

## 5. Monetary Base Control III

9/1/81  
to  
16/1/81

Chancellor of the Exchequer

cc Sir Douglas Wass  
Mr Burns  
Mr Ryrle  
Mr Unwin  
Mr Britton  
Mrs Lomax  
Mr Monck  
Mr Turnbull  
Mr Ridley  
Mr Fforde - B/Eng

2/6/03G

MONETARY CONTROL

I attach a Progress Report for the Prime Minister as requested in Mr Lankester's letter of 22 December. It incorporates comments from the Bank.

*B. D. Clarke*

PP

P E MIDDLETON  
9 January 1981

Enc

## MONETARY CONTROL

1. Following the seminar on 18 November the Chancellor set out the next stages on monetary control in his statement of 24 November. This was accompanied by a background note from the Bank. Copies of the relevant parts of the Chancellor's statement and the note by the Bank are attached. These make clear that although no decision has yet been taken on monetary base control, the changes would be consistent with further moves in that direction. The notes below record the state of play on the main items.

### Phasing Out the Reserve Asset Ratio

2. The RAR was reduced to 10% from 5 January. The change was well taken by the markets as being in line with Government policy. There have been no suggestions that it could result in a loss of monetary or prudential control.

3. Final abolition of the RAR depends on making sufficient progress with new arrangements for ensuring adequate liquidity for the banks so that confidence in the banking system is fully maintained. These new arrangements also have to be tied in with the proposed changes in the Bank of England's operating procedures (paragraph 7 below). The Bank are carrying their discussions on this and related technical questions further and are discussing it with the Treasury.

4. We are aiming to carry negotiations with the banking system far enough by the Budget for the RAR to be abolished without raising prudential risks.

### The Cash Ratio

5. In order to clear the way for a possible move in the direction of monetary base control, the 1½% cash ratio (which applies only to the London clearing banks) also needs to be removed. This could be done without loss of monetary control but it would deprive the Bank of an important source of income. Discussions are taking place with the Bank about possible supplementary sources of income to replace what would be lost if the



banks held less of their cash reserves with the Bank.

6. It is expected that we shall be able to make recommendations before the Budget.

#### Money Market Management and Lender of Last Resort

7. The Bank has already started to make its operating techniques in the money markets more flexible. Discussions are taking place between the Treasury and the Bank in order to specify more precisely the further changes described in the Bank paper for the Prime Minister's seminar. This includes the introduction of a band in which interest rates might be allowed to fluctuate. It will be important to conduct these operations so that we do gain as much experience as we can about the banks' own requirements for base money.

8. A report will be brought to Ministers so that the new arrangements, along with those already described, could be implemented at Budget time.

#### A New Series for Retail Deposits (M2)

9. The above changes would be enough to move, when sufficient experience has been gained, to a system of monetary base control where the base itself was targeted, and the banks were left to determine their own requirements for cash (a non-mandatory system).

10. In order to ensure that the alternative of moving to a system of monetary base control in which the authorities set the requirement for the base, is also kept open, and because it would be a useful indicator in its own right, work is in hand. The next stage is to consult the banks; this is about to take place. There are a number of complications, including the treatment of building society deposits, but it is hoped that the work will be sufficiently advanced to allow progress to be reported at Budget time, with the series introduced later in the year.

#### Funding

11. There are 3 issues:

a. Funding Techniques for conventional stocks. This is being discussed in a Treasury/Bank group chaired by Sir Douglas Wass. It is taking a very wide look at funding methods.

b. Widening the Market by selling more short term Government debt. Selling more short term debt is a possibility once the RAR is out of the way. The Bank are forming a small advisory group from the market to assess the practical possibilities. This will also be considered in Sir Douglas Wass' group.

c. Indexed Gilts for Pension Funds. The Financial Secretary will shortly be letting the Prime Minister have a paper for further Ministerial discussion. It will take account of the points made in the Scott Report.

General

12. A good deal of progress is being made on the issues raised at the Prime Minister's seminar. The early March Budget date means that time is extremely short, but it should be possible to report to Ministers in good time before the Budget.



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Extract from Chancellor's Statement  
24. 11. 80

The Treasury and Bank of England have completed the consultations arising from the Green Paper on methods of monetary control published last March. As a result between now and the Budget a number of improvements will be set in hand.

First, detailed consideration of new prudential arrangements for the banks will be brought to a conclusion so that the reserve asset ratio, which has complicated monetary control, can be phased out.

Second, the Bank of England will develop changes in its open market operations and last resort lending - in ways that will allow the market a greater role in the determination of the structure of short-term interest rates. Third, we are considering the future of the clearing banks' cash ratio and also collecting and publishing an additional series for banking retail deposits. These steps are desirable in their own right. They would be consistent with a gradual evolution towards a monetary base system, and will help us to judge how far such a system would contribute towards our medium-term monetary objectives.

2/6/03 G

Mrs Lomax

cc without encls:

Mr Burns  
Mr Britton  
Mr Grice

I attach the two papers by Mr Howard about which we spoke. I should be grateful if they could be taken into account in the work which you are doing, and for any immediate comments which Mr Grice may have on them following his discussion with Mr Howard.

I think I mentioned to you that Professor Walters said that Maurice Perlman at LSE had also done some work on the demand for base money. He promised to bring this with him when he comes over to see me on Monday, but it may be a good idea if someone could get hold of Perlman.

I am sure it would be helpful if one of your people could compile some sort of digest of empirical work done on the properties of the base with brief comments on its value.

P E MIDDLETON  
16 January 1981

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