

File FEA/0000000099, Part B – Monetary Base
Control

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PART 6

15/4/1981 – 30/6/1981

Pages 95-115

D The exercise of judgment

28 Whatever the exact form of these suggested new arrangements, the judgments exercised by the authorities in running it would, at least for some time, continue to exercise a critical degree of influence over at least part of the interest rate spectrum. For the authorities' actions would be the dominant determinant of the supply of cash, and the implicit 'lending rate' set by these operations - while it might be less easily visible than the present published MLR and could certainly be operated as a rapidly moving range rather than as a set figure as at present - would be established by the market from the price at which we conducted business.

29 There might nonetheless be greater scope for independent market forces than at present in the determination of somewhat longer (say three-month) rates. Much as now, these forces could always be expected to do part of the authorities' work, in that all rates would tend to rise as soon as the market guessed that the authorities were dissatisfied or would have to become dissatisfied with the prevailing conditions. However, the longer-term effects on market expectations of a posted MLR would no longer exist and, while the market would undoubtedly look for substitute indicators, it might be possible to avoid providing a consistently reliable substitute.

30 In practice, of course, the way in which the system was operated would be heavily influenced by the wider policy aims being sought; and it would be important to be clear what the intermediate objectives of monetary policy are at any point in time. Currently, the guidelines for operating the suggested arrangements would be set primarily with regard to the achievement of annual targets for EM3. But it would be open to the authorities in the constant adaptation of their tactics, to consider a wider range of economic and financial indicators and to change the balance of particular factors over time.

B The significance of the changes

31 The conclusions of Section D are that the changes outlined in C might permit:

- (a) some extension of the influence of independent and free market forces in the setting of short-term interest rates:
- (b) the creation of a veil over the authorities' dominant influence on very short-term money rates and the reasons for changes in the day-to-day conduct of policy.

Such development might well have presentational and psychological advantages. While moreover they would seem to do little of themselves to increase the sensitivity of M3 to changes in interest rates they might make it somewhat easier to establish the level of rates which would produce the desired growth of M3 over an appropriate time horizon.

32 It has been suggested that the adoption of a much more flexible system would cause the banks to modify the relative importance which currently they attach to their lending as opposed to their borrowing operations, such that a worth while restraint on the availability of credit could be obtained during a restrictive phase of policy. But it remains our view, in the light of all the consultations following the Green Paper, that such restraint would be unlikely and that banks individually would continue to respond to persistent stringency by bidding for additional resources in the money market.

33 It is, however, likely that greater volatility in very short-term rates would lead the banks either to abandon base-rate related lending in its present form or else to move base rates much more readily. Indeed, if they did not, round-tripping of the kind all too familiar in the present system could become an intolerable nuisance notwithstanding the removal of the Reserve Asset Ratio. Such a change would be a desirable development.

Other changes might well follow, for example, more frequent changes in deposit rates, with a possibly greater need for flexibility of

and while the arrangements set out in Section C are not necessary for it to occur, they could well lead the clearing banks to adopt lending rates more closely related to market rates than at present. This would improve the control of EM3 to the limited extent of removing the short-term distortions presently caused, on occasion, by round-tripping.

34 It has also been suggested that changes of the kind outlined in Section C would significantly reduce the relative attraction of Treasury Bills to the banks, thereby making it more likely that some useful short-run smoothing of EM3 could occur because banks and non-banks could actively and easily trade in Bills with each other. The implications of the analysis in Section C are, however, not encouraging in this respect. For the banks' need for liquid short-term assets is likely to go on dominating the demand for Bills unless the supply were increased in a manner immediately damaging to constraint of EM3. Even then, there could be no assurance that interest rate relativities would thereafter generally move so as to permit regular trading in the right direction (smoothing EM3) between banks and non-banks, in response to pressure by the authorities on the system.

35 Questions regarding evolution towards monetary base control are discussed in another paper, to be circulated by the Treasury. It suffices to say here that the changes outlined in Section C would not preclude an evolution towards monetary base control of either the 'mandatory' or 'non-mandatory' variety.

