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PART 1

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10 DOWNING STREET

MR. BURNS
MR. MIDDLETON

In order to attempt, perhaps vainly, to clear my mind in the current confusion of "progress" in monetary base control, I have prepared the enclosed notes. Would you please let me know if I have been grossly inaccurate or unfair?

I am depressed by the thought that I shall have to go back to the Prime Minister and tell her that very little progress has been made. Can we see what can be done about it?

AW

15 April 1981

ALAN WALTERS

cc Mr. Hoskyns
Mr. Wolfson
Mr. Sanders

25814

NOTES ON MOVEMENT TO MONETARY BASE CONTROL

Phasing Out the Reserve Asset Ratio

The reserve asset ratio was reduced from 12½% to 10% on 2 January. It was said that final abolition of the reserve asset ratio depends on making sufficient progress with new arrangements for assuring adequate liquidity for the banks so that confidence in the banking system is fully maintained. Such measures were referred to in the article on the liquidity of banks in the Bank of England Quarterly Bulletin March 1981. However, there has been no formal progress on reducing the reserve asset ratio below 10% and no sign of eventual abolition. Presumably this is being held up while additional discussions are taking place on the nature of acceptable and applicable bases for measuring the overall liquidity of banks. The Bank was supposed to provide a paper as a basis for further discussion of this aspect but so far as I know, it has not appeared. The Bank still envisages the early abolition of the reserve asset ratio which it says is not a prudential ratio and is not regarded by the Bank as such. But apparently it is still being held up because the Bank wants to discuss with individual banks the appropriate normal level of holdings of assets which at present are required for the reserve asset ratio. It says that these discussions may not have been completed when the reserve asset ratio is abolished as a minimum requirement.

It is clear that progress on this is extraordinarily slow. It is difficult to see why the reserve asset ratio should not be abolished now.

Cash Ratio

So far as we know the discussions between Sir Douglas Wass and the Governor have not yet produced an alternative source of income to the 1½% cash ratio deposits at the Bank of England. It is quite clear that the 1½% cash ratio has nothing to do with the business of monetary control, it merely supplies the Bank with its most important source of income. It was expected that recommendations on this issue were to be made before the Budget. Yet apparently none have appeared.

Money Market Management, Lending Operations and the Bill Market

It does seem that the Bank has retreated from the discount window and instead of providing funds in that way it is buying bills. The Bank clearly wants to extend its bill operations so that it has an adequate market in which to conduct open market operations in eligible commercial bills. The eligible acceptance houses largeley are restricted to British banks. In discussing (in the Bank of England Quarterly Bulletin March 1981) the extensions of these eligibility criteria to foreign banks in London, the Bank lists as one of its undertakings that the banks would agree to place an average level of funds with the discount houses. This would enable the discount houses to make a market in bills. Superficially it seems to be a mechanism for keeping the discount houses in business, or at least in the bill business.

Minimum Lending Rate

The Bank still appears to be publishing minimum lending rate and apparently will go on publishing it, even though little or no business is done by the Bank at this rate. So far there doesn't appear to be any agreed bands within which the rate of interest is to be operated. This is a matter of urgency. The Bank now does not quote prices at which it will buy eligible bills of over one month maturity and simply now responds to offers of sale of such bills. It would be nice to know the criteria on which sales are accepted. And how is the band to be moved.

Sales of Debt

The Committee chaired by Sir Douglas Wass broadly reported that it was not really possible to mix the tender system with our existing form of tap issues. The successful tender issue of the indexed gilts suggests there were very few problems with tenders of indexed or perhaps non-indexed stock. It is likely, however, that the issue of indexed stock will expand quite rapidly. The Bank, however, are still clearly concerned to keep their gilt edged jobbers in business, see para 11 on page 39 of the Bank of England Quarterly Bulletin March 1981. They clearly regard the efficient functioning of the market as requiring the jobbing operation, and so are continuing with the tap issues.

Conclusions

The main conclusion is that the movement to monetary base control is clearly a long, long way behind the timetable of the programme that was outlined in November of last year and in January this year. The reserve asset ratio has not gone; the cash ratio is still operative; the minimum lending rate is still announced and there is no evidence of the band of rates being used. Unless the Treasury takes a new initiative it is difficult to see how any progress will be made.

15 April 1981

cc Mr Britton
Mr Monck
Mrs Lomax
Mr Pirie
Mr Davies

MR MIDDLETON

MONETARY CONTROL: MR FFORDE'S LETTER OF 10 APRIL

You asked for advice on Mr Fforde's letter of 10 April which belatedly replies to your letter of 11 March. It is a pretty unsatisfactory reply all the way through.

2. First, you asked the Bank, in their discussions with the banks and the discount houses, to make it clear that there would be an increase in variability/^{interest rates} and that the new arrangements were not a guarantee of survival. Mr Fforde's reply is evasive. When he says "we did however keep your points well in mind in our discussions" it is not clear who "we" is and whether he made the point explicitly to the institutions.

3. On the second point, the future structure of the gilts market, his reply is somewhat more convincing though it is still not clear in what terms the issue was presented to the market.

4. Thirdly, you asked for a further description of the paper on the definition of liquidity. His reply is meagre in the extreme - reminiscent of the^{invitation in the} South Sea Bubble to invest in a project "to be revealed at a later date".

5. Fourthly, the answer on the timing of abolition of the RAR takes us very little further forward. We are asked to wait until the discussions on "Monetary Control: Next Steps" are complete.

6. Finally, he records the Bank's interpretation of the phrase "developments in the economy more generally". He includes in this trends in output and employment, though these were not specifically mentioned in the Budget speech.

7. Should you therefore return to the fray? Having consulted Mr Pirie, I would advise against writing back

immediately. We will have opportunities to take up these issues shortly, either when we resume discussions on monetary control or when we pick up the threads of the funding debate again. We will need to keep up the pressure on the liquidity paper and we will also need to watch out for recidivism on the terms in which any cuts in interest rates are announced.

AT

A TURNBULL
16 April 1981

MR RYRIE

cc Mr Burns
Mr Middleton
Mr Britton o/r
Mr Monck
Mr Turnbull
Mr H Davies
Mr Grice
Mr Shields

MONETARY BASE CONTROL: WHERE NOW?

I attach a further paper on MBC. You will also shortly be receiving a companion piece by Mr Turnbull on other monetary control issues. As you know, we have already had some discussion of these papers with Mr Middleton. My paper is intended to form part of our response to Prof. Walters' recent initiative on MBC, which led to his further remit from the Prime Minister. It is more overtly negative about MBC than previous papers, and argues that the decision to take a wider range of factors into account in setting short term interest rates marked a significant step away from MBC. In the light of the Budget, and our internal discussions over the past six months, MBC looks less relevant than ever to our main monetary control preoccupations. But we may have some difficulty in getting Prof. Walters to accept this proposition - hence the length of my paper.

RL
RACHEL LOMAX
22 April 1981

Encl.