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(a) repurchase agreements for gilts and fixed rate export credit paper. These were used during 1980 but were finally run off in December. Such operations are regarded very much as a last resort, but in extreme circumstances it would be possible to reactivate them though the Bank would first consult the Treasury before doing so.

(b) foreign exchange swaps. On occasions swaps have been made, mostly over the end of banking months, but within calendar months, on the presumption that they would not be "visible" in any published statistics. It is only possible to use this device if it is seen as consistent with exchange market and reserves management. Thus the scope for these operations may be limited.

(ii) Discount window lending

23. Though discount window lending is being reduced in importance, (it has only been used on days so far this year) it will still have a role to play. The Bank's background note of 24 November stated "The Bank would normally charge a rate on its discount window lending somewhat above comparable market rates but within the unpublished band ..."

24. Two distinct sets of circumstances can be envisaged. In the first, discount window lending might be used as a deliberate operating technique when it is desired to increase

market rates - either within an existing band or concurrently with a raising of the bank - or to resist a decline in rates which the market is bringing about. Implicitly, the rates at which bills were being offered by the market would not be acceptable, or not in sufficient quantity for the whole shortage to be relieved, and a visit to the Bank would become necessary for the Houses to square their books. The size of the penalty to be applied when lending to them would reflect the size of the increase in market rates that was desired. It would be unnecessary to charge a rate higher than the top of the band, and the November paper said that the Bank would not do so. Nor would the Bank wish always to charge a rate exactly equal to the top of the band, if the objective remained to conceal precisely where the band lies. When lending is undertaken as a deliberate act of policy execution by the Bank, it would be done under the so called 2.30 arrangements, and the fact and details of the lending would be immediately made known.

25. There are other possible circumstances in which the Bank might wish to use discount window lending as a deliberate technique of market management, but without having any policy objective on interest rates to pursue. An example is provided by the events of last March 2. On that day the market was massively short because of the payments of Petroleum Revenue Tax that was due; but the projections for the immediate future suggested that a considerable reflux would take place over the next week or so. Market management

considerations therefore indicated that much of the cash provided should be repayable in about seven days, and this would not have been possible by outright purchase of bills. In principle, bills could have been bought on a repurchase basis, but the available supply of bills was too limited for that to be done. The only available technique was, accordingly, to lend at non-penal rates. In such circumstances, the lending would be explained to the market as an exception to the normal rule of "lending somewhat above comparable market rates".

26. Thus it may not be appropriate in all circumstances to impose a penalty but in general the lending rate should be somewhat above comparable bill rates in order to ensure that the discount houses offer sufficient paper at acceptable rates and thus that bills operations remain the main means for supplying cash. A modest fraction - e.g. $\frac{1}{4}$ per cent would generally be sufficient. On occasions, however, a larger penalty might be required, the limit being the upper end of the band.

(iv) Bankers' balances

27. Under the old arrangements, the clearing banks maintained $1\frac{1}{2}$ per cent of their eligible liabilities as bankers' balances with the Bank of England. This sum served as the fulcrum for money market management. Under the new arrangements all banks and licensed deposit takers with eligible liabilities in excess

of £10 million will maintain a non-operational non-interest bearing deposit of ½ per cent of eligible liabilities - currently about £330 million. In addition the clearers will voluntarily maintain operational balances, again non-interest bearing, initially of around £150-200 million. The non-operational balances will be an amount to be observed at all times. Overdrafts will not be permitted. Under the old averaging system, holdings of cash above the required level were tolerated more readily as they in effect bought the right to go below at a later date. Under the new system, any "excess" holdings will have an opportunity cost and the clearers will therefore have strong incentive to keep such holdings on the minimum required to operate the clearing system. As experience is gained with the new system, the clearers may be able to cut down the size of the operational balances.