Bank of England
14 November 1980

MR GEORGE ✓

Copies to: Mr Coleby
Mr Drake
Mr Goodhart
Mr Willetts
Mr Latter

NON-OPERATIONAL AND OPERATIONAL BALANCES AT THE BANK ✓

You asked for briefing, (to pass on to HMT) on the likely level of non-operational balances when the new Monetary Control arrangements come into effect:

(a) Non-operational balances

Our proposal here, of course, is for 1/2% of eligible liabilities (ELs) from all banks and licensed deposit-takers (LDTs) above a de minimis of £10 million of ELs. It is not possible to say precisely how much this will raise, because the proposals involve changes to the present definition of ELs and the inclusion of institutions whose ELs we do not calculate at present; but a rough central estimate - if the scheme were introduced now - is £330 million.

(b) Operational balances

Discussions with the clearers individually elicited rough orders of magnitude for their likely balances at the start of the scheme and even more approximate figures for what they would hope to achieve once they had gained experience of the new system. Starting balances in total might be between £150-200 million⁽¹⁾. It is impossible to say at this stage how far they might fall in due course or how frequently banks will wish to revise their targets; but the banks have made it clear that they will be seeking to achieve a substantial reduction.

(1) A typical comment was "expect to start at £50/60 million and refine over time".

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Mar 24 13

The present scheme

Target balances for the London clearers under the present scheme have ranged from £500-530 million in recent months. A central estimate for the sum of non-operational and operational balances now (if the new scheme were in force) would be around the lower end of this range.

Gilt-Edged Division HO-G
18 May 1981

Michael Foot
M D K W Foot (4086)

Mr Davis

(to 20/5)

Para 5 is important + definitely for the group work though of 17th 6

EM 20/5

MONETARY CONTROL: NEXT STEPS

1. You may find it useful to have a note of what was agreed at Mr Middleton's meeting on 19 May, and particularly of the points which you have been asked to take up in your group.
2. The overall objective is to put a note to the Chancellor, which he can refer on to the Prime Minister, before the summer recess (date not yet fixed). It will report on the progress made in developing the new arrangements. In preparation for this we need to revise Mr Turnbull's note, and to discuss Mr Britton's paper on setting interest rates with the Bank and Mr Walters. We shall also be discussing the Wass group paper on funding with Treasury Ministers.
3. Mr Fforde reported on progress in the various negotiations the Bank are conducting with financial institutions. On the cash ratio, there remain problems with the Irish banks and the Finance Houses. And the clearers have objected to some elements of their proposed relationship with the discount market. But the Bank expect their revised proposals to be acceptable. The CLCB meet again in early June and the Bank see them on 10 June. The problem should be resolved at that meeting. The second area in the revised list of eligible banks. This will involve a series of bilateral discussions which will take some time, though the Bank think they will have a reasonable idea by 10 June of who should and should not be included. The third problem is statistical coverage. The Bank think it would be possible to start the new arrangements with the existing eligible liabilities modified only in respect of the change in the discount market. A second stage later would bring in the rest of the LDTs.
4. In discussion of the draft on Mr Turnbull's paper the following points emerged as requiring further detailed work in your group:
 - a) The abolition/suspension of MLR. Mr George's reply of 18 May to your letter of 10 April gets us no further. But at the meeting Mr Fforde said a little more about the circumstances in which they through MLR might still be useful as a market signal. They thought that during a civil service strike, when money market arrangements were in the process of

10/5

change, it might still have a role as a stabiliser of short-term rates.
(N.E. The MAPP problem referred to in Mr George's letter has been resolved).

