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The timetable 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 money-brokers and gilt-edged jobbers and money-trading banks over the period.⁽⁹⁾ The initial deposits will remain unchanged until sufficient figures using the new definition

(9) The Bank can calculate these offsets from statistics already provided.

of 1974 are available (see para 22 below). The requirements that IFR will be adjusted every six months. The undersigned officials have will continue on the same definition of IFR and in respect of their latest available IFR's figures.

22. As soon as possible, currently reporting institutions will be asked to produce figures for one reporting date on the basis used in 1973 and on the basis of the enlarged list of institutions comprising the new Monetary Sector. These will be for the institutions which are not currently in the established 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 in the 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 not at 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.

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BANK OF ENGLAND
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16 June 1981

cc. to Mr. Foot
17/6

P E Middleton Esq
HM Treasury
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Dear Peter

Mr Fforde asked me to pass on to you the final version of our draft proposals on monetary control, which we would hope to be sending out to all banks and LDTs at the end of this week. I enclose two copies.

Yours sincerely

M D K W Foot

M D K W Foot

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MONETARY CONTROL - DRAFT PROVISIONS

Introduction

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 (LDTs) in "Monetary control: next steps". The present paper sets out the provisions resulting from discussions that have taken place since with the various associations, as well as with a number of individual institutions.

The cash ratio

2 A substantial part of the Bank's resources and income in recent years has been provided by the average of 1 1/2% of Eligible Liabilities (ELs) maintained by the London clearing banks in non-interest-bearing accounts at the Bank. This sum has also served as a fulcrum for money market management. The Bank's paper in March proposed that this latter purpose should in future be served by the volume of operational funds which the London clearing banks would retain voluntarily at the Bank for clearing purposes, while the Bank's resources and income should additionally be secured primarily by a uniform requirement on all banks and LDTs to hold non-operational, non-interest-bearing deposits with the Bank. The provisions set out in this section have accordingly been designed to provide, in aggregate, broadly the same amount of non-interest-bearing funds initially as did the previous arrangements with the London clearing banks alone.

3 This non-operational requirement will be 1/2% of an institution's ELs and will apply to recognised banks and LDTs (and National Girobank) having ELs which average £10 million or more in the latest period over which the requirement is calculated. The level of an institution's non-operational balance will be set twice a year in relation to its average ELs in the previous six months⁽¹⁾.

(1) A deposit due in, say, March would relate to the monthly average of ELs from September to February inclusive.

4 For institutions not on the present statistical list of banks and whose business mainly comprises the provision of fixed rate finance for periods in excess of one year, the Bank accepts that the introduction of the 1/2% cash ratio may present a special transitional problem. The Bank will be prepared to consider individual representations from such institutions for some temporary alleviation of the requirement.

5 ELs are to be redefined to reflect the changes set out in this paper. In future, offsets will be allowed in the calculation of ELs in respect of:

- (i) funds (other than cash ratio deposits or Special Deposits placed with the Bank) lent by one institution in the newly defined monetary sector⁽¹⁾ to any other;
- (ii) money at call placed with money brokers and gilt-edged jobbers in the Stock Exchange, and secured on gilt-edged stock, Treasury bills, local authority bills and bills of exchange.

6 ELs will be calculated in uniform fashion for all reporting institutions⁽²⁾ except:

- (i) members of the London Discount Market Association (LDMA), whose ELs will be calculated as the total of sterling deposits other than from institutions within the monetary sector;
- (ii) certain banks with money trading departments, who will be allowed to omit from their ELs secured money at call placed by other banks with these departments, up to a limit set by the Bank.⁽³⁾

7 It would be contrary to the objective of these agreed arrangements for any institution to reduce its ELs deliberately or artificially on reporting dates. The Bank accordingly reserves the right to make a spot check on the level of an institution's ELs on days when it would not normally report.

(1) See paragraph 16 below.

(2) The present arrangements for those finance houses which have observed a 10% reserve asset ratio since 1971 will lapse accordingly.

(3) The banks concerned are: Algemene Bank Nederland, Banque Belge, Charterhouse Japhet, Leopold Joseph and Samuel Montagu. Hitherto, funds placed on this basis, up to a limit set by the Bank, have counted as reserve assets.