28. Observation of the banks' desired cash holdings might make it possible to learn something about the properties of monetary base system, particularly a non-mandatory one consisting of bankers' balances. However, while it is true that some element of voluntary or excess balances will appear for the first time, it cannot be assumed that the level of balances banks choose to hold under one set of arrangements will be translated to another. Desired balances will depend on the degree of uncertainty about the cost of funds, the assurance that there is on upper limit to the cost and the

availability of assets only slightly inferor to cash such as money at call with the discount houses.

29. The present banking sector for statistical purposes will shortly be enlarged into a new monetary sector, to include all recognised banks and LDT's, National Girobank, banks in the Channel Islands and Isle of Man, the Trustee Savings Bank and the Banking Department of the Bank. This will produce a once over addition to the stock of £M3 of around £8 billion (13 per cent). In assessing progress against the monetary target, allowance will be made for this. It is not expected that the trend growth of £M3 will be significantly affected.

<u>(v) Special Deposits</u>

30. The Special Deposits Scheme will remain in place under the new arrangements, and will apply to all institutions with eligible liabilities of £10 million or more. As before, calls will be set as a percentage of eligible liabilities. Special Deposits carry Treasury bill rates. The authorities have to give 7 days' notice, and, because of the number of banks involved, it may take up to ten days for a call to become effective, though releasing deposits takes only a matter of a few days.

31. Since the early 1970's Special Deposits have not been used deliberately to squeeze bank liquidity, since banks

tended to respond to reserve asset pressure in ways which increased rather than reduced the money supply. Special Deposits were however used to mop up excess bank liquidity, to pre-empt a rise in bank lending by indirectly raising the cost of wholesale funds. Under the old RAR, a call for Special Deposits was no different from varying the level of the reserve asset ratio. The same technical effect could (and can) be achieved by official sales of bills providing the banks are willing to buy and hold bills offered for sale. Special Deposits may sometimes be a surer way of offsetting fairly short lived fluctuations in liquidity. They also have an announcement effect, which can be useful if the authorities want to give a clear signal to the market.

32. Under the new arrangements, Special Deposits should still provide one way of mopping up excess bank liquidity. The new prudential arrangements will be much more flexible than the RAR, and it is not intended that they should operate as a monetary control. But it is probable that the banks will have a reasonably stable demand for liquid assets - and will continue to regard Special Deposits as, to some extent, a substitute for bills and LA deposits. The chief difference may be that there will be much more elastic in the system; how much depends on how far the banks hold excess reserves, in response to changed money market tactics. The risk of distorting the monetary aggregates if Special Deposits are used to squeeze bank liquidity may therefore be rather less

than under the old RAR. Since the option of varying the reserve asset ratio will no longer exist, Special Deposits - though possibly a rather weaker instrument - may still prove a useful addition to the authorities' armoury of instruments.

(vi) Reserve asset ratio and prudential supervision.

33. The reserve asset ratio will be abolished on the starting date for the new arrangements. While discussions on developments in supervision are continuing, the banks have given assurances that they will discuss in advance any changes in their policies for the management of their liquidity. Meanwhile supervision will continue to be exercised by the Bank in the normal way. The Bank will shortly be resuming discussions with the banks on a new prudential regime on the basis of a new paper on liquidity measurement. The evolving prudential system will not be characterised by a universal ~~norm~~ requirement for all banks like the RAR but will seek to establish with individual banks what are the liquidity characteristics which are appropriate given the type of business they conduct.

34. These liquidity policies will not be operated as requirements to be observed either constantly or on make up days. It is intended that there should be a substantial degree of variability around the liquidity pattern agreed so as to accommodate pressures on bank liquidity, for example during periods of high tax payments. This will permit liquidity to be used when it is most needed, something which the RAR tended to obstruct. These new arrangements should therefore help in avoiding local crises of shortage of liquid assets and should

therefore conflict less with the operation of monetary policy. It would be an exaggeration, however, to claim that the requirements set for individual banks will not have any monetary effect. The new arrangements cannot help solve a potential secular shortage of bank liquidity caused by a tendency for bank lending to grow faster than deposits. If liquidity has been seriously eroded, there is likely to be pressure on the money supply as banks seek deposits in order to increase their holdings of liquid assets. While the liquidity norms can accommodate seasonal variations, it will not be appropriate to relax general prudential standards to accommodate a chronic problem of monetary policy.