- b) Prudential requirements. Mr Coleby reported that the supervisors were working on a new liquidity paper. It would be less detailed than the last one. It was generally agreed that it would be useful to bring them into further discussions on the new arrangements. This could most easily be done in your group.
- c) Guidance for Ministers. If there is to be any 'depoliticisation' of interest rates it will be important to ensure that Ministers are aware of the new arrangements and of the appropriate attitude to take to interest rate movements and prospects. Your group is to prepare guidance.
- d) Rates for discount lending Paragraph 3 b) of Mr Turnbull's paper raises the question of the size of the penalty element in discount window lending. We did not discuss the substance at Mr Middleton's meeting.
- e) The Interest Rate band Mr Britton's paper takes discussion of this further, but you were asked to look into the purpose of the band - is it just to accommodate noise? - in your group.

5. A further point which was not referred to you, but which remains outstanding, is the question of the Bank's operations in bills in the interbank market (paragraph 19(b) of Mr Turnbull's paper).

Handwritten signature

H J DAVIES

20 May 1981

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

Handwritten notes:
- Tank
- Dumb
- Pirie

27 May 1981

N Monck Esq
H M Treasury
Parliament Street
London SW1P 3AG

Dear Sir,

You will wish to be aware of two particular points that have arisen in the course of our negotiations on Monetary Control: Next Steps.

The first concerns the position of the Trustee Savings Banks. We have proposed to the TSB Central Board that the regional TSBs should be excused from the cash ratio arrangements, but only for as long as they remain exempt under the Banking Act. We decided upon this treatment of the regional TSBs in view of the fact that they are outside our present statistical and credit control arrangements and are subject to a variety of official controls; and because their exemption under the Banking Act is not expected to last indefinitely. The TSB movement as a whole will not be entirely free from any cash ratio obligation, since the Central TSB will, as a recognised bank, be required to conform. We are confident of the agreement of the Central Board and the CTSB to the respective arrangements, although consultations are not yet complete.

The second point concerns the National Girobank. Girobank is already within our statistical reporting and credit control nets, and we have in the past, given firm undertakings to the CLCB that Girobank should not enjoy any competitive privileges. We have therefore had little option but to seek to include them in the cash ratio arrangements, and, although discussions with them are not quite so far advanced as those with the TSBs, there should be no great difficulty in securing Girobank's agreement.

Yours sincerely

Adair

Handwritten mark: 23/5

Chambers
Quick Comments p1

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

29 May 1981

P E Middleton Esq
H M Treasury
Parliament Street SW1P 3AG

File

Dear Peter

MONETARY CONTROL

I enclose a further brief Progress Report together with a provisional timetable or count-down which looks to August 20th as the 'appointed day' for the main changes to occur. Perhaps we could have a word about this when we meet on Monday evening.

Yours ever

John Goss

*1. Summary of progress
2. Main points*

1385/5

MONETARY CONTROL: A FURTHER PROGRESS REPORT AND PROVISIONAL
TIMETABLE

Progress

1 We expect to hear by the close of business today that the London clearing banks have accepted the proposals as outlined in "Monetary Control: Next Steps" and as elaborated and modified in our letter to Mr Graham of 20 May (copy attached).

2 There are a number of remaining loose ends. Apart from questions of timing (considered further below) and of the nature of various transitional arrangements, we have outstanding requests for special treatment (notably from the Northern Irish banks and the Finance Houses); we also await firm decisions by the Channel Islands and the Isle of Man as to whether they will co-operate in the cash ratio requirement. These loose ends need resolution as soon as possible.

3 We have begun to consider applications from banks wishing to be added to the list of those whose bills are eligible for purchase or discount by the Bank and to examine the evidence regarding reciprocity where this is relevant. It is expected that a fairly full provisional list of eligible banks could be ready for publication by mid-July.

The Treasury's programme

4 HMT have in hand an exercise on the determination of the future interest rate band. There are a number of related issues (such as the future of MLR) and all these require discussion between HMT and the Bank. It would seem reasonable to plan on the assumption that the issues could be settled by the end of June, and this is the assumption behind the provisional timetable outlined below.

A provisional timetable

5 We can now proceed to set a provisional timetable or "count-down", bearing in mind the Chancellor's intention to report to the Prime Minister by the summer recess at latest.

