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LONDON
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29 December 1982

N J Monck Esq
H M Treasury
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London
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Dear Nick,

I enclose as promised the paper for discussion with the Discount Market that I mentioned to you on the telephone earlier this afternoon.

Yours,

Tony

PAPER FOR THE LDMA ON THE MONETARY CONTROL REVIEW

1 The Bank's paper of 5 August 1981 on Monetary Control provisions noted that the Bank would be prepared to review the undertakings given by eligible banks, "in consultation with eligible banks and the LDMA, when sufficient experience of the operation of the arrangements has been gained, covering at least a year". The CLCB have requested such a review.

2 The Bank considers that the key elements of the present monetary arrangements have worked well, in a period of considerable interest rate volatility and against a background of unexpectedly large and persistent cash shortage. The arrangements have not yet been tested in the converse conditions, when the Bank would not be an active buyer of bills. Nevertheless, there is experience enough to enable certain aspects of the functioning of the system to be reviewed, under three broad heads:

A SUPPLYING THE CASH THAT IS NEEDED

3 The arrangements relied on transactions with Discount Houses as the means of injecting into the system the cash that is needed. The process of determining interest rates relied on the transactions with Discount Houses being predominantly by the purchase of bills, so that the terms of any lending by the Bank had to be such as would discourage reliance on that in preference to selling bills.

4 Supplying the cash that is needed becomes difficult, and has on occasion proved impossible, if for any reason the system shortage is not sufficiently fully reflected in the collective shortages of the Discount Houses. This may happen either because the banks do not identify the need to position enough shortage into the market or because they do not have the available means to do so.

i) Identifying the need

5 Publication of the official estimate of the day's shortage was undertaken so as to give the fullest possible guidance to market

p ticipants of the prospective need. The estimates are by no means infallible; all possible steps to improve them are being pursued. Banks will, rightly, continue to be guided also by the information flowing through their internal systems. It is, of course, their responsibility to aim for target balances at the Bank sufficient to absorb any settlements against them that are not picked up by their own internal information arrangements. Even the best of such arrangements, however, cannot pick up at all precisely or quickly the effects of substantial diversion to Discount Houses, during the course of the business day, of funds that had previously been held on deposit with the banks. Even if - the counsel of perfection - they did so, the banks' response would be to draw yet more cash out of the market, so that the Houses <u>collectively</u> would not benefit from aggressive bidding in the inter-bank market; the only effect would be to redistribute the day's shortage among them.

6 Better performance in identifying the need to position the day's shortage into the discount market therefore calls for improvements in three ways; more accurate official forecasts, better information systems within individual banks, and the avoidance of sharp changes in the amount of funds taken by Discount Houses from the interbank market. <u>The Bank would like to discuss with the Houses how that last objective might best be achieved</u>.

ii) The means to position the shortage

7 The banks position a shortage into the market by calling money or by selling bills. Both bills and money with the Houses form part of their liquidity, the management of which is subject to the monitoring of the Banking Supervision Department. The usability of their placements with the Houses is further governed by the 'club money' rules applicable to eligible banks. There is a potential contradiction in any rules governing banks' liquidity, in that their purpose is to ensure that banks always have enough liquidity for their needs but, if the need arises, it must be possible to meet it by using the assets held for liquidity purposes - otherwise those assets are not really liquid.

8 The 1981 club money arrangements were intended to restore usability to the banks' holdings of their most easily realisable assets, which the nature of the reserve asset ratio arrangements had denied to them. This was done by allowing freedom for their club money holdings to fluctuate around a 'norm', which need only be maintained on average over a period, subject to their not falling below a somewhat lower minimum level, save in exceptional circumstances. The minimum was set at a level equal to two-thirds of the norm.

9 There are two ways in which the club money arrangements as currently operated may be said to hinder the full and effective positioning of shortages into the market. The first is a technical point about the method of calculating the 'average requirement' (or norm) over six- or twelve-month accounting periods. The system at present requires the banks choosing the former option to average 6% over months 1-6, 2-7, 3-8 and so on. In other words, each new month has now become the closing month of a new six-month period. This has provided much less flexibility to meet unexpected liquidity pressure than the arrangements were originally intended to do. The Bank now proposes to replace the rolling average arrangement just described with discrete six-or twelve-month periods. The net result should be modestly greater operational flexibility for individual banks, while the quantum of funds provided to the LDMA would maintain the average set by the norm.

