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## 8. Monetary Base Control III

Monetary Control

Reserve Asset Ratio

16/12/1980 – 22/12/1980



MR MORCK ✓

cc Mr Burns  
Mr Middleton  
Mr Britton o/r  
Mr Riley  
Mr Culpin  
Mr Grice  
Mr Shields

#### MONEY CONTROL SEMINAR

Last Friday Robert Culpin and I attended a seminar on monetary control at the City University: Charles Goodhart was also there from the Bank. Half of the session took the form of a lecture by Professor Brunner, developing now familiar themes: viz:-

- (i) the superiority of targeting monetary aggregates rather than interest rates, where output shocks dominate shocks to the demand for money;
- (ii) the superiority of rules over discretion where there is major uncertainty about structural relationships, where the authorities do not have superior information to other market participants, and where rational economic agents are quick to discover, and exploit, the feedback rules used by the authorities.
- (iii) the superiority of monetary base control over interest rate targeting as an instrument for controlling the money supply, due, according to Brunner to the empirical fact that the money multiplier is more stable than the relationship between money and interest rates.

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2. The discussion raised some points of more immediate relevance to the UK. Sam Brittain and Charles Goodhart pressed Brunner on whether he saw control of the base as a target in its own right, or as an intermediate means of controlling  $\text{M3}$  (or some appropriate measure of the money supply proper). I understood Brunner to say, rather surprisingly in view of his remarks at the Bank's seminar, that he thought we should control the base in order to meet targets for  $\text{M2}$ . He repeated his assertion that over a run of years control of the base was necessary to control inflation, but it came over this time as a statement about the empirical stability of the money multiplier. The tone of his remarks may have been influenced by a heated reminder, from Tim Congdon, of the discrepancy between the growth in the base and the growth in the money supply in the US during the Great Depression.

3. Brunner has become very clear, since we met last, that the inclusion of wholesale money in  $\text{M3}$  makes it "quite unsuitable" as a target aggregate. We should be aiming to control transactions balances (ie  $\text{M2}$ ). He was noticeably cool, though not overtly hostile, to Sam Brittain's suggestion that we should have targets for nominal incomes, pointing out that the ultimate target of monetary policy was prices, but that, of course, we could look at anything we wanted.


4. Someone raised the question of what we could hope to learn about the money multiplier in advance of a move to MBC. Brunner agreed that changes in institutional arrangements (including the cash ratio, and the operation of discount window facilities) would cause shifts in the money multiplier, albeit in a predictable direction (eg. a more restrictive approach to providing cash would probably reduce the multiplier). But he did not accept that there was no useful information to be extracted from past UK data, though he agreed that the necessary analysis had not been done. And he argued that we could still make a start at controlling the base - the consequence of shifts in the money multiplier would



be to impart a more deflationary bias to monetary policy than had been intended, a prospect he seemed able to contemplate with some equanimity.

5. Charles Goodhart attempted to press Brunner on the problem of disintermediation, without much success. The answer, heavily cued by Brian Griffiths was (as far as I understood it), that if the tax element was minimal, and the banking system reasonably competitive, there should be little incentive to disintermediation. I did not find this very convincing: it is not possible to eliminate the tax element entirely, if the system is to have any "bite" at the margin, and if there are close substitutes for "money", even a small incentive can give rise to large flows (possibly exemplified by the recent growth in the eurosterling market).

6. There was some discussion of the Nov 24 changes. The NBC proponents seemed ready to accept them as a step in the right direction, though long overdue, and subject to some scepticism as to what the Bank would actually make of them in practice. There was some pantomime between Brian Griffiths and Charles Goodhart over the purpose of increasing uncertainty. Griffiths professed himself baffled as to whether this could ever be a good idea. Charles tried to argue that controlling the base only impinged on individual banks via uncertainty about the future cost of money, so that making that less certain and predictable was an intrinsic part of the transition. This was greeted with considerable scorn by Brunner. Charles tried again, with the argument about depoliticising interest rates, as a means of making the present approach work better. Somewhat surprisingly this was hailed as a major breakthrough in understanding, and a potentially important contribution to monetary control - (surprisingly, because he explained it as a way of making interest rate targeting work better thus, by implication, rendering NBC unnecessary). And on this agreeable, if somewhat confusing, note the seminar broke up.

