2. Monetary Base Control III

5/11/1980 – 7/11/1980

Chancellor of the Exchequer

Financial Secretary
cc Sir Douglas Wass
Mr Ryrie
Mr Burns
Mr Monck
Mr Britton
Mr Unwin
Mrs Lomax
Mr Riley

2/6/03 G

MONETARY TARGETS AND MONETARY CONTROL

1. We have not yet seen the Bank's papers which may be with you before the meeting tomorrow afternoon. They are still being discussed with the Governor. It is not therefore possible to let you have a proper brief. But the following might help you guide the discussion.

2. There are a number of issues of relatively minor importance or which are in a fairly complete state which you will not wish to discuss tomorrow. These include:

   a. National Savings
   b. the Restricted Indexed Gilt
   c. Smoothing the PSBR

They are all required for the Prime Minister's next meeting; but if they are to be discussed in any detail we need a special meeting.

3. The two main items on which we must make progress are:

   a. the roll forward of the target
   b. monetary control

Attached is a further minute by Mr Monck which could serve as the basis for the discussion on the roll over. You might also wish to refer to his earlier minute of 10 October and the record of your discussion with the Governor on 22 October. On monetary base control we have nothing yet to add to the papers prepared for the seminar though we may wish to comment on the Bank's papers when we see them.

4. The presentational problem is: what do we say on these two subjects in late November and what do we leave for the Budget? We have to say something on both in conjunction with the Industry

SECRET

Act forecast.

5. The substantive problem is that with the present forecast for the PSBR this year and next, a natural uncertainty about what might be possible in the Budget, and the growth so far experienced in the money supply during the present target period, all the options for rolling the target forward are difficult. And with the possibility of having to risk a reduction in interest rates it is not too easy to announce moves to improve the system of monetary control which in present circumstances would indicate a move in the opposite direction. Current worries about the exchange rate compound these difficulties.

6. In these circumstances major moves must await the Budget. We can then reset the annual target, and relate it to the MTFS which can itself be reassessed at the same time. Effective changes in the system of monetary control can then be made against the right sort of background - one in which we have reformulated the strategy and its main components, rather than at a time when it is out of balance and when the strains on interest rates are too great to allow much of a role to the market.

7. To carry conviction and maintain confidence, what is announced in November must be a clear step in the direction of re-establishing control.

<u>The Roll Forward</u>

8. The least unattractive option seems to be to announce that the authorities expect to get near to the present target range, but that the target will not be rolled forward until the Budget. The October money supply figures mean that we cannot say that we hope to be within the 7-11 range, even in an underlying sense. But we can still explain why the growth in the money stock is expected to moderate - and any reduction in interest rates we feel compelled to make will have to be based on this conviction. It should be possible to gain credit for taking a breathing space until the Budget, provided it is not thought that the whole strategy is being abandoned.

<u>Monetary Control</u>

9. In this connection it is important to make a convincing announcement about the result of the monetary control discussions. You must therefore press the Governor for answers on the following

key questions:

a. Can we make a statement in principle that it is intended to give the market more of a say in the determination of interest rates? And can we say that we are going to make changes which could allow a gradual move in the direction of monetary base control. Are we aiming at mandatory system (one with a compulsory cash requirement) or a non mandatory system (which is based on the banks' own cash requirements)?

b. In the light of these general questions there are some concrete issues which we must resolve. Can the reserve asset ratio be abolished forthwith? If not, how can it be modified so that it ceases to have any impact on monetary control?

c. How quickly can the Bank carry forward their discussions on prudential control. It seems clear to us that any liquidity norm, to be consistent with my method of monetary base control would have to apply to both primary and secondary liquidity combined; do the Bank agree?

d. How should the long delayed consultation paper be revised if we are to move to a monetary base system. The characteristics on which decisions are needed are:

i. <u>coverage</u>: should it apply to all banks (the present $1\frac{1}{2}$% ratio applies only to London clearers);

ii. the <u>denominator</u> is now eligible liabilities which approximates to £M3 but which offers substantial room for disintermediation like the corset. We argued for retail deposits;

iii. <u>penalties</u>: what sanctions for non compliance?

iv. <u>size of ratio</u>: is $1\frac{1}{2}$% big enough for a viable system (we have suggested 5-10%)

v. <u>interest</u>: do we pay interest on required reserves to minimise distortions?

e. What changes in the Bank's lender of last resort facility will need to accompany effective changes in the system of monetary control?