10 The second limitation on the day-to-day usability of money placed with the Houses is that the daily minimum stands as high as it does in relation to the norm. The daily minimum was adopted as one of the 'long-stops' of the 1981 arrangements. It denied ~~genuine~~ free liquidity to a part of the banks' holdings, in order to provide assurance of a continuous minimum source of funds to the Houses. The original aim was around £2 billion. With the growth in the number of eligible banks, and in the eligible liabilities of banks in general, the current 4% minimum produces a sum in excess of £3 billion. The Bank now proposes that the minimum be set at a level equal to one-half of the norm, instead of two-thirds.

B THE STRUCTURE OF THE SYSTEM

11 Review of the fundamental structure of the new system would be both premature and unjustified by experience to date. But in one respect at least it is possible to compare with an original benchmark what has subsequently happened, and to draw conclusions. That concerns the quantum of resources provided as the 6% 'norm' by eligible banks.

12 The benchmark adopted in 1981 was that the eligible banks' obligations to hold funds with the Discount Houses should amount to about two-thirds of the secured call money previously provided by the reserve asset system. That implied around £3 billion, against £4½ billion. There was a clear objective to impel Houses to seek funds from other, less captive, sources if they wished to maintain their books at their then levels. The purpose was to avoid such a degree of bargaining advantage over the captive placers of funds as might create a false market and bring the system into disrepute.

13 The growth of Houses' books over the past year has led them to be keen bidders for funds almost continously. But the growth of the ELs of eligible banks, together with the increase in their number, has led to a progressive increase in the proportion of LDMA borrowed funds that is provided by club money. Moreover, the original norm was set somewhat higher than proved necessary to provide £3 billion, so that the level of club money currently exceeds £4½ billion and amounts to about five-sixths of total borrowed funds. That is a higher level than is consistent with the original objectives. The Bank now proposes that the norm be reduced to 5%, which would produce about £3.8 billion.

FULLER INFORMATION

14 The publication of the Bank's daily forecasts and operations has been intended to give price sensitive information simultaneously to all money market participants. There is one respect in which this information is not complete, and some participants may be at a disadvantage. It concerns transactions undertaken after the

Bank's afternoon round - e.g. lending under 2.45 facilities - which are sometimes significant in relation to the gap between the published official operations and the previously forecast shortage. The banks have asked if the Bank would consider publishing a figures of later transactions.

15 The Bank envisages no change in the operation of the present 2.45 facilities and there is no question of publishing the terms (rate or maturity) of 2.45 transactions, because this would impinge upon the confidentiality of the banker-customer relationship. Nevertheless, it would seem possible to publish via Reuters at, say, 3 pm the total of what could be described as 'late business'. It could be made clear (especially to the press) that this in no way necessarily meant that members of the LDMA had borrowed because the figure would include lending to money-brokers and jobbers and, also, late transactions in bills. Transactions after this final published figure would not be ruled out but, as now, would be regarded as exceptional. The Bank invites comments on this suggestion.

c/10

35/1

cc Mr Middleton
Mr Odling-Smee
Mr Sedgwick
Mr Turnbull
Mr Willetts

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N J Monck
Under Secretary

6 January 1983

D Somerset Esq
Bank of England
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Dear Daniel

We are now about to discuss with the Bank the working of the monetary control arrangements formally introduced in August 1981. It seems a good time to return to the question of clearing bank overdrafts with the Bank of the kind covered in my letter to Tony Coleby of 26 April and your letter to me of 10 June.

2. Our concern is with how the new arrangements have worked and are likely to work in future. I think the importance of ensuring that the clearers do not go into overdraft is common ground. If that were not achieved such restraints as there are on bank lending would clearly be weakened. But since no interest is paid on the balances held with you, there is a commercial incentive to the clearers to keep balances at a lower level than are required to avoid going into overdraft taking account of the inevitable uncertainty, unless the penalties of overdraft are high enough to deter this behaviour.

4. In your letter of 10 June you explained that you understandably had no explicit rules "for events which should not occur" but that in practi in the absence of any special factors you have charged interest on the occasional overdraft at rates not less than the highest closing rate for overnight funds in the inter-bank market.

5. For the purposes of the current review it would be useful if you could answer the following questions:

a. how many occasions of overdraft by individual banks have their been over some long convenient period - say the last 12 months or the whole period since August 1981 - and is there any visible trend. On how many of these occasions have you taken the view that the fault lay not with the bank but with some special factor or problem in the system generally?

b. do you regard this record as satisfactory? If so, on what criteria? (It is arguable that 'special factors' should not be allowed for at all; that if they are, there should certainly be no other occasions of overdraft; and that since they do occur, even if only exceptionally the penalties are not big enough. Is the extra interest cost of an occasional overdraft sufficient to deter banks from earning extra interest on most days by aiming at balances lower than would be needed to cope with exceptional situations.)