  
RACHEL LOMAX  
16 December 1980





- 1) MR MONCK
- 2) FINANCIAL SECRETARY

27/10/80  
cc Chancellor  
Sir D Wass  
Mr Ryrie  
Mr Middleton ✓  
Mrs Lomax  
Mr Riley  
Mr Pickford  
Mr Britton

#### BUILDING SOCIETIES AND M2

Work on the development of an M2 series is being pressed forward in consultation with the Bank following the Chancellor's statement on 24 November.

2. One issue which immediately arises is whether deposits with building societies should be included in the statistic or not. We and the Bank are agreed that the answer in principle must be "yes". Whether one sees M2 as covering retail deposits or transactions balances, or some related variant, deposits with building societies will constitute an important component of it. It would be strange, and difficult to defend vis a vis the banks, to leave building societies out altogether.
3. In practice, however, it is important not to seem to prejudge the question whether building societies should be brought within monetary controls applied to the banks. Your speech in May set out the policy that, provided societies continued to develop on lines consistent with their evolution so far, they need not expect a changed framework of control. The development of an M2 statistic which included them could lead the societies (and the banks) to assume that policy had changed, and it is therefore necessary to guard against misunderstandings on the point.
4. We propose, therefore, to work towards the presentation of M2 in two versions - including and excluding the relevant building society deposits. The reasons for this will have to be explained to banks and building societies at the appropriate stage, on the following lines:-
  - a) M2 statistics are intended to provide information only at this stage;
  - b) No decision on their implications for monetary control has been taken or is likely to be reached for a considerable time; and
  - c) The two series are being developed in parallel to avoid in any way prejudging the question whether building societies would be included within any monetary controls that might ultimately result from study of the M2 series over time.

*Al*  
A C PIRIE  
17 December 1980



MANCHESTER OF THE EXCHEQUER

cc Financial Secretary  
Sir Douglas Warr  
Mr Byrie  
Mr Burns  
✓ Mr Middleton  
Mr Britton  
Mr Pirie  
Mr Riley  
Mrs Lomax  
Mr Turnbull  
Mr Davies  
Mr Culpin

*7/10/83*  
*cc Mr Riley*  
*24/12*

# INTERIM ADJUSTMENTS TO THE RESERVE ASSETS RATIO REQUIREMENT

I attach a paper by the Bank of England, agreed with us, which recommends that the banks' reserve assets ratio should be reduced early in January from 12½% to 10% of their eligible liabilities. This should enable the banking system to get through the revenue quarter without further sale and repurchase operations in gilts. The Bank are satisfied that it will not detract in any way from the soundness of the banking system. Nor will it prejudice decisions yet to be taken about the future of the Bank's open market operations or about the prudential guidelines to succeed the RAR. It will simply reduce the embarrassing visibility of the Bank's support for the market.

2. The paper is being submitted simultaneously to the Governor. If you and he are content with its recommendation, you will want to report the decision to the Prime Minister. I attach a draft Private Secretary letter, but this has not yet been cleared with the Bank. We will submit any necessary revisions early next week.

3. We shall of course put up separate advice later on the public announcement of the change, which would naturally be made by the Bank.

