.4	13.3	-0.9
Autumn 1978	6.5	16.5	-10.0	3.1	12.4	-9.3	2.8	11.6	-8.8	3.8	11.3	-7.5
Autumn 1979	20.0	7.4	12.6	12.1	2.9	+9.2	9.7	5.2	4.5	9.7	2.8	6.9
Winter 1979	-0.4	-1.4	1.0	0.4	4.2	-3.8	2.4	1.4	1.0	2.2	3.7	-1.5
Summer 1980	8.6	-4.1	12.7	7.3	3.2	4.1	6.8	7.9	-0.9	6.8	n/a	n/a
Autumn 1980	6.8	11.0	-4.2	4.3	14.4	-10.1	4.7	n/a	n/a	5.6	n/a	n/a
Spring 1981	13.6	n/a	n/a	6.4	n/a	n/a	12.1	n/a	n/a	12.2	n/a	n/a

NC: PARAMETER ESTIMATES

(t values in brackets)

From 64.1 to:

	81.1	80.3	80.2	79.4	79.3
CNST	-1.22 (2.9)	-1.33 (3.2)	-1.31 (3.2)	-1.45 (4.0)	-1.47 (4.1)
PC	0.40 (3.9)	0.40 (4.0)	0.38 (3.8)	0.47 (5.2)	0.47 (5.2)
RPDI	0.35 (4.7)	0.36 (4.9)	0.35 (4.7)	0.41 (6.0)	0.41 (6.0)
RLAA	-0.20 (2.0)	-0.22 (2.3)	-0.22 (2.3)	-0.12 (1.4)	-0.10 (1.2)
RLA4	-0.23 (2.1)	-0.16 (1.5)	-0.14 (1.2)	-0.16 (1.6)	-0.16 (1.6)
NC1	0.50 (4.0)	0.43 (3.4)	0.43 (3.4)	0.21 (1.7)	0.19 (1.5)
NC4	0.03 (0.4)	0.10 (1.1)	0.13 (1.5)	0.26 (3.0)	0.28 (3.3)
	78.3	78.1	77.2	77.1	76.3
CNST	-1.43 (3.8)	-1.52 (4.2)	-1.51 (4.2)	-1.55 (4.3)	-1.20 (3.1)
PC	0.41 (4.1)	0.51 (5.0)	0.56 (5.5)	0.60 (5.6)	0.55 (5.2)
RPDI	0.38 (5.1)	0.45 (6.0)	0.48 (6.4)	0.52 (6.3)	0.43 (5.1)
RLAA	-0.11 (1.1)	-0.11 (1.2)	-0.01 (0.1)	0.02 (0.2)	0.06 (0.5)
RLA4	-0.11 (1.0)	-0.00 (0.1)	-0.07 (0.6)	0.05 (0.5)	-0.08 (0.7)
NC1	0.28 (2.1)	0.15 (1.1)	0.08 (0.6)	0.04 (0.3)	0.11 (0.8)
NC4	0.25 (2.7)	0.25 (2.8)	0.25 (2.9)	0.23 (2.6)	0.24 (2.6)
	76.2	76.1	75.4	75.2	75.1
CNST	-1.25 (3.1)	-1.29 (2.9)	-1.41 (2.9)	-0.94 (1.3)	0.25 (0.3)
PC	0.55 (5.1)	0.57 (5.1)	0.57 (5.0)	0.66 (4.7)	0.83 (5.0)
RPDI	0.44 (5.0)	0.46 (4.9)	0.48 (4.5)	0.44 (3.6)	0.34 (2.9)
RLAA	0.04 (0.4)	0.07 (0.6)	0.08 (0.7)	0.10 (0.8)	0.09 (0.8)
RLA4	-0.06 (0.5)	0.01 (0.1)	0.04 (0.3)	-0.05 (0.4)	-0.04 (0.3)
NC1	0.11 (0.8)	0.11 (0.8)	0.10 (0.7)	0.07 (0.5)	0.02 (0.1)
NC4	0.24 (2.6)	0.22 (2.3)	0.21 (2.2)	0.19 (1.9)	0.13 (1.2)
	74.4				
CNST	0.08 (0.1)				
PC	0.82 (4.8)				
RPDI	0.36 (2.8)				
RLAA	0.11 (0.9)				
RLA4	-0.05 (0.4)				
NC1	0.01 (0.0)				
NC4	0.14 (1.3)				

where:

CNST = constant

PC = price index of consumer goods

RPDI = real personal disposable income

RLAA = local authority three month rate (contemporaneous)

RLA4 = local authority three month rate (lagged four quarters)

NC1 = notes and coin in circulation lagged one period

NC4 = notes and coin in circulation lagged four periods

M1: PARAMETER ESTIMATES

(t values in brackets)

From 64.1 to:

	81.1	80.3	80.2	79.4	79.3
LX1	0.191 (4.20)	0.195 (4.17)	0.171 (3.79)	0.201 (4.04)	0.179 (3.4
LP1	0.468 (2.42)	0.630 (2.74)	0.775 (3.63)	0.632 (2.73)	0.745 (3.1
LP2	-0.381 (1.88)	-0.550 (2.29)	-0.711 (3.19)	-0.555 (2.30)	-0.682 (2.7
RO	-0.007 (6.30)	-0.007 (6.10)	-0.007 (6.44)	-0.007 (6.13)	-0.007 (6.0
R2	-0.002 (1.39)	-0.003 (1.72)	-0.003 (1.85)	-0.002 (1.42)	-0.003 (1.6
LM1	0.689 (8.37)	0.655 (7.96)	0.677 (8.53)	0.693 (8.26)	0.676 (8.1
LM4	0.225 (3.24)	0.269 (3.78)	0.269 (4.02)	0.226 (3.16)	0.270 (3.6
CNST	-1.023 (2.02)	-1.146 (2.18)	-1.131 (2.23)	-1.168 (2.18)	-1.203 (2.2
	78.3	78.1	77.2	77.1	76.3
LX1	X0.246 (4.04)	0.230 (3.47)	0.255 (3.58)	0.225 (2.96)	0.213 (2.7
LP1	0.870 (3.69)	0.550 (2.21)	0.613 (2.42)	0.627 (2.12)	0.534 (1.7
LP2	-0.743 (3.07)	-0.461 (1.83)	-0.484 (1.90)	-0.540 (1.85)	-0.406 (1.3
RO	-0.007 (6.34)	-0.007 (5.56)	-0.007 (4.70)	-0.007 (4.53)	-0.007 (3.9
R2	-0.004 (2.43)	-0.002 (1.24)	-0.003 (1.63)	-0.002 (1.00)	-0.003 (1.0
LM1	0.611 (7.02)	0.669 (6.98)	0.617 (6.20)	0.656 (6.41)	0.624 (5.8
LM4	0.236 (3.17)	0.229 (2.62)	0.226 (2.46)	0.248 (2.70)	0.247 (2.5
CNST	-0.926 (1.74)	-1.276 (2.14)	-0.993 (1.64)	-1.278 (2.11)	-0.820 (1.2
	76.2	76.1	75.4	75.2	75.1
LX1	0.208 (2.59)	0.215 (2.46)	0.224 (2.30)	0.160 (1.38)	0.086 (0.7
LP1	0.543 (1.72)	0.580 (1.70)	0.631 (1.54)	0.665 (1.50)	0.667 (1.4
LP2	-0.435 (1.37)	-0.447 (1.29)	-0.533 (1.23)	-0.468 (0.98)	-0.440 (0.9
RO	-0.007 (3.76)	-0.007 (3.81)	-0.007 (3.66)	-0.006 (3.13)	-0.006 (3.0
R2	-0.003 (1.04)	-0.003 (1.10)	-0.003 (1.02)	-0.004 (1.54)	-0.004 (1.4
LM1	0.643 (5.95)	0.616 (5.61)	0.647 (5.83)	0.577 (4.99)	0.594 (5.0
LM4	0.253 (2.60)	0.250 (2.50)	0.245 (2.45)	0.256 (2.53)	0.250 (2.4
CNST	-1.005 (1.41)	-0.790 (1.03)	-1.149 (1.29)	0.131 (0.10)	0.808 (0.5
	74.4				
LX1	0.120 (0.77)				
LP1	0.699 (1.35)				
LP2	-0.502 (0.86)				
RO	-0.006 (3.02)				
R2	-0.004 (1.45)				
LM1	0.587 (4.82)				
LM4	0.270 (2.34)				
CNST	0.309 (0.15)				

where:

- LX1 = log of real output (TFE at constant 1975 prices) lagged one quarter
 LP1 = log of prices (TFE price deflator 1975=100) lagged one quarter
 LP2 = LP1 lagged one quarter
 RO = LA 3 month deposit rate
 R2 = RO lagged two quarters
 LM1 = log of M1 sa (smoothed for breaks in series) lagged one quarter
 LM4 = LM1 lagged three quarters
 CNST = constant

APPENDIX 3

ACTUAL MONETARY FORECASTS IN THE NIF, OUTFURN AND ERRORS

Forecast date	Q1			Q2			Q3			Q4		
	F/C	A	E	F/C	A	E	F/C	A	E	F/C	A	E
Autumn 1978	7.1	6.3	0.8	8.4	15.6	-7.2	8.8	10.9	-2.0	8.9	11.8	-2.9
M1	5.7	16.5	-10.8	6.4	12.4	-6.0	3.5	11.6	-8.1	3.0	11.3	-8.3
Autumn 1979	15.2	7.0	+8.2	16.3	5.6	10.7	16.5	5.9	10.6	15.0	5.8	9.2
M1	11.7	7.4	4.3	12.1	2.9	9.2	12.2	5.2	7.0	11.7	2.8	8.9
Winter 1979	15.3	4.3	11.0	15.2	5.3	9.9	13.5	5.3	8.2	12.6	6.9	5.7
M1	10.9	-1.4	12.3	13.7	4.2	9.5	12.2	1.4	10.8	11.5	3.7	7.8
Summer 1980	11.2	5.4	5.8	11.4	8.5	2.9	11.5	5.9	5.6	13.5	n/a	n/a
M1	2.3	-4.1	6.4	-2.9	3.2	-0.3	6.7	7.9	-1.2	9.9	n/a	n/a
Autumn 1980	4.4	11.8	-7.4	4.8	6.1	-1.3	7.0	n/a	n/a	7.5	n/a	n/a
M1	-0.1	11.0	-11.1	-0.8	14.4	-15.2	0.8	n/a	n/a	2.6	n/a	n/a
Spring 1981	18.5	n/a	n/a	14.6	n/a	n/a	13.2	n/a	n/a	12.9	n/a	n/a
M1	17.9	n/a	n/a	15.2	n/a	n/a	13.9	n/a	n/a	14.1	n/a	n/a

MR MONCK

cc Mr Middleton ✓
Mr Britton
Mrs Lomax
Mr Davies

FUTURE OF MLR ✓

I attach a draft of the passage from the New Arrangements paper concerning MLR. I would welcome comments on this by lunchtime on Monday, so that I can incorporate the revised passage into the version of the paper circulated for Wednesday's Middleton/Fforde meeting.

AT

A TURNBULL
26 June 1981

Transitional Problems: Minimum Lending Rate

1. It was announced in the Budget that the Government's intention was "in due course to suspend altogether the practice of having an announced MLR, which would by then have lost its operational significance". Retention of an MLR would not fit well within the new arrangements as it would present a clear signal of the authorities' views about interest rates which would limit the expression of a market view. It would also retain the high political profile of administered changes.

2. It is important, however, to recognise what is implied by suspending the practice of an announced MLR. Relying on open market operations, the authorities will not be able to provide a signal about its interest rate objectives as precisely, quickly or credibly as they could with MLR. This will apply particularly to the longer shorter term rates where the Bank's influence in the market will no longer predominate. If market pressures were generating a sharp rise in these rates which the authorities found unwelcome or unjustified, this might only be prevented by intervening to cap the longer short-term rates, a step which de facto, would represent a return to an announced MLR. In short giving the market more influence can only mean giving the authorities less. In general, the Bank feel more confident about their ability to achieve an upward movement through money market operations, than they do about leading the market downwards.