II. Transitional Problems: Minimum Lending Rate

35. 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 beyond the very short rates which the authorities will keep within the band. This would limit the expression of a market view. It would also retain the high political profile of administered changes.

36. It is important, however, to recognise the full implications by suspending the practice of an announced MLR which would be operational as well as presentational. The

authorities leverage over longer short term rates (1-3 months) would be less and this may sometimes be unwelcome. 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. The Banks and building societies have in the past, related their base and mortgage rates to MLR. In its absence, their behaviour is likely to be less predictable. If market pressures were generating a sharp rise in 3 months rates for example which the authorities considered to be unjustified, this might only be prevented by intervening to cap the longer short-term rates, a step which even if it did not formally amount t reviving MLR would be tantamount to doing so. In short, giving the market more influence - in order to secure prompt changes in interest rates and reduce Ministerial responsibility further - 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.

37. 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 create upward pressures

on very short term interest rates which for monetary policy reasons the Government may consider inappropriate to see reflected further up the yield curve. 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.

38. These considerations point to delaying the final demise of MLR until the autumn. The case against delay, which could prove to be prolonged unless the strike and its effects come to an end earlier than at present seems likely, 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 presentation and operational benefits which the new system is intended to bring and could cast doubt on the authorities' commitment to the new arrangements. The timing of the suspension of MLR is an issue which needs to be decided at the seminar.

III. Prsentation

39. The new arrangements are intended to:

(i) reduce the high political profile and scale down the degree of direct Ministerial responsibility. If this can be done it should help to:

(ii) reduce the so-called bias for delay. Interest rates will be adjusted more promptly and there will no longer be the presumption that the direction of a change will not be reversible within a matter of weeks.

40. In principle control of a quantity - money - should imply freedom for the price - interest rates - to vary. In practice, however, it will be difficult to achieve public acceptance of this proposition. Although the monetary target is a quantity rule, the links between money and interest rates are not very direct or precise nor have we committed ourselves to being guided only by one monetary aggregate. What we do not have is a quantity rule at the point at which monetary policy is operated i.e. in the money markets. This contrasts with the position on the exchange rate where the objective of achieving no net intervention rule is directly operational or with monetary policy in the US where the Fed sets a path for the supply of non-borrowed reserves. Only if we were operating a policy of controlling the supply of monetary base month by month (targetting the wide base over 6 months would be little different from targetting other aggregates) would there be a sufficiently precise quantity rule.

41. Although the task will not be easy, there are ways in which the arguments can be presented and which emphasise interest rates as the product of policy rather than their objective.

(i) It should be stressed that control of a quantity, money, implies that interest rates cannot be controlled. Though the Government has some discretion this is very much circumscribed. The authorities can influence the timing of interest rate changes and can choose the speed with which deviations from the monetary target are corrected. They cannot control the general level of interest rates.

(ii) There will eventually be no MLR which is pivotal to the whole structure of interest rates, and thus a single rate to which banks can link a base rate. It is to be expected that base rates will both be less important in pricing loans and be moved more often.

42. A change will be needed in the way briefing is prepared and in the way Ministers refer to interest rates. Above all it will be necessary to cease talking about "setting", "cutting" or "raising" interest rates. Instead the emphasis must be on creating conditions which produce or permit lower rates, or if rates have to go higher, on the need for higher rates. Ministers' statements will have to be symmetrical, refraining from taking credit when they have "cut" rates. Ministers will also have to refrain from commenting on interest rate changes by banks and building societies and still more from attempting to exert moral suasion on them.

43. There are a number of practical steps by which public understanding of the Government's position on interest rates could be got across:

(i) Guidance could be prepared for the Press Office and Economic Briefing setting out the way in which interest rates will be determined and how this should be presented.

