4. Monetary Base Control III

23/12/80
to
6/1/81

FINANCIAL SECRETARY TO THE TREASURY

2/6/03G.

MR MONCK

cc Mr Ryrie
Mr Burns
~~Mr~~ Middleton
Mr Britton
Mr Pirie
Mr Riley

RESERVE ASSET RATIO SUCCESSOR SCHEME

You will have seen my minute to PPS of 22 December reporting the Financial Secretary's views on the Bank paper attached to your minute of 19 December.

Because of the importance he attaches to agreeing a suitable RAR successor scheme, he would find it helpful to have a progress report on officials' thinking in this area, early in the new year.

Roy Westwater

R G WESTWATER

23 December 1980

15/1/12

FEU. 2/6/03G

Mr Monck

cc Sir Douglas Wass
Mr Ryrie
Mr Burns
Mr Riley

THE CASH RATIO AND THE SOURCE OF THE INCOME OF THE BANK OF ENGLAND

The Bank will obviously wish to talk to the clearers about their reserve requirements under a non-mandatory system. But I hope that in the process they do not twist the clearers arms so that they in fact operate an informal mandatory system.

PEM

P E MIDDLETON
29 December 1980

Mr Monck

We must try to avoid a mandatory system

MR MONCK

cc Mr Ryrie
Mr Burns
Mr Middleton
Mr Riley

THE CASH RATIO AND THE SOURCE OF THE INCOME OF THE BANK OF ENGLAND

After lunch today I raised with the Governor the question of how he was getting on in his consideration of an alternative source of income for the Bank if the compulsory cash ratio for the clearers were to be abolished.

The Governor told me that he had mentioned this matter to the Court and had described to them the consequences for the Bank of a change in the present monetary system. He had assured them that he was alive to the need to protect the Bank, and they had been content for him to explore alternative solutions.

On the substance of the matter, the Governor said that he would like the Deputy to have detailed discussions with me. What the Bank were thinking of was a reversion to what he described as the statutory basis for the payment to the Treasury of the profits of the note issue. At present the profits were paid over to the Treasury more rapidly than was statutorily required, and some slowing down of the payments to the statutory basis would yield the Bank a significant income. A second, and not necessarily exclusive, possibility was to revert to the minimum statutory dividend. This would increase the net income of the Bank, if not its gross income. Any discussion of the two possibilities mentioned above would however turn on what the likely voluntary

11/26/12

level of the clearers deposits of the Bank would be once the mandatory cash ratio was abolished. Discussions with the clearers on this point were currently in progress.

I said that I was quite happy to discuss this matter further with the Deputy Governor and would bring the question up at one of the meetings I was due to have with him in the new year.

DW

DOUGLAS WASS
19 December 1980

Mr Middleton
You may want to have a copy by you.
RC 30/12

1. MR ~~MIDDLETON~~ Bm
2. CHANCELLOR OF THE EXCHEQUER

cc: Financial Secretary
Sir Douglas Wass
Mr Ryrie
Mr Burns
Mr Monck o/r
Mr Pirie

2/6/03G

THE BANKS' RESERVE ASSETS RATIO

No 10 have not yet replied to Mr Wiggins' letter of 23 December, reporting your and the Governor's decision that the banks' reserve assets ratio should be reduced from 12½% to 10% of eligible liabilities. Provided, however, that the Prime Minister is content with the decision, the Bank propose to announce it on Friday, to take effect from Monday 5 January: this is when the Central Government is expected to go into surplus and so drain cash from the banking system.

2. I attach for your approval the Bank's draft press notice.

3. I also attach a draft of Question and Answer briefing. This needs further work, and we will let you have a more polished version later; but it would be helpful if we could finalise the press notice while work on the Q and A brief goes on.

Robert Culpin

ROBERT CULPIN
30 December 1980

I am sorry to have to put this to you again at short notice, but if we are to avoid upward pressure on short term interest rates, we need to go ahead. The important thing is to agree the press notice; there are one or two other points on the briefing which we shall wish to discuss further

PRESS NOTICE

The Bank of England announce that the minimum Reserve Asset Ratio of 12½% required to be maintained by banks and certain other deposit-taking institutions will be reduced to 10% of eligible liabilities with effect from 5 January 1981.

NOTE TO EDITORS

It was announced in November that the Reserve Asset Ratio, which is not necessary to monetary control, would be phased out, and abolished once appropriate prudential liquidity norms had been agreed. The interim step announced today is intended to ease the seasonal pressure on the reserve assets of the banking system that will result from heavy tax payments to the Exchequer during the present calendar quarter, consistently with the eventual adoption of norms for liquidity purposes.

DRAFT

Q & A BRIEFING

Q1 What are reserve assets?

A1 Reserve assets consist of the following:

(a) balances with the Bank of England (other than special deposits;

(b) money at call with listed discount market institutions and brokers;

(c) Treasury Bills issued by the British and Northern Irish Governments;

(d) British Government marketable securities (gilts) with less than one year to maturity;

(e) UK local authority bills eligible for rediscount at the Bank;

(f) commercial bills eligible for rediscount at the Bank (to a maximum of 2% of eligible liabilities).

Q2 Will the reduction in, and ultimate abolition of, the reserve asset ratio lead to a loss of monetary control?

A2 No. The reserve asset ratio was never designed as an officially controlled monetary base through which the pyramid of credit created by banks might be directly limited. Instead, it was regarded as an element in the control of short term interest rates. The reasons why it is no longer considered necessary for that purpose are set out in Annex A of the Green Paper on Monetary Control issued last March (Cmnd 7858).

Q3 Does the reduction in the reserve asset ratio mean a weakening in prudential strength of the banking system?