*S. Wilkes*  
*PP* N MORCK  
19 December 1980

*10487*





MEMORANDUM OF THE EXCHEQUER

cc Financial Secretary  
Sir Douglas Hoare  
Mr Byrie  
Mr Burns  
✓ Mr Middleton  
Mr Britton  
Mr Pirie  
Mr Riley  
Mrs Lomax  
Mr Turnbull  
Mr Davies  
Mr Culpin

*2/10/83*  
*cc Mr Riley*  
*22/12*

INTERIM ADJUSTMENTS TO THE RESERVE ASSETS RATIO REQUIREMENT

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*S. Walker*  
*PP* N. MOROK  
19 December 1980

*10487*



## INTERIM ADJUSTMENTS TO THE RESERVE ASSET RATIO REQUIREMENT

1 It has been agreed that the Reserve Asset Ratio (RAR) should be abolished as soon as permitted by the progress of consultations with the banking system on future prudential liquidity requirements. It does not look as if abolition will be possible before the spring; and in the meantime, an early recurrence of heavy pressure on banks' reserve ratios is foreseen. If nothing were done, the result would be heavy upward pressure on short-term interest rates.

2 The major source of the problem is that the CGBR is forecast to improve considerably in unadjusted terms (going into substantial surplus in banking January), draining cash out of the banking system and into the Exchequer. The normal response of the banks to the situation would be to rebuild their cash holdings by running-down their surplus reserve assets (for example by taking cash when their Treasury Bills mature). But, of course, the banks' reserve asset position has been extremely tight through most of 1980 and they do not have anything like the amount of surplus reserve assets that would be needed in the next few months if they were to continue to meet the present  $12\frac{1}{2}\%$  minimum RAR requirement.

3 When the same problem appeared earlier in 1980, the Bank responded firstly by conducting open-market operations in commercial bills and secondly by offering the banks purchase and resale facilities in gilt-edged with over one year to maturity. Both responses in effect converted non-reserve assets into cash (commercial bills only count as reserve assets up to 2% of eligible liabilities).

4 If renewed action is to be taken, we are likely to have to act on a scale, over the next few months, roughly 50% larger than at any time in 1980 (see below). This would almost certainly involve the reintroduction of purchase and resale facilities, with the attendant

publicity, together with further large-scale open-market operations in commercial bills.\* We have therefore explored ways in which the risk of having to resort to further purchase and resale agreements in the next few months could be minimised without, at the same time, prejudicing the longer-term objectives for monetary control set out in the Chancellor's Statement and the Bank's Background Notice of 24 November.

#### The scale of the problem

5 On present projections and given the present RAR requirement, the authorities would have to convert some 2,000 non-reserve assets into cash during banking January for the London clearers to meet their cash ratio requirement and for all banks to meet their reserve asset ratio requirement. The problem would ease in February but worsen again in March and April (see table below).

As at make-up day

Reserve asset creation:

	Over the month	Total outstanding
December		870
January	+ 2150	3020
February	- 850	2170
March	+ 600	2770
April	+ 400	3170

By April, the total - 3170 - would compare with the highest figure on any make-up day in 1980 of 2200.

#### Possible responses

6 It is widely accepted that open-market operations in commercial bills and, to a much more limited extent, foreign exchange swaps

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\* The scale of these operations can usually be deduced by outside observers after the event but they are less obvious and are generally regarded as more normal money market management.



are a logical response to the problem outlined above. We thus convert non-reserve assets into cash and the banks avoid the need to run down their reserve assets to obtain cash. A significant part of the problem can undoubtedly be met in this way. Official purchases of commercial bills would be the main route, as earlier this year,\* and we are currently developing our dealing techniques in the bill markets so as to facilitate an increase in the scale of this business. The scope for foreign exchange swaps (selling sterling and buying dollars, reversing the operation later) is generally more limited. Unless sterling is strong on the exchanges the managers of the Exchange Equalisation Account would not regard such swap operations as consistent with the mandate governing their activities. But, to the extent that it is possible, the levels of cash and reserves in the banking system rise *pari passu*. Overall this route - largely commercial bills - could probably provide at least 2000 of the assistance; this would be slightly more than double any level achieved on a make-up day so far.

7 This route apart, two main options are available.

(i) Relax the present restriction whereby only 2% out of the 12½% minimum RAR can be in the form of eligible commercial bills. This step would encourage an increase in the supply of commercial bills, thereby effectively turning non-reserve into reserve assets. It would not, however, of itself ease the cash shortage. Assuming that there is no discount window lending, the banking system can obtain cash only by allowing central Government reserve assets to mature or by selling assets to us. In the latter case public attention focuses only upon our purchases of private sector debt (commercial bills) and - much more keenly - upon our purchases of public sector non-reserve assets (over one year gilts).