(ii) A guidance note could be prepared for Ministers on the same lines.

(iii) On a suitable speech occasion a Treasury Minister could include a passage about interest rates under the new arrangements.

Finally, it will be necessary to consider the terms in which the Bank's operations in the money markets are described e.g. in the Quarterly Bulletin. Para above indicated that we will not want to reveal the width or location of the band. The description, therefore, will have to be carefully constructed so as to give the public an adequate account of developments without undermining the authorities' freedom of action.

IV. Procedure

44. The procedure for reviewing monetary developments and prospects and for deciding on the interest rate band will represent a development of current practice. Shortly after

the publication of the provisional money figures for one month, an exercise is undertaken to assess the prospects for the current plus the following two months. This, together with a report on recent money market operations, is then discussed at a Treasury/Bank meeting chaired by Mr Ryrie – the Bank team is led by the Deputy Governor. The meeting will consider not just the monetary prospects but also developments in the economy more generally, against the background of the short term forecast, or between rounds, of updating reports. The meeting will attempt to form a view about interest rates and in particular whether changes in the interest rate band are required. It will also consider the prospects for funding and what our objectives should be over the coming months.

45. Initially the Bank will aim to keep rates within the band without being committed to aiming at the centre. Indeed the amount of "noise" might make this difficult to achieve. However, as experience grows, a band of 2 per cent might prove more than enough to accommodate noise. One response would be a decision to operate with a narrower band. Alternatively deciding to aim at a particular area of the band might become a possibility e.g. in circumstances in which the case for an upward shift of the band was accumulating but one of the regular occasions for decisions was not imminent. The authorities in these circumstances might want to push rates within the band towards the upper limit or not seek to resist a tendency for rates to stay near the upper limit.

It is too soon to guage whether such tactics would be desirable.

46. The outcome of the meeting will, as now, be a submission to the Chancellor (the Bank representatives will send their own submission to the Governor) which will set out the monetary prospects and, if necessary, make recommendations on the interest band. The Chancellor will then discuss the proposals with the Governor and seek the agreement of the Prime Minister.

47. Although this procedure is built around the banking month and the publication of the money figures, there will certainly be occasions when interest changes need to be considered outside this timetable. Once MLR has gone, however, there will no longer need to be a presumption that changes are made on a Thursday; indeed it will be desirable to prevent an easily predictable pattern of behaviour by the authorities from becoming recognisable.

HF3 Division
29 June 1981

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Mr Britton
Mr Monck
Mrs Lomax
Mr Turnbull
Mr H Davies

Mr Fforde)
Mr George)
Mr Goodhart) B/Eng
Mr Coleby)
Mr Foot)

Mr Walters No 10

cc for inf

Sir Douglas Wass
Mr Ryrie
Mr Burns
Mr Riley
Mr Grice
Mr Shields
Mr Bennett

MONETARY CONTROL: PAPERS FOR THE PRIME MINISTER'S SEMINAR

I attach three papers for the meeting on Wednesday 1 July:

a. a draft covering brief

b. a redraft of Mr Britton's paper.

You should already have a redraft of:

c. A role for the Narrow Aggregates which was circulated by Mrs Lomax under cover of her minute of 26 June.

d. Monetary Control: The New Arrangements, circulated under cover of Mr Turnbull's minute of 29 June.

P E MIDDLETON
29 June 1981

Encs

SEMINAR WITH THE PRIME MINISTER: NOTE BY OFFICIALS

1. In his Budget statement the Chancellor said:

"Discussions are now to take place with the financial institutions about these and other changes, including the future of the cash ratio. When they are complete, the Bank will aim to keep very short-term interest rates within an unpublished band, and in due course suspend altogether the practice of having an announced MLR, which would by then have lost its operational significance."

2. The purpose of the seminar is:

a. to take note of the new arrangements. Some elements are in place already; a further set of changes will come into effect on 20 August.

b. to consider how the unpublished bands should be determined.