10. We also need to discuss the Bank's ideas on new methods of gilt funding. Would their proposals be adequate if we moved to

monetary base control and wish to continue to pursue a target for one of the wider monetary aggregates such as £M3 or PSL1?

P E MIDDLETON
5 November 1980

Enc

MONETARY POLICY: ROLLING OVER THE TARGET
(Supplementary Note)

This note supplements the paper of 10 October, in the light of the Chancellor's discussion with the Governor on 22 October and events since then:

a. the rise in the exchange rate which has increased the pressure for lower interest rates, although the NIF assumed no change in short term interest rates before the end of 1981;

b. the October rise of £M3 (2.1% compared with a forecast of 0.9%);

c. the Chancellor's evidence to the TCSC, which has been given a tentative estimate that the underlying growth of £M3 was 19% to September. The Chancellor explained why monetary growth would slow down in the second half of 1980/81 but did not claim that it could be kept within the top of the target range.

It is not yet clear whether the NIF's PSBR forecast of £11.3 billion for 1981/82 was too high or too low. The MTFS implied a PSBR of £7½ billion.

2. The original paper focussed on:

a. maintaining the present target for the 14 month period to April 1981 (the "April Option"); and

b. announcing a new target covering a period ending in October 1981 (the "October Option").

3. If the October and September increases are averaged, the result is close to 1½%, a monthly rate corresponding to the 19% figure for February to September in paragraph 1(c) above. The annex gives

(Table A) revised actual and forecast figures for £M3 in terms of ranges, the lower end assuming reversal of the October excess and the high end assuming an addition of up to 1½% to the NIF forecast of £M3.

Implications of the Changes

4. The October figures means that it is no longer credible for the Government to state its intention of getting adjusted £M3 with the top of the current target range - 11% at an annual rate or 12.9% over 14 months. The actual growth for February to October is 15.5%(recorded) and 12.9% (adjusted). Even on an adjusted basis there is no margin now for the remaining 6 months.

5. In effect therefore sticking with the present target wouldnow appear more clearly than before to be a suspension of the target.

6. The growth of £M3 at an annual rate from February 1980 to January 1' the last month for which statistics will be available before the Budge' is likely to be at least 15 or perhaps 17% on an adjusted basis, about 3 percentage points higher than the forecast for the whole of the current target period ending in April.

7. On the other hand the hazards of announcing a new target in advanc of the 1981 Budget have if anything been increased by the strengthened pressure for reducing interest rates. We believe that a significant c in MLR in the near future would add several points to monetary growth by the end of 1981.

The Main Choice

8. The basic choice remains between:

a. deciding not to announce a new target before the Budget; and

b. announcing a new target covering the next 12 (or perhaps 18) months in November.

No New Target

9. The problem with this option is how to present it in a way that minimises damage to the Government's credibility. In addition to stressing the reasons for expecting a slow down of monetary growth in the coming months and the remaining uncertainties about the interpretation of the figures, Ministers would presumably rely a good deal on other evidence of economic and financial stringency. It might also help a little to limit damage from an apparent suspension of the target if the Chancellor were to say that he would be setting a new target based on January 1981 at the time of the Budget. There would then be only 3 banking months to go before the start of the new target period, although the announcement itself would not of course be before March.

A New Target Announced in November

10. This option raises the basic policy issues of the extent to which Ministers wish the path of monetary growth to be in line with the forecast, which is close to the MTFS path, and to take the validating decisions, notably on interest rates and on measures affecting the PSBR for 1981/82. Some of these eg on public expenditure will be taken in the next few weeks but others will be delayed until the Budget.