Special Deposits

8 The Special Deposits scheme remains in place and will apply to all institutions with ELs of £10 million or more⁽¹⁾. As hitherto, calls will be set as a percentage of ELs. The scheme for Differential Special Deposits⁽²⁾ will lapse once the provisions in the 1981 Finance Bill relating to additional exchange control powers become law.

Eligibility

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

- (i) whether the applicant has and maintains a broadly based and substantial acceptance business in the United Kingdom;
- (ii) whether its acceptances command the finest rates in the market for ineligible bills;
- (iii) whether, in the case of foreign-owned banks, British banks enjoy reciprocal opportunities in the foreign owners' domestic market.

A first list of eligible banks is attached.*

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.

(1) Hitherto only banks on the statistical list and finance houses observing a reserve asset ratio have been subject to Special Deposits.

(2) The scheme was devised and agreed with banks in 1972 but never used. It would have permitted the authorities to call, as Special Deposits, different proportions of any increase from a specified base in (i) domestic residents' and (ii) overseas residents' sterling deposits. Details can be found in the Bank's Quarterly Bulletin for March 1973.

* It will be attached to the final version of this document.

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⁽¹⁾ - all at market rates appropriate to the nature of the lending - such that:

- (i) the total funds so held normally average []* of that bank's ELs;
- (ii) the amount held in the form of secured money with members of the LDMA does not normally fall below [] of ELs on any day.

12 In relation to the above undertaking, each eligible bank will

- (i) aim to meet the daily average ratio over either six or twelve month periods at its discretion, the ratio on any particular day being calculated as a proportion of ELs at the latest make-up day.
- 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 be ready to explain such action to the Bank when the relevant monthly return is made.

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

(1) The Bank's concern with the adequate availability of funds for the efficient functioning of the gilt-edged market was noted in "Monetary control: next steps". There are six recognised money-brokers - James Capel & Co, Cazenove & Co, Hoare Govett Ltd, Laurie Milbank & Co, Rowe & Pitman Moneybroking and Sheppards & Chase (Moneybroking). Secured call money with these firms has hitherto counted as a reserve asset. The amount of such money which these firms can take will continue to be limited by the Bank.

* The figure in this sub-paragraph will be calculated to produce an aggregate amount of around £3 billion and is expected to be around 5% of ELs as presently defined, or perhaps 6% on the new definition. The figure in sub-paragraph (ii) will be approximately two-thirds of that in (i).

Prudential considerations

14 The Bank has received the assurances mentioned in the Chancellor's Budget Speech, and 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 by the Bank, changes in their policies for the management of their liquidity and its composition. Discussions on developments in supervision are continuing and a separate paper on liquidity will be issued by the Bank when appropriate.

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 and the list of discount market institutions. These lists were drawn up prior to the Banking Act and are no longer appropriate to current circumstances. They exclude 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) all recognised banks and LDTs;
- (ii) National Girobank;
- (iii) banks in the Channel Islands and the Isle of Man, so long as they are subject to broadly parallel arrangements for a cash ratio.
- (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 business of many of the new contributors is relatively small. In total, the

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

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.

The timetable for change and the transitional arrangements

19 The essential features of the new arrangements can be brought rapidly into effect. This section sets out 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 discount at the Bank will begin to observe the requirements set out in paragraph 11 above;
- (iii) the agreement with the London clearing banks, 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 On this operative date, the first cash deposits will be placed by institutions on the present statistical list of banks and by members of the LDMA; the statistics necessary to include other institutions are not yet available. These initial deposits will relate to the average of institutions' ELs over the latest six-month period available, ELs being 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.⁽¹⁾ These initial deposits will remain unchanged until sufficient figures using the new definition of ELs are available (see paragraph 22 below).

⁽¹⁾ The Bank can calculate these offsets from statistics already provided.

Thereafter, these deposits will be adjusted every six months. The undertakings by eligible banks will commence on the operative date, on the same definition of ELs and in respect of their latest available ELs figures.