3. Though it is agreed that MLR should eventually be suspended, there may be a case for not doing so simultaneously with the start of the rest of the new arrangements. There are two arguments for delay. The first sees some advantage in a phased transition. Market participants might find it easier to adapt to the new arrangements with less uncertainty if MLR were retained for a time. The second argument is that a possible use for MLR has been identified when the Civil Service dispute is being unwound. This will tend to create upward pressures on interest rates which for monetary policy reasons the Government may consider inappropriate. Although operations within the interest rate band could give a signal about the authorities' views, having MLR available would enable this to be done more clearly.

4. These considerations point to delaying the final demise of MLR until the autumn. The case against delay is that it slows progress in depoliticising interest rates. There will be a tendency for much public discussion to remain focussed on MLR (even if some expert commentators were beginning to appreciate its reduced status). Retention of MLR could therefore delay the presentational benefits which the new system is intended to bring and could cast doubt on the authorities' commitment to the new arrangements.

— MR MIDDLETON
MR MONCK
MR BRITTON
MRS LOMAX
MR DAVIES

cc Mr Pirie
Mr Nendick (Bank)

MR FFORDE)
MR GEORGE)
MR COLEBY) Bank of England
MR GOODHART)
MR FOOT)

cc Mr Walters No 10
Sir Douglas Glass
Mr Ryne
W. Brown
Mr Riley
Mr Gira ✓
Mr Shields
Mr Bennett.

MIDDLETON/FFORDE GROUP: 1 JULY

MONETARY CONTROL: THE NEW ARRANGEMENTS

I attach a redraft of the paper discussed last week in the Monck Group.

AT

A TURNBULL
29 June 1981

MONETARY CONTROL: THE NEW ARRANGEMENTS

I. Introduction

1. The purpose of this paper is to set out:

(i) the form that the new arrangements, which are shortly to be put into effect, will take;

(ii) how they will function;

(iii) what they are seeking to achieve.

It is not, of course, possible to provide a complete textbook before the new arrangements have even been put fully into effect. It is inevitable that they will evolve with use and experience. With the exception of the timing of the suspension of MLR, the paper is agreed between the Treasury and the Bank.

2. One of the features of the new arrangements is that they can be operated with a variety of styles of monetary policy; for example, with a high or low degree of discretion in the setting of interest rates, with greater emphasis given to wide or narrow aggregates. The focus of this paper is essentially technical, concentrating on how the new mechanisms can be operated rather than the form of monetary policy which they are made to serve. The wider issues on the determination of interest rates and the role

of different monetary aggregates in this are discussed in the companion papers []

3. This paper will discuss:

(I) The characteristics of the New Arrangements

- (a) The interest rate band
- (b) Operations in bills
- (c) Discount window lending
- (d) Bankers' balances
- (e) Special deposits
- (f) Reserve asset ratio, prudential norms.

(II) Transitional problems: minimum lending rate.

(III) Presentation.

(IV) Procedures.

4. Following the debate on monetary control, culminating in the Prime Minister's seminar last November, the Chancellor announced a series of changes to be made to the system of monetary control. These were set out in the Bank's Background Note of 24 November. The process was carried forward in the Budget and in the Bank's paper of 12 March. These changes had a number of aims:

(i) to allow greater scope for market forces in determining the structure of short term interest rates. The Bank would confine its operations to very short term rates (0-14 days), leaving the longer short term rates (up to three months) freer to vary.

(ii) to reduce the bias for delay which was thought to characterise administered interest rate changes.

(iii) to achieve a lower political profile for interest rate changes.

These changes could also lead to more flexible market related pricing of overdraft facilities which might reduce the scope for round-tripping and the distortions to monthly money supply figures which this can produce.

5. The Chancellor also said in November that no decision had been taken about the desirability of moving to a system of monetary base control. However, the changes to be made were seen as consistent with further evolution in that direction.