11. Table 1 below shows the forecast for monetary growth over various possible target periods either for announcement in November or for announcement in the Budget. The key assumptions underlying these monetary forecasts in the NIF are in paragraph above.

TABLE 1

	Forecast growth (adjusted at an annual rate)
New target period for November announcement	
October 1980-October 1981	5.7-7.2%
October 1980-April 1982	6.3-7.3%
February 1980-October 1981	11.2-12.2%
New target periods for Budget announcement	
January 1981-April 1982	8%
January 1981-January 1982	6½%
April 1981-April 1982	7%

Corresponding 'recorded' figures, which are higher, are in Table A of t Annex.

12. If there were to be a new target based on October 1980, it may be worth considering an 18 month target extending to April 1982. This would not in reality reduce the hazards of such a target, but it might postpone the chickens coming home to roost.

13. Table 1 shows the forecast figures for various target periods. Since they all follow the NIF path, they are all equally strict, althou the numbers differ for different periods.

14. The amount of base drift likely to be embodied in different startin dates varies widely (see Table B of the Annex). There is of course none in the February 1980 base. But an October 1980 base would embody a good deal (about 6%) and a January 1981 base is forecast to be simila April 1981 would embody less base drift (1½-3 %) if the forecast slo down in the early months of 1981 takes place.

10 15. The policy decisions mentioned in paragraph above would be the determinant of the tightness of the chosen number for a new target to be announced in November. Until they are taken, a new monetary target cannot sensibly be settled. The choice of base and length of the new target period would be primarily questions of presentation.

Conclusion

16. Ministers are invited to decide whether or not they wish to announce a new monetary target in November.

17. A decision against announcing a new target would not be easy to present because the current target is virtually certain to be overshot and this is likely to be apparent. On the other hand a new target would involve basic policy decisions on the tightness of monetary growth, interest rates and measures affecting the PSBR for 1981/82.

18. A final decision not to announce a new target in November could be taken now. But if Ministers were to favour a new target in November, further work would be needed in the light of the associated policy decisions before final decisions could be taken on the target number and its period.

FIGURES RELEVANT TO ROLLOVER DECISION

The figures in Table A replace those in the Treasury paper of 10 Octobe on "Monetary Policy: Rolling over the Target". As in that paper the figures are actuals for the past and for the future assume that £M3 follows the path forecast in the NIF.

2. The changes in the figures since 10 October reflect the following points:-

a. the preliminary actual for October of 2.1% compared with a forecast of 0.9%;

b. the figures for the future are expressed as a range. This takes account of forecasting errors in the externals and the CGBR in October. In both cases, an assumption is required as to whether or not these deviations will be offset in subsequent months. The low figure in the ranges supposes that the high externals in October are fully offset in later months, but that the low CGBR is not offset. The high figure supposes that the October externals are not offset by lower outturns in subsequent months, but that the CGBR is higher after October to bring its financial year total back to the original forecast. (This implies, for example, that the April 1981 level of £M3 is 1.3% higher than in the low case - approximately 1% for the externals, 0.3% for CGBR.) These figures are still subject to the normal forecasting range of plus or minus 2%;

c. correction of small errors in the earlier figures, which understated the growth by about 0.3%;

d. new terminal or starting dates - October 1980 and January 1981, the last month for which figures will be available at the time of the Budget. Table B shows the base drift at various starting dates.