22 As soon as possible thereafter, currently reporting institutions will be asked to produce figures for one reporting date both on the basis used hitherto and on the basis of the enlarged list of institutions comprising the new monetary sector. At the same time, 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 join the reporting network (and will be asked to place cash deposits with the Bank shortly thereafter).

23 Monetary aggregates will be calculated on both bases for this one 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 paragraph 18 will be brought into the reporting network only when the current review of banking statistics has been completed.

MR MONCK

cc Mr Middleton (for information)
Mr Britton
Mrs Lomax
Mr Pirie
Mr Davies

MONETARY CONTROL: PM'S SEMINAR

You asked me to prepare an outline of a paper on the new arrangements. This I have done and a copy is attached. However, the most difficult question is the demarcation between this and other papers. It seems to me we will need the following.

(i) A paper setting out what the new arrangements are, what they are trying to achieve and how they should be operated. I have envisaged this as a rather factual, not very controversial piece, and it is for this that I have prepared the outline.

(ii) On operations, the really difficult question is setting interest rates. I envisage this as being in a separate paper devoted solely to this aspect, which would emerge from discussion of Mr Britton's paper. Mrs Lomax's paper on the role of the narrow aggregates could either be a separate paper or an annex to (ii).

(iii) Monetary base control - an update of Mrs Lomax's paper produced in response to the first Walter's initiative.

(iv) Funding - possibly updated after discussion with Treasury Ministers.

An alternative would be to try and roll (i) and (ii) into one longer paper, again with the paper on narrow aggregates as an Annex. Before drafting can be set in hand we need to settle the question of demarcation.

AT

A TURNBULL
17 June 1981

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MONETARY CONTROL: THE NEW ARRANGEMENTS

Introduction

- (i) Purpose of the paper
 - (a) To set out new arrangements in form in which are shortly to be put into effect.
 - (b) To consider what we want to achieve from the system.
 - (c) To consider how it should be operated.
 - (d) Outstanding issues
 - MLR
 - Setting interest rates.
- (ii) Recap of history
 - November 1980
 - Budget
- (iii) Relationship with other papers
 - Setting interest rates
 - Narrow aggregates
 - Monetary base control
 - Funding.

Characteristics of the new arrangements

- (i) Band for interest rates
 - position in maturity spectrum
 - its width
 - aiming at centre or extremes.
- (ii) Greater emphasis on operations in bills
 - enlargement of eligibility
 - support for discount houses.

- (iii) Discount window
 - more restricted role
 - circumstances in which to be used
 - degree of penalty.

- (iv) Special deposits
 - retained in reserve role

- (v) Abolition of reserve asset ratio and development of prudential norms
 - their monetary impact.

- (vi) Bankers balances
 - non-operational
 - operational.

Objectives

- (i) greater role for market forces
- (ii) less bias for delay
- (iii) lower political profile
- (iv) less round tripping
- (v) possible transition towards MBC.

Presentation

- (i) why need to keep position and width of band secret
- (ii) how to maximise depolitisation despite strong element of discretion and absence of a quantity rule.

Outstanding issues

- (i) Timing of abolition of MLR.
- (ii) Groundrules for interest rate policy - see comparison paper.

MR MIDDLETON

cc Mr Britton
Mrs Lomax
Mr Turnbull
Mr Pirie
Mr Davies

MONETARY CONTROL: PM'S SEMINAR

This note sets out some points you might like to have in mind before your meeting with Mr Fforde on Monday.

2. The Chancellor replied to the Prime Minister on 19 June welcoming the seminar and saying that it would need to settle how we shall be operating the new arrangements immediately after they are introduced, probably in August. He mentioned "the basis for short term interest rates and the Bank's intervention in the money markets" and said that the discussion would cover the role of the narrow monetary aggregates, including the monetary base, in these decisions and in any later developments of the system. He also sent over the Bank's "draft provisions on monetary control" which have already been circulated confidentially to the clearers and will go to other banks on Monday.
3. Mr Britton, Mrs Lomax, Mr Turnbull and I have discussed the objectives for this seminar, the papers for it and the timing of their preparation.
4. We thought the objective should be for the Chancellor and the Governor to go to the seminar with an agreed position on most of the substance about how to operate the new system. Recent evidence suggests that this should be possible since the approach of the Chancellor and the Governor and of their officials seem pretty close together. This assumes a discretionary approach, as envisaged in Mr Britton's paper and implied by giving weight to forecasts as well as past figures.
5. On timing this suggests that we should get officially agreed papers to the Chancellor and the Governor in time for them to meet by Friday, 17 June (2 weeks before the PM's seminar) or very early in the following week. That would if necessary allow time for a second meeting to iron out any difficult points on the basis - if that is necessary - of revised papers.