II. Characteristics of the New Arrangements

6. Following the November statement, work was undertaken to design a system which would implement these objectives. Some changes have been made already - reduced emphasis on discount window lending, a movement by the Bank away from posting three

months dealing rates. After the Budget, the Bank put proposals to the banks and other financial institutions. Discussion of these is more or less complete and a final draft of the detailed provisions was circulated in June. (A copy was sent to the Prime Minister on 19 June.) Subject to any points raised by market participants, the final text will be issued in mid July, with the intention of putting them progressively into effect, beginning on 20 August (the start of banking September). The main features of the new arrangements are as follows.

(i) Interest rate band.

7. The Bank will aim to keep very short-term interest rates within an unpublished band, the level of which will be determined by the authorities according to the requirements of its monetary policy. The band will relate to rates on Treasury bills of 0-14 days maturity from which equivalent rates for eligible bank bills will be derived. Although the Bank's open market operations will still extend to longer maturities it is only at the very short end that it will seek to control rates. It is proposed initially to set a width of 2 per cent which would be achieved on average over a week. The aim would be to keep actual dealing rates within an outer limit of 1 per cent on either side of the band. The width of the band would be reviewed from time to time, in the first place after six months. It should be noted that maintenance of bill rates within the band is

consistent with wider fluctuations of comparable inter bank rates e.g. if shortages or surpluses develop late in the day.

8. One of the objectives of the modifications to monetary control arrangements we are now introducing is to allow market factors more influence over short-term interest rates, both for their informational content and to facilitate prompter adjustment by de-politicising as far as possible the process of interest rate formation. There will still of course be substantial official influence over the general level of rates through the interest rate band at the very short end of the money market, but that influence will be less dominant and will be capable of being changed more flexibly if the level and width of the band are not revealed at the time. Otherwise, as with MLR in the past, official interest rate decisions would tend automatically to set the whole pattern of short-term rates - including bank base rates and mortgage rates - and so will continue as major political decisions which can lead to a "bias to delay". It is accepted that the proposed arrangements will mean more uncertainty about official interest rate intentions in the financial market but this is a necessary part of allowing the market's own expectations a greater role.

9. Given that we do not wish to reveal details of the band at the time, it follows that we will not wish to reveal, even after the event, details of the rates to which the band

applies, how precisely it is operated, or how wide it is, since to do so would make it much easier for the market to discover the key parameters within which we operate and to use this information - rather than their own market judgement - to forecast future interest rates.

10. To a substantial extent fluctuations within the band will reflect random factors or "noise", arising from imperfect estimates by market participants, including the public sector, of the size of surpluses and deficits expected to emerge during the day. Movements in the longer short rates beyond the horizon of the band will be more informative than fluctuations of the rates confined within the band. But this is not necessarily to say that the latter can have no informational content. If overnight to 7 day rates move to the top of the band without any corresponding movement in three month rates we might assume that the market expected the fluctuation to be temporary. In this case we would interpret the movement as "noise" in the system. If, on the other hand, short rates moved to the top of the band for a period, and rates further out adjusted in sympathy, then the market would clearly be signalling its belief that rates need to rise generally - in other words that the band should be moved. This could also be the case if longer short term rates rose but technical factors were continuing to hold down very short rates.

11. The precise figure of 2 per cent is very much a matter of judgement, as is the additional outer band of a further 2 per cent. Too narrow a band would leave existing arrangements in practice unaltered, and could not be expected to have any significant effect on the banks' behaviour in a direction that might be helpful to monetary control. Too wide a band could risk creating a damaging degree of volatility.

12. The very wide band set by the Federal Reserve in the US - often as much as 5 or 6 per cent - is not comparable to that to be introduced here. The Fed operates with a guideline for the quantity of market intervention (non-borrowed reserves) in a given period, and allows interest rates to fluctuate within a band whose purpose is essentially to trigger reconsideration of the reserves target between monthly FOMC meetings. Since we are not proposing to operate a system of quantity targeting, our band does not fulfill this role. Without such a guideline, a very wide band would serve only to increase uncertainty. While some element of uncertainty will be an essential factor in inducing changes in banks' behaviour such as the pricing of loans, there is little merit in increasing uncertainty per se, beyond the point necessary to give the Bank sufficient flexibility in its market dealings.