6. I am sending a copy of this letter to Tony Coleby.

Yours
Nick

N MONCK

c/10 56/1

MONCK

FROM: A TURNBULL
10 January 1982

cc Mr Middleton
Mr Odling-Smee
Mr Sedgwick
Mr Willetts
Mr Pickford

MONETARY CONTROL REVIEW

I attach a copy of the version of my paper which has been sent to the Bank. It differs in only minor respects from the version circulated on 9 December. It is for discussion at your meeting today at 4.45 pm and at your meeting with the Bank tomorrow afternoon.

A TURNBULL

MONETARY CONTROL REVISITED

Introduction

The new arrangements which were introduced as the culmination of the review of monetary control in 1980-81 have been in force for nearly 18 months. A number of articles have appeared reviewing their operation and the clearing banks, in particular, have made representations seeking changes. Comment has been mixed;- some critical, some expressing satisfaction that the new arrangements, even if they have not operated precisely as envisaged, have represented an improvement on the preceding arrangements.

2. The comment has been at several levels. Some people have argued that the wrong choice was made. Rather than developing improved mechanisms for operating on short term interest rates as a way of influencing demand for money, an attempt should have been made to control the supply of money through monetary base control.

3. This paper takes as its starting point the assumption that the reasons for not adopting MBC remain valid - viz, the difficulty in the case of a voluntary system of knowing what level of balances banks would wish to hold; the danger in a mandatory system, of provoking disintermediation; concern about the volatility of interest rates; our lack of confidence about a stable relationship between the base and the monetary aggregates.

4. The paper also does not seek to reopen the question of the aggregate on which monetary control is based. From the 1982 Budget we have established a system of monitoring several aggregates in relation to targets. Its purpose therefore is to take the existing framework and to examine how those arrangements have functioned, whether they have met the original objectives and what further modifications might be made. Nor does it discuss funding policy though this has had a significant influence on the way money market operations have developed over the past year.

Criticisms of the present system

5. The paper on The New Arrangements prepared for the Prime Minister's seminar in July 1981 set out a number of objectives.

> "(i) to allow greater scope for market forces in determing the structure of short term interest rates. The Bank would formulate its objectives in terms of very short term rates (0-14 days), leaving the longer short term rates (up to three months) freer to vary;
>
> (ii) to reduce the bias for delay which was thought to characterise administered interest rate changes;
>
> (iii) to achieve a lower political profile for interest rate changes."

6. A number of commentators have endorsed these objectives but have argued that the new arrangements have failed to give the market the greater role in determining the structure of short term interest rates. In particular, it is argued that the system has relapsed into a variant of MLR, thereby the Bank's dealing rates, particularly in Band 1, provide the signal.

7. It is true that the new arrangements have not worked entirely as intended, but it is an exaggeration to say that they have relapsed into MLR. A lower political profile has been achieved and adjustments made more promptly as is illustrated by the two occasions when a rise in interest rates was generated by a fall in sterling - September 1981 and November 1982. In each case the drama of a MLR rise was avoided, though in the first occasion discount window lending was deployed. Also the steady fall in interest rates during the first ten months of 1982 was achieved without the authorities having to appear in the role of driving interest rates down. Thus there have been some genuine gains.

(a) Scope for market influence

8. Where the new arrangements have been weakest has been in giving the market greater scope for influencing the structure of short

term rates though we have moved some way from the days when the Bank posted dealing rates out to three months/were derived from the Treasury bill tender. It was envisaged that

(i) the market would be expected to experience both days of shortage and of surplus. The old practice of deliberately creating a shortage by over issue of Treasury bills was discontinued;

(ii) the Bank would confine its operations to short term paper, Bands 1 and 2, intervening only rarely in Bands 3 and 4, thereby leaving rates in these maturities freer to move in line with market forces. These movements were expected to provide valuable information on market expectations.

9. In practice there have been almost continuous market shortages. The stock of money market assets acquired in relief of shortages rose from about £1½ billion at the end of October 1981 to nearly £9 billion by March 1982, reflecting principally heavy funding at a time when the PSBR was very low as a result of the normal revenue season coinciding with recovery of strike delayed revenues.[1] Since the Spring of 1982, the stock of money market assistance has increased much more slowly, in part reflecting some success in increasing the CGBR relative to the PSBR, and now stands at around £9 million.