Papers

6. Working back from that, I hope that you can settle the remit for the paper on setting interest rates etc at or very soon after, your meeting with Mr Fforde. This will presumably be based on Mr Britton's earlier paper, which we have not yet discussed in detail with the Bank, plus annexes on the narrow aggregates and other subjects. Another meeting of your Group needs to take place in about a fortnight's time in the week beginning 6 July.

7. Meanwhile my Group will be discussing (Thursday) a draft of the paper describing the new machinery, its levers and the associated procedures which Mr Turnbull is drafting. The main aims of this paper are to embody an agreement between us and the Bank and to ensure that Ministers know what to expect of the new machinery. I hope we can define the decisions about which the Bank will consult us, but at the same time avoid having to get agreement from No 10 for particular acts or forms of intervention which do not involve major issues or shifts of policy. We shall still of course need support from No 10 on the main lines of policy.

8. Another paper would be Mrs Lomax's on monetary base control. Apart from some minor points, the Bank have said they agree with it. The next step would be for you to consult Mr Walters about it. He will not like it but we cannot spring it on him blind for the seminar.

9. A possible fourth paper, though I am not convinced this is necessary, is one on funding. At present it does not seem likely that there will be any major disagreement between us and the Bank. If that remains true, after we have discussed the funding papers with Treasury Ministers, I doubt if we need a paper on this. We could, however put the Wass Report on the agenda for the proposed meeting in mid-July between the Chancellor and the Governor (the Financial Secretary is holding a meeting on funding in the next few months on 24 June. He will also be holding a meeting about National Savings.)

Bank Lending and Overfunding

10. You may also like to know that Mrs Lomax is writing a new paper on overfunding and bank lending; and the options of restraining bank

lending either by higher short term interest rates or by credit controls, overfunding combined with massive money market assistance, and raising £M3 targets for the period after 1981/82 in recognition of a possible secular rising share of banks in financial flows. I mention this work in this context because it might make sense to seek a remit for further work on bank lending and the problems it poses for banks' balance sheets and hence money market assistance at the seminar.


N MONCK

19 June 1981

BANK OF ENGLAND
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22 June 1981

A J C Britton, Esq.
H M Treasury
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Dear Andrew

✓ You might like to see this further correspondence,
which I am also copying to Rachel Lomax.

Yours sincerely

Charles

C A E Goodhart

1466



10 DOWNING STREET

17 June 1981

Dear Charles

Thank you for your letter of 12 June. The fact that you have had to revise your equation since you last wrote is not a congenital hazard in econometrics; it is evidence of dementia econometrica. I will be waiting for the stop press.

But I think the point that emerges from your figuring is not the point you make that correcting a 2% shortfall in currency would require an 8% move in interest rates. This is for six months only. In fact most of the effect will come through in the next six months because in Templeton's para 6 he says a 1% rise in interest rates will produce a 0.6% fall in the stock of notes and coin over the course of a year. Thus this implies that the shortfall we have been seeing recently would require a move of about 3% over the year. There is almost twice as much kick in the second six months as there is in the first six months.

I suppose that both of us know enough about econometrics to take all this with large pinches of salt. Indeed, if the dynamic effects were as Templeton describes them, if one wanted to do it all in six months one would have to increase interest rates, as you say, by about 8% and then dramatically reduce them again since the delayed effect of your first reduction would be raging away during the second six months. All a bit daft, since the six months rule would probably lead to an explosive sequence. At least that's my conjecture!

Yours
Alan

C.A.E. Goodhart, Esq.