13. One of the implications of having an interest rate band rather than MLR is that banks' and building societies will

not have an easily identifiable rate to which they can peg their base and mortgage rates. They will be left to make their own judgements. As a consequence it is likely that there will be less uniformity between individual banks and building societies, a further factor weakening the latter's cartel arrangements. In general the variability of banks and building societies rates is likely to depend more on the frequency of adjustment of the band than of fluctuations within it, though if rates were at the top of the band and were expected to stay there or to presage an upward adjustment, some institutions might

adjust their rates. As with prime rates in the US, it is possible that a bank will misjudge the market and have to reverse an interest rate change within a short period.

(ii) Operations in bills

14. The Bank is placing greater emphasis on open market operations and less on discount window lending. These operations are being conducted in bill markets rather than the inter bank market, largely through the Discount Houses. A number of consequential changes are necessary to ensure an adequate stock of commercial bills is held by the discount market:

- (a) the list of banks whose acceptances are eligible for discount at the Bank and hence can be used in open market operations is being extended.

(b) In contrast with the sum of over £4 billion held on a daily basis with the discount houses under the reserve asset ratio, eligible banks will undertake to maintain a minimum of secured money with the discount market - initially around £2 billion - and to aim at a higher daily average. Included in the calculation of the latter will be secured call money with money brokers and gilt edged jobbers.

15. The Bank's normal operating procedure (already largely in place) will be to make a daily estimate of the banking system's net cash shortage or surplus and then, if there is no desire to influence short-term rates in any particular direction, to offset the shortage or surplus by matching bill transactions.

16. In the case of a shortage, the Bank will invite the discount houses to offer bills for sale, either outright or for repurchase on a specified future date. The Bank may indicate the kinds of paper it wishes to buy - normally Treasury, local authority and eligible bank bills - and also the desired maturities. At present, the Bank distinguishes four maturity bands for bills -

- (i) 1-14 days,
- (ii) 15-33 days,
- (iii) 34-64 days,
- (iv) 64-91 days.

It may, however, on occasion be more precise still and specify paper maturing on particular dates.

17. The Bank's choice of maturity is influenced primarily by the expected future pattern of surpluses and deficits so that, for example, the prospect of four weeks of continuing shortage will encourage the Bank to buy bills with a maturity of one month or more. When there is the expectation of a significant cash surplus at some known future date, the Bank may set out to buy bills for repurchase by the discount houses on that date. With such a transaction, both the current shortage and the prospective surplus are simultaneously smoothed.

18. A second factor affecting the Bank's choice of maturity and the relative attraction of outright transactions compared with repurchase arrangements is the state of the market. The Bank may know, for example, that there are insufficient short-term bills in market hands to allow a large shortage to be dealt with.

19. For the reasons set out in paras 17-18, the Bank may therefore undertake operations in a range of maturities in pursuit of its objective for 1-14 day rates.

20. If, in a cash shortage, a discount house wishes to respond to an invitation from the Bank, it may offer various amounts at a range of prices, just after midday. (This contrasts with the arrangements which operated until early this year,

under which the Bank posted dealing rates based on the result of the previous week's Treasury bill tender.) The Bank then accepts or rejects these offers in the light of the agreed objective; if the 1-14 day rates are required to rise, the Bank will not accept sufficient offers to reduce the cash shortage rejecting the higher prices (lower interest rates). The market then has a second chance to offer bills in the early afternoon at lower prices and the same process will occur again. If the Bank still has not offset the cash shortage in full, the discount houses will be left to borrow from the Bank at a rate of the Bank's choosing (see paras below).

21. In the case of a prospective cash surplus for the day, the Bank will seek to "mop-up" spare cash by offering to sell Treasury bills⁽¹⁾, the maturity of which will be chosen to smooth out a prospective cash shortage on some specific future date. As in the case of a cash shortage (paras ¹⁷⁻¹⁸ 8-9), this may involve operations spanning more than 14 days though more typically only very short maturities are offered. Traditionally, the offer of mop-up bills has been confined largely to the discount market but in future it will be made also to banks active in the money markets.

22. There are a number of other techniques which have been used for coping with money market imbalances. For example:

(1) It is both cheaper (for the Government) and administratively easier for both the Bank and the market to sell Treasury bills than other forms of paper.