10. The position we have now reached is that even if no net new shortages were being generated, with the majority of the Bank's holding of bills being of short maturity, daily shortages would occur of £400 million or so, just as a result of the maturing each day of bills in the existing stock. Thus the position of permanent shortages it was hoped to avoid has been recreated.

11. This has meant that the Bank is having to deal much more extensively than originally envisaged and because it cannot acquire

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(1) Overfunding is normally defined as the difference between the PSBR and sales of debt to the non bank public. Other things being equal an increase in overfunding will generate greater money market shortages. However, a number of other factors can also affect the money market position e.g. changes in the reserves, sales of debt to sectors other than the non-banks, a change in the CGBR relative to the PSBR.

sufficient bills by operating solely in the shortest bands, it is having to operate in the longer maturity bills. As a result the Bank has become more of a price setter over a wider spectrum than originally intended. In consequence the discount houses have not moved their bids radically from day to day and the rates at which the Bank have dealt have been scrutinised minutely by the market, with changes of 1/16 or ⅛ being invested with policy significance.

(b) Impact on interest rate differentials

12. When the policy of operating largely in bills was announced, doubts were expressed about the ability of the supply of bills to expand sufficiently to give the Bank a large enough market to operate in. With the total stock of bills expanding from £3 billion in mid 1981 to around £13 billion now, such fears were misplaced, though there are now doubts about whether the supply of bills can be increased much further without running into problems of quality or without extending bill finance into international trade which may have exchange rate implications.

13. Even when the supply of bills has not been a problem, other difficulties have arisen. A further criticism of the present arrangements has been that the heavy reliance on purchases of commercial bills has distorted relative interest rates - driving down bill yields relative to deposit rates. On occasions this may have created opportunities for commercial bill round-tripping i.e. borrowing by companies through the issue of bills, the proceeds of which are deposited at a profit even after allowing for transactions costs such as the acceptance commission. (It should be noted however that under the new arrangements base rates have been adjusted promptly and the old style round-tripping by borrowing on overdraft seems to have been eliminated.) It is notoriously difficult to identify occurrences of this kind, let alone quantify it. It is most likely to have occurred in March and September when the gap between bill yields and deposit rates widened in response to greater purchases by the Bank.

14. Even when, as generally seems to have been the case, opportunities for positive profits have not been present, lower bill

rates relative to deposit rates may have reduced the cost of simultaneously borrowing and holding deposits which many companies ɔ. This would tend to inflate both bank lending and money. Independently of short run changes in bill rates which reflect the extent of the Bank's buying of bills, there seems to have been a shift in the general relativity of bill rates to deposit rates, with bill rates falling below deposit rates in the second half of 1980 as the corset was ended and the Bank's purchases of bills began to increase.

15. The problem with these effects lies not so much in the impact of greater gross liquidity on the economy (if the holding of greater assets is more or less directly associated with greater borrowing it is unlikely to affect spending plans significantly), but in the difficulty they create for interpreting monetary data. It becomes very difficult to establish whether a surge in lending in any month is telling us something genuine about developments in the economy or whether it merely reflects movements in financial variables. There is also the presentational problem of the authorities being responsible for creating opportunities for arbitrage margins. Although it is not easy to identify at whose expense such profits would be made, the likelihood is that it is the public sector which ultimately is issuing long term debt and increasing its holdings of low yielding bills.

(c) Signalling the authorities' intentions

16. A conscious objective of the new system was that the authorities would signal their wishes about changes in interest rates less overtly than previously. This was the counterpart to giving the market more influence and reducing the political profile of interest rate changes. The choices were set out clearly in the July 1981 paper

> "It is important, however, to recognise the full implications of 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 to 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."

17. There are doubts about whether the new arrangements can adequately handle all conceivable circumstances i.e. be effective both when rates are falling or rising, or when the authorities wish to lead or restrain. Certain circumstances do appear to be adequately covered

(i) where rates are falling too fast, the Bank can refuse to accept bids at 12.30. Later in the day it can either accept higher bids if these came forward, undertake repurchase agreements or as on 18 August by requiring discount window lending;

(ii) where the authorities wish to give an unambiguous signal and are prepared to be seen to be doing so, it can be announced that the discount houses will be required to borrow from the discount window at a specified rate. This amounts to an ad hoc use of an MLR. An example of this was 14 September 1981.