TABLE A

ACTUAL AND FORECAST (IN THE NIF)† GROWTH OF £M3

	Annual Rates	
	Recorded £M3	Adjusted £M3
Current Target Period (or January, last statistic before the Budget)		
February 1980-April 1981	14.7-16.1	12.4-13.8
(February 1980-January 1981)*	18.3-20.1	15.3-17.0
New Target Periods with November Announcement		
[September 1980-October 1981	7.4- 8.8	6.9- 8.3
October 1980-October 1981*	5.9- 7.4	5.7- 7.2
October 1980-April 1982*	6.4- 7.4	6.3- 7.3
February 1980-October 1981	12.8-13.8	11.2-12.2
[October 1979-October 1981	12.0-12.8	10.9-11.7]
New Target Periods with Announcement in Next Budget		
April 1981-April 1982	7.9	7.9
January 1981-January 1982*	6.6	6.6
January 1981-April 1982*	6.9	6.9

* Periods not covered in the paper of 10 October.

† NIF assumes PSBR of £10.7 billion in 1980-81 and £11.3 billion in 1981-82 and no cut in short term interest rates before the end of 1981.

TABLE B

ACTUAL OR FORECAST BASE DRIFT AT START OF NEW TARGET PERIODS COMPARED WITH MID POINT OF MTFS RANGES

	Recorded	Adjusted
October 1980	9.0%	about 6½%
January 1981	7.8%-9.3%	5.3-6.7%
April	3.9%-5.5%	1.5-3.0%

Mrs Lomax

Many thanks. What do you suggest the next steps should be

MR MIDDLETON

BM 20/11.

2/6/038

cc Sir D Wass
Mr Ryrie
Mr Burns
Mr Britton
Mr Monck
Mr Unwin
Mr Riley
Mr Shields
Mr Grice) without
Mr Culpin) attach-
Mr Bennett) ment

MONETARY CONTROL: M2

By way of background to the various forthcoming meetings on this subject, you may like to know how far we have got on the question of reviving M2. The attached note by Mr Bennett summarises the results of our discussions with the Bank (and CSO) statisticians. It is neither enormously encouraging, nor quite hopeless. We still feel a definition based on size of deposit is the most promising. But there are drawbacks. The series might be particularly volatile, nor could it be leakproof if used as the basis for control. Like almost all the other possible definitions of retail deposits (except initial maturity) it would involve collecting new data, involving tiresome problems for non-computerised banks; we could not hope to put together a back series, and it would be some years before the seasonal characteristics of the new aggregate could be determined, or its relationship with other economic variables. The Bank statisticians are very cool: the economists less so. But even the latter, who originally were quite enthusiastic about M2, seem to be toying with the notion of patching up eligible liabilities as the more practical basis for an early move to an MBC type system. We, on the other hand would be anxious about introducing any quantitative scheme based on EL's: and would look on our own illustrative scheme with less favour if we felt this was the only practical option.

2. This will all need taking further after the PM's seminar.

RL

RACHEL LOMAX

5 November 1980

133/11

NOTE FOR THE RECORD

REVIVING A RETAIL DEPOSITS MEASURE OF MONEY

This note records the position we have reached in the possibilities of reviving an M2 - like measure of the money supply. We have now had a substantial preliminary discussion with the Bank of England and the CSO statisticians involved.

The old M2 series

2. The old M2 series consisted of M1 plus private sector sterling time deposits with the discount houses and deposit banks. The latter comprised the London, Scottish and Northern Ireland clearing banks, plus a handful of other British banks carrying on retail type business (eg. the Co-op Bank and the Yorkshire Bank). The great majority of private sector time deposits with these banks were at seven day notice. Until the early 1970's there was a reasonably clear distinction between the business done by these banks (retail) and that done by other banks. After Competition and Credit Control however, the clearers started bidding for wholesale deposits directly (rather than, as previously, leaving wholesale business to their subsidiaries), and other banks started to compete more in the clearers tradition retail markets. It was because the distinction was no longer felt to be valid that the M2 series was discontinued (March 1972).

New criteria for the definition of an 'M2' series

3. It should be noted at the outset that any definition of M2 could be rendered meaningless if disintermediation on a large scale occurred. Policies which worked primarily by causing disintermediation would quickly lead to any definition of retail deposits becoming so distorted that the credibility of the resulting statistic was impaired.