A3 No. The reserve asset ratio was intended primarily as an instrument of monetary control. But to the extent that it entails a requirement to hold liquid assets, its reduction at times of pressure, such as the tax-paying season, is consistent with the Bank's approach to liquidity norms - that is, that liquidity is there to be used at times of pressure.

Q4 Won't the reduction in the reserve asset ratio enable the banks to increase their lending?

A4 The seasonal cash flow to the Exchequer resulting from heavy tax payments acts to destroy bank liquidity. If the liquidity pressure were not relieved the banks would either have to <u>reduce</u> their lending very sharply - at a time when the demand for credit to pay taxes is seasonally strong but when the underlying demand is already moderating - or, more probably, would bid for deposits so tending to put strong upwards pressure on the level of short-term interest rates, which - against the background of moderating underlying demand for credit - is not considered necessary for the purpose of monetary control.

Q5 Why was the reserve asset ratio not reduced last year instead of the Bank providing repos in gilts?

A5 When the Bank began to offer repos in gilts the timetable for the replacement of the reserve asset ratio was less clear. It could have created uncertainty if the ratio had been reduced at that time.

Q6 Will the reduction in the RAR remove the need for repos in gilts?

A6 It will certainly reduce the need for repos, and we hope that it will remove it. The Bank will of course continue its normal operations in the markets.

Q7 Is this the first in a series of reductions in the RAR? That is, will the cut from 12½% to 10% be followed by reductions to 8%, 6% ...?

A7 No. It is simply a sensible interim step, without prejudice either to monetary control or to future prudential arrangements.

Q8 When will you complete consultations which will enable you to abolish the RAR?

A8 As soon as possible.

2/6/030

CH/EXCHEQUER

REC.	31 DEC 1980
ACTION	—
COPIES TO	FST
	SIR D. WASS
	MR RYRIE
	MR BURNS
	MR MIDDLETON
	MR BRITTON
	MR PIRIE
	MR RILEY

10 DOWNING STREET

From the Private Secretary

MRS LOMAX
MR TURNBULL
MR DAVIES
MR CULPIN
MR MONCK

31 ~~December, 1980~~.

Dear John.

This is to confirm that the Prime Minister is content with the proposed change in the reserve assets ratio which, I understand, is to be announced on Friday. But she has said that it will require very careful briefing if it is not to be misunderstood. You have assured me that considerable attention has been given to the briefing.

I am sending a copy of this letter to Tim Allen at the Bank of England.

Yours ever

Tim Lankester

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A.J. Wiggins, Esq.,
HM Treasury.

CONFIDENTIAL

Mr Monck

cc Sir Douglas Wass
Mr Ryrie

2/6/03G

I had a long discussion with Mr Fforde on Tuesday, some of which is worth recording.

2. First he said that the Bank had as yet done no serious thinking about the role of monetary targets. He is of course personally keen to get as far away from any sort of monetary target as possible, but he was at pains to say that he did not think that that would be the Governor's final position. I gather they are doing work on some alternatives and that the Deputy Government is himself preparing some thoughts on the possibility of moving to a fixed exchange rate regime as an alternative. We may well therefore find that the Bank come back with suggestions that we join the EMS - presumably accompanied by a substantial devaluation. I said to Mr Fforde that if the Bank were going to come forward with radical proposals of this sort it would be important not to do it at the last minute. I also told him in general terms of the sort of work which Mr Burns and I had been discussing on the lines of our recent exchange of minutes.

3. As far as monetary control is concerned we went over the ground. And I will have a first shot at a progress report for the Prime Minister when I come back next week. We concluded that though it would be something of a rush to get everything completed in time for the Budget, it was certainly possible to do so provided we were not diverted too much by emergencies in the interim. I agreed with him that we would have a meeting to review the progress of the work in your group covering both prudential and monetary control issues in the middle of January. I should be grateful if our secretaries could sort out an approp time for this meeting. We also spoke about the two issues whic are being taken by Sir Douglas Wass. The Bank's ground on fund seems to be shifting towards a general argument of not interf with the structure of the securities market; it is clearly go to be very difficult to get the Bank to agree to any changes this area. The Bank's income is not being dealt with on Mr

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side of things. It is being considered by the Deputy Governor and Mr Blunden. It is I think fairly important however that Sir Douglas Wass should get a meeting in the diary with the Bank to discuss this issue also, so that it does not get too far behind the rest of the work.

PEM

P E MIDDLETON
31 December 1980

MR MONCK

cc: Mr Middleton
Mr Britton
Mr Turnbull
Mr Pirie
Mrs Lomax
Mr H Davies
Mr Monaghan

2/6/03G

ENQUIRIES FROM BROKERS

Michael Foot phoned to say that the Bank have decided not to enlarge to brokers on the text of Bank press notices on the day they are released. This is to avoid any risk of favouritism.

2. Unfortunately, no one in the Bank considered that brokers might ring the Treasury instead. Mr Foot apologised for the mistake (on others' behalf), and asked me to alert people here to the Bank's decision.

3. There is no directive to us to follow suit, though if anything were to get out on a day of Bank silence, there would be some presumption that it came from here.

4. I suggested to Mr Foot that there is a general "information policy" interest in such decisions, and that it might at least be tactful for Mr Quinn to mention them to his Treasury counterparts. He will pass the message back.

ROBERT CULPIN
6 January 1981

Mr Monck,

This is very odd. Is one to take it that there is no question of favouritism on day 2. Does this mean that they only ~~brokers~~ journalists are spoken to - or are there intermediate categories. How do they guide the markets, other than by ~~these~~ very terse statements.

BM. 9/1/81.