18. There are a number of situations in which the system may function less effectively:

(i) where the authorities want to ease interest rates up without making a fully overt statement but conditions

of surplus are expected in the money markets for a number of days. It might be necessary to create conditions of shortage first e.g. by selling mopping up Treasury bills before higher dealing dates could be made effective. (If a sharp and immediate move were required it would be possible to announce the rate at which cash will be provided on the next available occasion.) One consequence of the unintended recreation of permanent shortages has been that waiting for a suitable opportunity has not generally been a problem.

(ii) where the authorities want to ease interest rates down but again want to do so with a light touch. The tactic here would be to "overdo the help" for a number of days, forcing the short inter-bank rates down but again this can take several days to become effective.

(iii) interest rates may be tending to rise against the wishes of the authorities. Although the Bank has a choice about which bills it accepts, it normally adopts a commercial approach and accepts the cheapest/highest yielding bills first, thereby finding itself in the position of validating the rise. One possibility, though it would be a break with established practice, would be to accept the higher price/ lower yielding bills. Another, would be to announce that the discount window would be open at lower rates, though this would give a rather more overt signal.

19. In the rare instances where a very strong signal is required, e.g. in response to a sharp fall in sterling, use of the discount window seems to provide a satisfactory solution. It is more difficult to achieve what is sought where a deft touch is desired but conditions in the market are unhelpful i.e. persistant shortages when an easing is sought or surpluses when a rise is sought. There can be difficulties in moving in either direction, though achieving a fall or braking a rise may prove slightly more difficult under present arrangements. OF have on occasions expressed concern about the "weak signals" approach though their reservations relate not so much to the system itself since the option of an

override already exists, but to the wisdom of avoiding clear signalling of the authorities' intentions at times when the exchange rate is weak.

(d) Clearing bank criticisms

20. The Committee of London Clearing Banks has submitted representations on the working of the new arrangements. They argue that it is not necessary for

"(a) the Bank's intervention to be confined to the bill markets;

(b) bill transactions to be channelled almost exclusively through the discount houses;

(c) the houses to maintain large holdings of bills (as opposed to jobbing in them); and

(d) special arrangements to be made to enable the houses to finance their holdings."

They advocate a move towards intervention in the interbank market.

21. The banks make a number of specific criticisms:

(i) Under the present arrangements, the channelling of cash through the discount houses does not always ensure that cash reaches the points of the system where there is a shortage. The banks have a facility whereby, after the discount houses have sought unpublished assistance at 2.45pm, they can offer Treasury and local authority bills to the market if they still find themselves with a shortage. When the Bank takes these bills it is usually on penal rates. The banks feel that the system does not transmit information on shortages effectively and that the discount houses can exacerbate the banks shortages by hanging on to the bills, forcing the banks to seek assistance at penal rates, on account of events outside their controls. The effect of this can be to generate perverse movements in the very short term money market rates. If the Discount Houses predict that the Bank will be cutting its dealing rates by small amounts over several days they will have a strong incentive to hang on to their bills, particularly longer dated ones.

(ii) The banks also complain about the requirement to hold on average 6 per cent of their eligible liabilities with the discount houses (subject to a minimum of 4 per cent). This currently amounts to around £3 billion. They see this as money they could deploy elsewhere more profitably. They suggest that if the objective is to maintain a bill market of a given size, the banks could be given a choice between holding the bills directly and putting money with the discount market.

22. There are a number of adjustments which can be made to accommodate the banks position. For example, it may be that the figures set for the club money may have turned out to be larger than really necessary, though we have not of course seen whether an active bill market persists when the Bank is not a substantial buyer. But there remain a number of objections to the banks' arguments. First, the clearers do not acknowledge the advantages that the new system has given them. Instead of holding 1½ per cent of eligible liabilities as balances with the Bank, which would currently amount to £890 million, they hold ½ per cent as a non operational balance - approximately £290 million - and operational balances which have averaged just over £200 million. In total therefore they now hold about £500 million. Secondly, following the removal of the reserve asset ratio, banks' holdings of reserve assets are now generally much lower than the old 12½ per cent. This will have released assets for more remunerative purposes. Thirdly, the banks do not recognise that under the club money arrangements, they hold <u>less</u> with the discount houses than they had before. Finally, the banks do not acknowledge that the return on whatever instrument the actual bank operates in to regulate band liquidity will tend to be depressed simply by the fact that it is eligible for sale or rediscount at the central bank. There may thus be very little advantage to the banks in being able to hold bills themselves.