4. A second general consideration relates to the linkage between qualifying liabilities and the target aggregate. It would certainly be a desirable feature of any criterion that it should yield a definition of qualifying liabilities which was closer to M2 than is the present definition of eligible liabilities to £M3. Any criterion which excludes certificates of deposit and also the bulk of overseas residents' sterling deposits from qualifying liabilities would be acceptable from this point of view. Of the options considered below, the maturity criteria (iii) and (iv) appear least attractive in this light while the size criterion (vi) is probably the most attractive.

5. These points having been made, at least six different criteria have been put forward as a definition of retail deposits - those which would enter the new M2.

(i) Institutional criteria

6. Institutional criteria, whereby, for instance, deposits with the clearing banks would be defined as 'retail', being essentially the criteria used to define the old M2 series, fail for the same reasons. Targeting such a variable would be inequitable and would lead immediately to the diversion of business to subsidiaries to avoid the control. This criterion therefore has little to recommend it.

(ii) Type of deposits

7. A definition based on type of depositor would involve classifying bank accounts in some way. In practice, the only viable distinction would be between personal and business accounts. Much would depend on the conscientiousness of the banks in making the distinction, and it would be difficult to do so in any case with marginal accounts such as those of small unincorporated businesses. It should also be noted that any resulting series would be highly volatile since it would be affected by all transactions between companies and persons.

8. A further problem with this criterion is that by defining retail deposits as personal deposits, there arises the issue of why personal building society deposits should not also be included. There is, indeed, a general problem as to why building society deposits should be excluded from M2 (see para 19, below). But it is thrown up in particularly strong relief by the type of depositor criterion.

(iii) Initial Maturity

9. Since 'retail' deposits must, by their nature, be highly liquid whereas wholesale deposits are usually of a longer maturity; one approach to their distinction is by reference to the initial maturity of the deposit. Selection of the cut off maturity of 7 days, as in the old definition, would simply lead to retail time deposits being defined as of 8 days maturity. The likelihood of this happening could be reduced if a much longer cut-off maturity were adopted - say three months. But there still remains the problem that retail deposits could be arranged 'back to back' (though this facility would probably only be available to companies) - ie. a deposit of eg. 6 months maturity would be taken by a bank with the promise of an overdraft facility at the same rate of interest, for the same amount, which could be drawn upon at a moment's notice. Moreover initial maturity is not always a guide to the original length of period which must elapse before the deposit becomes encashable. Under existing banking practices, early encashment is normally possible on payment of a small penalty. Both of these considerations detract from the use of initial maturity as the adopted definition.

(iv) Residual Maturity

10. In order to counter the argument that long initial maturity does not necessarily mean illiquidity if the residual maturity is short, residual maturity itself is sometimes suggested as an alternative criterion. The problem, however, with residual maturity is that if one were to adopt this definition with respect to deposits, it would be difficult to justify the exclusion of Treasury bills, short dated gilts or even maturing life insurance policies.

(v) Rate of Interest paid

11. Currently, retail deposits tend to earn interest according to a published and relatively invariant base rate whilst wholesale deposits earn money market rates. But use of this as a criterion would simply lead to the disappearance of the concept of a stable base rate, with retail deposit rates bearing a closer relationship with money market rates.

(vi) Size of deposit

12. The most attractive option of this set of possible definitions is a criterion based on the size of the deposit. The choice of the cut off point is essentially arbitrary but it would not be unreasonable to draw the line somewhere between £10,000 and £50,000.

13. Size as a criterion, however, is not without its problems. Similar to the 'back to back' problem mentioned above in connection with initial maturity, it is open to the banks to 'accept' a deposit of £50,000 and 'lend' back £40,000 to secure a real deposit of only £10,000. Another problem is the possible emergence of Money Market Mutual Funds in the UK (as they exist in the USA). These institutions enable individuals to pool (small) deposits to obtain money market rates of interest. This argument can however, be rebutted by the observation that such Funds would probably be required to be Licensed Deposit Takers in the UK.