TCF 29/57

6 Drafting of detailed provisions (to be sent to all banks and LDTs for comment) should be sufficiently well advanced by the end of next week (5 June) for the draft to go to the Governors and Treasury officials. We see no particular reason why this draft should present serious problems or require much discussion. But, as the next stage - sending it to banks and LDTs - is an irreversible step, it would seem sensible to allow 10 days or so for clearance. It could then be sent to banks and LDTs around 19-24 June.

7 Those receiving the paper would know that comment would be welcome only on the details and, for many, the detail would not be new. Nevertheless, some of the provisions are quite complex and we should allow at least 2 weeks for comment (say to 8-10 July, depending on when the paper was sent out).

8 Definitive provisions, together with a provisional list of eligible banks, could be published shortly thereafter (say 16 July) and the written agreement of all banks and LDTs sought. It would not be necessary at that stage to say exactly when the provisions would come into force but publication would undoubtedly create the presumption that the change would not be long delayed.

9 The earliest date for the provisions to come into force would then be 20 August, the first day of banking September. On that day the reserve asset ratio would be discontinued, the undertakings regarding the discount market would commence, the new list of "eligible" banks would apply, and the $\frac{1}{2}\%$ cash ratio would be observed*. It would also be possible to go over to the "unpublished band" at the same time. All of this would require agreement between Ministers and the Governor by around the end of July; because the banks would require prior notice, by 5 August, if we wished to "go live" on 20 August.

Bank of England
29 May 1981

*Because of the need to bring a number of institutions which do not currently complete our statistical returns into the cash ratio arrangements, the $\frac{1}{2}\%$ requirement would apply initially only to those institutions which were both sufficiently large and on the present statistical list of banks; the others would be brought in as soon as possible.

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

20 May 1981

S T Graham Esq CBE DFC
Chairman
Chief Executive Officers' Committee
The Committee of London Clearing Bankers
10 Lombard Street EC3V 9AP

John M Graham

We have carefully considered the points raised in your letter of 9 April about 'Monetary Control: Next Steps' and can now let you have a considered reply.

It seems to us that the central point among your concerns is about the rate which would be obtained on money lent to the discount houses under the proposed arrangements. As we argued at the meeting last month, we do not ourselves judge that the arrangements would tilt the balance of bargaining power, in comparison with the present system, significantly against the banks. In this context we attach importance to the following factors:-

- (a) The suggested average quantity, let alone the minimum, is considerably below the levels which have been maintained with the discount houses under the reserve asset ratio arrangements and is likely to be below the levels which the discount houses will themselves seek. The houses are therefore likely to be bidders for funds above the average level and the rate they offer will reflect this.
- (b) The requirement can be met by secured funds of any maturity, thereby giving the banks freedom to negotiate on the maturity and the interest rate.
- (c) The discount houses themselves have a clear and vital interest in ensuring that the new arrangements work smoothly and do not give rise to distortions of the sort which have been suggested might occur.
- (d) In conditions where the market is clearly in surplus, the Bank and the banks will have a common interest in trying to prevent rates falling too far. In these conditions the Bank will offer 'mop-up' Treasury bills to the discount houses and the banks. This should prevent rates falling to excessively low levels, except perhaps towards the end of the day when official operations have been concluded.

Nevertheless, we have carefully considered what might be done to modify or elaborate the arrangements, so as to meet your concerns, and now propose:-

- (i) That the arrangements should include a reference to secured deposits with the discount houses being at 'market rates appropriate to the nature of the lending'. This description is not open to precise interpretation but would provide protection against obvious abuse. To that end, the arrangements would provide that either the discount houses or the placing banks could invoke the attention of the Bank if they judged their counterparties to be behaving contrary to those terms.
- (ii) That eligible banks should be free to choose between two alternative methods of giving effect to the understandings regarding money lent to the discount market. The first would be the one set out in the note sent to Mr Priestley following our meeting on 1 April (and of which a copy is attached). With the second method, banks would undertake to aim at a 'norm'. Performance relative to this norm would be monitored after the event through monthly returns of daily figures. It would be expected that the agreed normal percentage of eligible liabilities would be achieved over a period of months but not precisely in any individual month. In both methods there would be a specified minimum below which banks would not normally fall.
- (iii) There would be provision for banks, in exceptional circumstances, to go below the specified minimum requirement. Those banks not submitting monthly returns would be requested to consult the Bank before going below the minimum. Those banks opting for the 'norm' and sending in monthly returns would not need to consult before going below the minimum, as the Bank would have the opportunity to discuss the matter after seeing the returns.
- (iv) We would be prepared to review the general functioning of the new arrangements with the clearing banks, and indeed the banking system generally as soon as sufficient experience had been gained. We would not expect this to be sooner than 12 months after commencement.