3. There are 3 papers which:

a. Describe the new arrangements and explain how they work.

b. Discuss the role which the narrow aggregates could play in monetary policy decisions.

c. Explain how the considerations set out in the Budget Speech might be brought together in taking interest rate decisions.

The papers have been prepared by a Working Group of officials from the Treasury and the Bank. Mr Walters (No 10) was a member of the Group.

The Arrangements

4. The arrangements follow from decisions taken at the Prime Minister's seminar last November. They were first described in the Chancellor's November 1980 statement and were carried forward in the 1981 Budget. They reflect extensive discussions with the financial institutions culminating in the Draft Provisions issued by the Bank in June (and shown to the Prime Minister by the Chancellor on 19 June). The Draft Provisions are attached for the sake of completeness, but all the relevant points are covered in the paper.

5. <u>There is no dispute about the arrangements</u> which are due to go into operation on 20 August. The intention behind the changes was twofold:

a. to enable changes in short term interest rates to be made more promptly by making changes less overtly political.

b. to give the market a greater role in determining interest rates, apart from the 7 day rate on which the authorities would concentrate their open market operations.

Giving the market more of a role means giving the authorities less. Putting MLR into suspense is an essential element of this approach. Suspension will mean the authorities no longer give clear signals about their interest rate intentions - which for example provide a clear guide to changes in base rates.

6. There is however one unresolved issue - the timing of the suspension of MLR. Here there is a choice between:

a. <u>Suspending MLR when the new arrangements come into operation</u>. This would mean the new system would operate free from all the political overtones associated with MLR. We should get the maximum presentational benefit if this was done. There would be a clear break from past practice.

b. <u>Retaining MLR a Little Longer</u>. MLR gives a clear indication of the Government's intentions as regards 3 monthly rates; bank base rates, to which mortgage rates are closely related, usually move with these rates. MLR therefore provides a greater assurance about the 3 month rate than is possible by acting on shorter rates. Retaining MLR would give the authorities additional security in determining this particular rate at the expense of some loss of flexibility from the new arrangements. The situation would be very like the one we have been operating on an interim basis this year.

. It might be comforting to retain MLR until, for example, the effects of the Civil Service strike were out of the way; but this could mean a prolonged delay.

The issues are spelt out in paras of the paper.

<u>Setting Short Term Interest Rates</u>

7. The other two papers discuss the crucial issue of how we first

set, and then change, the band within which the 7 day rate is allowed to fluctuate.

8. The Government is presently committed to £M3 as the basis for its medium term strategy. There is no dispute about this.

9. The Government also restated its annual targets in terms of £M3 in the Budget, while recognising that other factors needed to be taken into account in determining short term interest rates.

10. The question still to be resolved is the relative importance attached to the annual £M3 target and other factors in setting short-term interest rates. In particular, the role of the narrow aggregates, M1 and the wide monetary base, has still to be settled. The group has concentrated on immediate changes which, to quote the Budget Speech are:

> "Desirable in their own right and consistent with a gradual evolution to monetary base control."

11. None of us is advocating an immediate move to a tight monetary base regime which would exclusively determine short-term interest rates.

12. The immediate issue, as we see it, concerns the trigger for interest rate changes. Broadly speaking there are two options:

a. Make this decision depend primarily on one or other of narrow aggregates - essentially the choice is between M1 and the wide monetary base. A formal target would mean either abandoning the annual £M3 target. The option of dual targets does not seem very attractive.

b. To attempt to formalise the principles set out in the Budget Speech. This said:

> "Decisions about short-term interest rates will continue to take account of the whole range of monetary indicators referred to earlier and other factors that affect the significance of the numbers, especially the progress of inflation."

The other factors included the narrow aggregates, the exchange rate and the real cost of borrowing.

With either approach it would be necessary to announce the policy regime which the Authorities were following. But we all agree that it would also be necessary to retain some discretion to depart from it in special circumstances.