14. Adoption of size as the criterion means that the volatility of the target aggregate will be greater than that of the underlying transactions causing it - ie. a transaction as small as £1 can in principle change the size of the aggregate by £50,000. This point has been made in connection with wage payments. A company making wage payments will be converting one large deposit into a large number of small ones and this practice may make a 'retail' type series very volatile. There are, however, arguments against this.

15. First, wage payments will tend to average out over a period as long as a month. Secondly, there is the likelihood that a large part of wages is likely to be held in the form of cash or be placed into a Building Society . If the former is the case the volatility will be merely transferred to the cash part of the aggregate, but if the latter is the case there will be no problem at all, since it is not intended to include building society deposits in M2. Nevertheless, the greater monthly volatility of M1 in relation to £M3 suggests that this argument cannot be dismissed entirely.

16. A final consideration is that no data exists on this basis as yet. Banks may oppose the request to provide yet more statistical information. For banks that are fully computerized there should not be a problem, but for banks that are not, the provision of this kind of data could be an extremely time consuming process.

(vii) <u>£M3 less CD's</u>

17. One suggestion has been to exclude from £M3 an asset which is indisputably wholesale, which is known to be a reasonably close substitute for other wholesale deposits and for which we have data already - CD's. The effect of control of what remains of the aggregate would be to encourage wholesale depositors to switch out of all other types of wholesale deposit into CD's and thus out of the targeted series. The problem is that one could never be sure just how many wholesale deposits remained. The amount remaining would presumably be a function of the tightness of control. This would not therefore be a satisfactory series to function as a target for monetary control.

18. Two more points should be noted. First, if a definition requests new statistics it may be some time before such statistics become available owing to (a) the need to persuade the banks to provide the statistics and (b) give them time to assemble them. This delay could, however, presumably be shortened if the request for new statistics were made firmly by the authorities.

19. Secondly, moving to a retail definition of money will almost certainly re-open the debate as to whether building society deposits should be included in the monetary control aggregate. This is already some intellectual case for doing so with £M3 since that aggregates includes some items - CD's for example - which are arguably less money-like than building society shares. But moving to an M2 target would increase the pressure to do so. Certainly the banks would take the opportunity of any change to press for inclusion of building society liabilities in the control total, a move they have wanted for some time. But since building society deposits are virtually all retail in nature, a move to a retail deposits definition of money would make this pressure less easy to resist.

J. W. Gice pp.

A BENNETT
31 October 1980

SIR DOUGLAS WASS

cc [illegible]
Mr [illegible]
Mr Middleton
Mr [illegible]
[illegible]
Mr Riley
Mr Culpin
Mr Grice

MONETARY CONTROL

1. I hope it will still be possible to hold the seminar on monetary control for senior officials which you suggested at a meeting earlier this week. We do, however, now have a meeting with the Bank arranged for Monday, so you may like to have in writing for the weekend some idea of the range of views on the subject amongst those of us who have been working on it over the last few months.

2. We have taken our terms of reference from the first of the Prime Minister's seminars on the subject. Our aim has been to set out the arguments for and against monetary base control (MBC) as objectively as we can. But, of course, our role is to some extent conditioned by the wide difference which emerged on that occasion between the views expressed by the Prime Minister and the position adopted by the Bank. We have been concerned to take MBC seriously as a real possibility; and I think we did devise and display an "illustrative scheme" which deserves serious consideration. That is not, of course, the same as advocating that scheme as the best available alternative.

3. We start from the position that the present system, as set out, for example, in the Green Paper, does not work well. Some of us see the problem as arising mainly from the Bank's tactics in the gilt-edged market, but others (myself included) believe it is more deep-seated. It arises from the fundamental difficulty of controlling a wide aggregate like £M3 by means of changes in the level of short-term interest rates. It is now becoming fashionable to say that the short-run response is actually perverse. None of us believes that, I think; but we all acknowledge that the relationship is uncertain and unreliable. A move to MBC would not resolve this problem - it would emerge in a slightly different form as disintermediation.