In proposing these modifications, we have gone as far as we are able to meet the concerns you have expressed. We cannot see our way to going down the road of giving the clearing banks an option to meet the proposed obligation by holding bills directly, in substitution for lending to discount houses. We cannot be confident that such an arrangement would contribute adequately and effectively to the maintenance of the broad market in bills which we have identified as necessary for the conduct of our operations.

With regard to quantities, we continue to judge that the amount of money to which the discount market would need assured access, at least until experience with the new arrangements suggests the contrary, is around £3 bn on average and £2 bn as a minimum (save in exceptional circumstances). We are however prepared to agree that the amount sought for the gilt-edged market should be incorporated within the above average and not be additional to it.

It would be our intention to incorporate these revised proposals in a technical paper covering the whole range of proposals put forward in the note entitled 'Monetary Control: Next Steps' that was issued at the time of the Budget. We would like to get further ahead with this as soon as possible, in consultation with the various groups of banks at technical level where necessary.

I am most grateful for the frank and constructive discussions that have taken place with yourself and your colleagues and very much hope that the CEOs will feel able to recommend these revised proposals to the CLCB.

Yours sincerely,

John Goad.

I enclose four copies of this letter, for your colleagues.

THE MECHANICS OF THE SECURED DEPOSIT RATIO

(a) The denominator should be the same as for the cash ratio:
ie ELs.

(b) The basic obligation for participating banks would be to maintain a daily average of not less than some agreed proportion of ELs in secured money with the discount market - comments:

(i) the agreed proportion to achieve a quantum of
£3 billion overall;

(ii) the daily average to be calculated over a banking
month;

(iii) the relevant ELs figure to relate to some agreed
earlier date, say the previous make-up day.

(c) The minimum level on any day should not fall below two-thirds
of the figure given by (b).

(d) There would be no systematic reporting obligation on
participating banks but the Bank would reserve the right to - and
would - make spot checks.

Bank Proposal

Possible Conditional Alternative

| | | |
|------------|---|--|
| 5 June | Revised draft of "Monetary Control: Next Steps" to Governors and Treasury officials | Also to Ministers |
| | | 10 June clearance by Ministers including PA |
| 19-24 June | Send draft to banks and LDTs | 12 June |
| 8-10 July | Deadline for comments (2½ weeks after) | 24 June |
| 16 July | Definitive provisions sent out (with provisional list of eligible banks) | 1 July |
| 5 Aug | Prior notice of appointed day | |
| 20 Aug | Appointed day (9 months) | 15 July |

* the condition is that Ministers clear proposals by about 10 June.

Chancellor of the Exchequer

cc Financial Secretary
Sir Douglas Wass
Mr Ryrie
Mr Monck
Mr Britton

W. M. Forde

Je

MONETARY CONTROL

1. I understand that the Prime Minister is likely to devote most of the time at your meeting with her this afternoon to a discussion of monetary control. She apparently had a long session with Mr Walters on the subject last Friday and he has apparently provided her with a brief for this meeting. So far as I can tell from conversation with him he is more or less content with the administrative arrangements which the Bank is negotiating with the banking system. But he wants the companion discussions which we are having on the factors which determine interest rate decisions to take place under a Ministerial directive that primacy should be given to the monetary base. He does not see this as incompatible with achieving the £M3 objectives for the medium term strategy.