8 It is impossible to quantify with any accuracy how far the banking system (including the discount houses) would be prepared to run down public sector reserve assets (thereby reducing our need to buy-in other assets) but holdings of these assets are already low by past

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\* Issue and Banking Department holdings of commercial bills have, in recent months, greatly exceeded the total of foreign exchange swaps.

standards\*. In our judgment it would be unwise to assume that it would part with more than 1,000. Even this would probably leave holdings of Treasury Bills significantly below the lowest point reached in recent years.

9 Consequently, this option would still leave a large cash shortage and thus a need for the large open-market operations in commercial bills described in para 6. It would also fail to make the point that would be made by option (ii) below that liquidity is there to be run down at times of pressure, such as occurs in the tax-revenue season. Finally, given the fairly short time horizon within which the supply of eligible commercial bills would have to rise, this option might unduly restrict our ability to supply cash via open-market operations in such bills, by increasing the number of bills that banks would wish to hold rather than sell to us.

10 (ii) Reduce the minimum reserve asset ratio.

As with option (i), this would help to meet the reserve asset shortage but would not eliminate the need for large-scale open-market operations in commercial bills. Unlike option (i), however, it would avoid anticipating conclusions about the ultimate role of eligible bills in banks' liquidity and would be consistent with the view that liquidity needs should in future be regarded in terms of a norm rather than a rigid minimum and that primary liquidity can reasonably be run down in the tax-paying season. A cut in the minimum required ratio from 12½% to 10% - reducing the need for open-market operations by perhaps 1,000 - is therefore recommended. Any larger cut would not further reduce the size of the open-market operations needed, for the reasons explained in paras 7-9.

11 A number of variants of these two options are possible. One could, for example, widen the definition of reserve assets. The most obvious possibility here would be to count gilt-edged with between one and, say, five years to maturity as reserve assets. The objection is that this would be a major step which, by increasing the relative attraction to banks of these gilts, would *prima facie*

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\* Reflecting the reserve asset squeeze of the last year.



go against the objective set out in the Bank's Notice of 24 November of encouraging broader markets - involving both banks and non-banks - in short-term Government debt. This is not the time to consider major initiatives of this kind in relation to a short-term "management problem.

12 Another option would be to reduce the minimum reserve asset ratio to 8% and narrow the definition of reserve assets to exclude commercial bills. This would have the same net effect as cutting the minimum required ratio to 10%, given that up to 2% of reserve assets currently can be commercial bills. It would also have the benefit of increasing the supply of commercial bills which the bank might wish to sell to us, thereby making our open-market operations easier. However, as with the variant considered in para 11, this would be to make a major conceptual change to the present system. It would anticipate conclusions on issues, such as the role of eligible commercial bills in providing liquidity in the "post-transition" system, that have not yet been considered fully.

#### Recommended action

13 We recommend that a cut be made from 12½% to 10% in the minimum reserve asset ratio requirement on banks. This could reduce the scale of our problem by around 1000. It is recommended that we seek to meet the balance of the problem (currently projected at some 2200 at worst) by open-market operations in commercial bills and, where appropriate, by limited foreign exchange swaps unless and until it becomes obvious that the scale of the shortage is such that further purchase and resale facilities for gilts are inevitable. It is hoped that such facilities will not, in fact, be necessary.

14 We should like to be able to announce the change in the RAR requirement by 5 January, or very shortly afterwards\*; the first major cash shortages are expected to appear in the first full week of January. We would strongly recommend against trying to respond by open-market operations alone for as long as possible and then

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\* Now that all banks know that they are liable to spot checks to establish that they are observing the minimum requirement, action cannot be left until just before the January make-up day.

announcing a cut in the minimum requirement only when the scope for such operations had been exhausted. This would not give the impression of a coherent, fully-prepared operational approach and would bring about some wholly unnecessary and probably damaging movements in relative (and perhaps in absolute) levels of interest rates.