Suggested amendments

(a) Operation in interbank markets

23. The banks have for a long time argued that the Bank should operate in the interbank market rather than the bill market. They argue that it is a much larger market, with many more participants. The Bank's operations would be a much smaller proportion of the total and would thus distort interest rates differentials much less than operations in the bill market. The banks also see advantages in dealing direct with the Bank if they can achieve a situation where their cash shortages are made good as late in the day as possible with minimal degree of penalty.

24. The Bank see the clearers' arguments differently. Although the interbank market is large and diverse, the operation of the clearing process means that at the time shortages have to be relieved, they have been concentrated in the hands of the London clearers. The Bank would then be dealing in a small and possibly collusive market.

25. A distinction needs to be made between dealing with the banks direct but dealing in assets, and dealing with the banks and acting on their liabilities, i.e. making deposits with them. The objections to the latter are stronger than to the former. If the Bank dealt by buying paper from the banks, it fears that it would be more difficult to get the banks to compete gainst each other in making bids. It would probably also be more difficult to enforce penalties on the banks when acceptable bids were not made or when the banks sought late assistance to relieve shortages.

26. There are additional difficulties in dealing with the banks in their liabilities. First, when dealing in interbank deposits, there is a likelihood that interbank rates would gravitate towards the Banks' dealing rates and the information content of interbank rates fluctuating independently would be lost. Secondly,

there is the problem of accepting claims directly on the banks. It has always been the Bank's practice to deal in either public sector paper (the scope for which is limited in current circumstances)or in private sector paper with two names on it - the original accepting bank and the discount house. In this way the Bank is not required to take a position on what line of credit it will grant to individual banks.[1] Finally, there would be the operational problems of deciding which banks were eligible to receive deposits from the Bank and the size of the facilities they would be allowed. In the interbank market at present, market forces are allowed to decide these questions.[2]

27. There are obvious difficulties in dealing in the interbank market as the vehicle for relieving money market shortages. But several suggestions for getting round at least some of these difficulties have been put forward.

28. One proposal for getting round the structural problem whereby, at the end of the day, the shortages gravitate to the clearers would be for the Bank to take out the first part of any day's shortage by dealing with the banks in the inter-bank market, leaving the final adjustment at the end of the day to be made as now through the bill market. The Bank have expressed several objections to this. First, they doubt whether the discount houses would prove viable as institutions conducting only marginal business. Secondly, they doubt if this would prevent a tendency for inter-bank rates to settle on the Bank's dealing rates. The Bank could, in an attempt to avoid dealing head on with the clearers make deposits with smaller banks. The clearers, however, are likely to object

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[1] The position of bank bills is ambiguous. Some banks hold their own acceptances. Although they are technically assets, the Bank would not want to purchase them as it would be acquiring an unguaranteed claim on the bank in question.

[2] A limited exception to the 'two names' principle has been the promissory notes provided by the banks in respect of export credit paper under the 1980 repurchase arrangements. While the banks had to give assurances that the amount of the notes was matched by holdings of export credit paper, the notes were not in a legal sense secured on the underlying assets.

to a system which they would see as providing those banks with a turn when the clearers were incurring the costs of operating the clearing system, particularly the maintenance of unremunerated operational deposits.

29. Another proposal is for an arrangement analogous to US Treasury Tax and Loan accounts (details in attached Annex). Under this system, tax payments are not, as in the UK, immediately passed to the Exchequer, but are left by the US Treasury in deposits with the banks. The US Treasury subsequently draws upon these accounts, thereby smoothing out the impact of revenue inflows on the money markets. The advantages of such a system are first that it would operate not at the margin but would cope with intra marginal shortages, thereby reducing the size of shortages to be dealt with in the day-to-day clearing process. It would leave the Bank free to deal in bills without the persistent one-way imbalances. Secondly, the interest rates earned on the balances could be set independently of the dealing rates, thereby not interfering with the objective of allowing market forces a greater influence in interest rate determination.

30. The objections to the system are that it would still involve the public sector (in this case the Treasury) in taking a direct claim on the banks and in deciding which banks could come into the scheme and with what limits.

31. The above discussion can be summarised in the following choices:

(i) are the transactions at the margin i.e. at the point of clearing market shortages, or are they intra marginal i.e. independent of a particular day's market position?

(ii) are the transactions in assets or in banks' liabilities?

(iii) if assets, are purchases made direct from the banks or via the discount houses?

(iv) if assets, are they public sector assets or private sector assets?

HF3 Division
HM Treasury.
10 January 1983