4. [illegible] M2 in this context. It is (or [illegible] wide aggregate) is the only meaningful definition of the money supply, [illegible] MO is an irrelevance. The advocates of M2, however, are not much concerned with £M3. They either favour a narrow definition of money or (increasingly) favour the base itself as the intermediate objective. Some of us (myself included) also attach significance to narrow aggregates as a better measure of transactions balances - this does not mean that £M3, PSL1 or PSL2 may not be significant as measures of liquidity. This view is, of course, the one generally adopted in the US. Actual measurement, and still more control, of transactions balances presents further problems. In the UK context, the main one (so far) is the treatment of building society deposits.

5. If control of (say) M2 is accepted as a worthwhile aim, it remains to be asked whether MBC is the best way of going about it. There is no doubt it is a leap in the dark, so perhaps the burden of proof should be on the advocates of change. The alternative is there in principle of targeting a narrow aggregate by means of discretionary changes in MLR. If MBC were not so much in vogue and if we did not start from where we are now, that might make good sense. But we do not start with a known relationship between interest rates and M2 - indeed we do not even know how to measure M2 - and we start from an understandable disillusion with a discretionary interest rate policy of any kind.

6. That is one line of argument for MBC, pointing towards a mandatory scheme based on retail deposits. A rather different line of argument which some of us find more cogent, is that the authorities in fact cannot control any definition of the money supply (except indirectly by controlling the level of output and prices). Any attempt to do so will just produce corset-style distortions. What the authorities can do is control the base. This accords with the general philosophy of non-intervention - put your own house in order and leave the rest to the market. This would (one hopes anyway) be enough to prevent really rapid inflation. To the extent that had a direct effect on bank deposits at all, presumably it would be retail rather than wholesale deposits, because it is for retail banking that the availability of cash is most important.

7. The Bank are particularly averse to a mandatory scheme of MBC, whilst we are pressing that this option should be left open. The cash ratio, therefore, becomes the main bone of contention. Since we need a revised cash ratio consultation paper soon, the issue cannot simply be shelved.

8. The Annex to the Bank's paper which we discussed yesterday sets out their views. They acknowledge the problem of disintermediation if the ratio applies to wholesale deposits, and suggest for that reason that the ratio should not be uniform. There is also a problem akin to disintermediation at the margin between retail and wholesale deposits. Any discrimination between the two creates an incentive for the artificial transformation of "retail" into "wholesale" deposits. The Bank's proposal to base the distinction on the payment of interest seems particularly open to that objection. It is one we considered and rejected. We prefer a distinction based on the size of deposit, which may not be perfect, but which is surely better.

9. The size of the cash ratio is also relevant to its use in a mandatory system. Our reasons for preferring a ratio of about 5-10 per cent (as compared with the present $1\frac{1}{2}$ per cent) are set out in the Annex to Mrs Lomax's paper on the steps to monetary base control. The Bank may contest this point.

10. The cash ratio also provides the Bank with their main source of income. Strictly this is irrelevant to the debate, since the same income could be secured in a variety of ways from a ratio of any size or application, but it could make the Bank especially keen not to lose the initiative in this area.

11. The meeting yesterday did not discuss debt sales at all. The Bank's paper is generally negative, but shows signs of considerable movement on one point. They now see hope of developing a wider market for short-term debt, based on a system of auctions. I have long pressed for just this development, so I for one would certainly want to encourage them. Their paper does not mention the interaction with local authority debt, on which we might seek their advice. We will also want to discuss the other proposals they include in their "piece-meal approach".

12. We cannot concede that nothing can be done in the gilts market proper on the basis of the analysis in the Bank's paper. I thought the argument about underwriting (as proposed by the Wilson Committee) was particularly thin.

AJCB

A J C BRITTON
7 November 1980