#### Anticipating public reaction

15 In adopting the above recommendations, we need to disabuse outside commentators of three misconceptions.

16 The first is that a reduction in the minimum RAR represents a weakening of the prudential strength of the banking system. In reply, we would emphasise the point made in the Green Paper that the RAR requirement has been regarded as a monetary control and has limited prudential relevance. We have made it clear from the outset of the current round of discussions that liquidity needs should be specified in terms of a norm and that such liquidity is to be held specifically as to enable it to be run down at times of abnormal pressure (such as in the tax-revenue season). The Bank's supervisors do not regard the proposed reduction in the minimum reserve asset requirement as conflicting with their responsibilities under the 1979 Banking Act.

17 The second misconception is that the proposed change foreshadows a staged reduction in the minimum ratio, or prejudges the nature of liquidity norms that may finally be agreed. This is simply not the case.

18 The third misconception is that our actions both in cutting the minimum ratio and conducting large open-market purchases of commercial bills increase  $\text{EM3}$ . It is true that if we did nothing in the coming months then interest rates would move sharply higher and, after a period of adjustment, recorded  $\text{EM3}$  probably would ultimately be lower than otherwise. In the process, however, there might well have been temporary upward distortions to  $\text{EM3}$  caused by round-tripping, if money market rates rose faster than banks' base rates.



DRAFT LETTER TO:

T P Lankester Esq  
10 Downing Street

#### THE BANKS' RESERVE ASSETS RATIO

At the Prime Minister's meeting on 18 November, it was agreed that the reserve assets ratio (RAR) could not be abolished until new prudential guidelines had been established and that this could not be done before the Budget. However, it was also agreed that it would be desirable to consider an interim change to avoid, if possible, the need for special Bank assistance to the market in the first quarter of 1981, when the central government surplus will drain cash out of the system.

The Chancellor and the Governor have concluded that such a change could indeed be made. A reduction in the ratio from 12½% to 10% of banks' eligible liabilities should enable the banking system to get through the revenue quarter without further sale and repurchase operations in gilts. The reduction would be justified on the ground that reserve assets are there to be run down at times of pressure. It would not create prudential risks. Nor would it prejudice decisions on future monetary controls or future prudential guidelines. The Chancellor and the Governor therefore propose to announce the reduction early in January, when the central government goes into surplus.

The scale of the problem is as follows. On present projections, the Government surplus is likely to take the cumulative cash shortage in the market from nearly £900 million at the end of banking December to about £3.2 billion by the end of banking April. (The shortage could be smaller if the Government's first



more than the £1 billion which would be released by reducing the RAR to 10%. Nor would it help to allow more private sector assets to count as reserves, for the same reason. Nor would it help to bring in gilts over one year (the present boundary), because this would make them more attractive to banks, and so could conflict with the objective of broadening the market in central government debt of this maturity.

If the Prime Minister is content, the Bank of England will announce the reduction in the RAR on or about 5 January.

A J WIGGINS







*Town*

*2/12/80*

PRINCIPAL PRIVATE SECRETARY

CC Sir D Wass  
Mr Ryrie  
Mr Burns  
~~Mr Middleton~~  
Mr Britton  
Mr Monck  
Mr Pirie  
Mr Riley  
Mrs Lomax  
Mr Turnbull  
Mr H Davies  
Mr Culpin

INTERIM ADJUSTMENTS TO THE RESERVE ASSET RATIO REQUIREMENT

The Financial Secretary has seen the paper by the Bank of England, which was under cover of Mr Monck's minute of 19 December. Since he has some doubts with the recommended course of action he has suggested that it will require great care in presentation.

However, the Financial Secretary does find the suggested course of action acceptable as a stop-gap measure until the RAR successor scheme is ready and has concluded that we should press on with the RAR successor scheme with all due haste.

*Roy Westwater*

R G WESTWATER

22 December 1980

*12/12*