The Latest Position

2. The Bank's talks with the banking system are now virtually complete. The clearing banks yesterday accepted the proposals set out in the Bank's paper "Monetary Control: Next Steps". This elaborated the proposals put forward following your November statement last year and was issued in March, two days after the Budget. There are a few minor loose ends, but these will be tidied up pretty quickly and will not hold up progress.

3. The Characteristics of the System you know. But I repeat them to give you a self-contained note to draw on. They are:

- a. there will be no Reserve Asset Ratio for the purposes of monetary control: it will have a transitional role as a prudential norm.
- b. Access to the discount window will be less freely available - and then - apart from exceptional cases - only at a penal rate.

- c. MLR will be abolished or suspended.
 - d. Bank operations will be conducted mainly in bills.
 - e. The Bank will operate to keep interest rates within an unpublished band.
4. There are a number of points to be resolved about how the system will operate. These are of two sorts.
5. First there are some outstanding questions on the operation of the new arrangements. These were set out in my minute of 14 May. We are already discussing them with the Bank. Mr Walters is taking part. Briefly these are:
- a. the question of whether and when MLR should be abolished or suspended.
 - b. the new prudential arrangements.
 - c. the size of the penalty element in discount window lending.
 - d. movements of interest rates within the band.
 - e. presentational issues; how to get this system off the ground so that we depoliticise interest rates - despite the large element of of continuing discretion - and make it easier to move them rather than the reverse.

We expect to resolve these issues in the next 4-6 weeks.

6. Second there are questions concerning the determination of interest rates. We have sent a paper to the Bank and Walters for discussion. A meeting is to take place this week. There are a lot of issues to resolve if we are to formalise things sufficiently to provide a clear presumption about when rates should move. This work includes considering the role of the monetary base which is relatively undistorted by the Civil Service strike and the other narrow aggregates - plus the other factors mentioned in the Budget Speech. There is a separate paper on monetary base control, which is being discussed with the Bank though Walters has not seen it yet. But we shall want to avoid anything which looks like a move away from £M3 at this stage. We intend to make a report on this work in the next 4-6 weeks also.

Timetable

7. In your minute of 18 May, you suggested that we should aim to have another round up on where we should go before the summer recess so you could report to the Prime Minister. The Bank - and Mr Walters - have agreed with this objective. The next steps are:

- a. about 5 June: a revised and expanded draft of "Monetary Control: Next Steps" to Ministers.
- b. 19-24 June - draft sent to banks and LDTs by Bank - only marginal changes will be possible at this stage.
- c. 16 July - definitive provisions sent out.
- d. Now to mid-July - report to Ministers on the outstanding issues set out in 5 and 6.
- e. August - new system becomes operational.

Tactics

8. Everything is set on the timetable you suggested. There will be plenty of time for Ministerial discussion. It would not however be helpful to have just now a seminar with the Prime Minister of the sort we had last autumn. I suggest you say:

- a. You will report the outcome of the Bank's discussion with the banks this month. This is in line with previous decisions and does not pre-empt decisions on the key issue of the basis for interest rate changes. Mr Walters is fully informed. Much of it is very detailed and is not appropriate for a seminar. We will of course be happy to explain the arrangements in detail to the Prime Minister - if she so wishes, but she might be content to leave this to Treasury Ministers.
- b. Talks on the points in para 5 and 6 are in the early stages. Mr Walters is taking part. When Treasury Ministers have considered them, on the timetable you set out, you will report to the Prime Minister. It would then be appropriate to hold a seminar type discussion if she so wished.

Funding

9. This is rather separate - and the ball is in your court

to discuss Sir Douglas Wass's submission with us. But:

- a. the tranches of stock issued last week represented a more flexible approach to funding.
- b. the next issue is expected to be a further tranche of indexed stock.
- c. the funding programme - including National Savings - has been going very well, though savings inflows are now much smaller.

Points to Make

10. I attach a note of points you might make if you get drawn into an extended discussion. It is familiar stuff.

F. K. Clark

if P E MIDDLETON
2 June 1981