10. Monetary Base Control III

16/1/81
to
20/1/81

MR MIDDLETON

cc Mr Britton
Mrs Lomax
Mr Turnbull
Mr Pirie
Mr H Davies
Mr Pickford
Mr Culpin

MONETARY CONTROL

This is an excellent report on where we have got to, or not got to, by Mr Culpin. I agree with the bleak conclusion. Much of the substance was inherent in the November decision which never did offer substantial gains in monetary control for 1981/82. In a sense, the main deterioration since then is one of timing and presentation - that we can no longer make much of the changes, as envisaged by the Bank, as a step towards MBC etc.

2. I suggest the main points for discussion are whether the Treasury should reopen the issues of substance in paragraphs 12 and 16 of Mr Culpin's note. We are in a weak position because we do not have worked out alternatives which we think are:

a. workable or
b. a reliable source of better monetary control.

I do not think that we are likely to make much progress answering these questions by dialogues with the Bank or asking them for alternative proposals unless we get some kind of Ministerial backing. We therefore need to seek that backing on the basis of misgivings. This will call either for some tactics eg instructions from No 10 or some brief report to Ministers seeking endorsement for the proposition that we should try to get something better than is now on offer both for control and presentation. This could cover debt as well

3. As background to Mr Culpin's note I attach the two papers we have so far got out of the Bank and minutes of the first meeting. You already have copies of my letter to Mr George of 28 November and 23 December.

N.M.

N MONCK
16 January 1981

Reg file

MR MIDDLETON

cc Mr Monck
Mrs Lomax
Mr Pirie
Mr Turnbull
Mr Culpin
Mr Grice

FEU.

2/6/03G

MONETARY CONTROL: THE CASH RATIO

I have been reflecting on the arguement that the cash ratio must be abolished as part of a move to MBC.

2. If the ratio is redefined as a minimum then it is correct to argue that we can observe the banks' demand for cash by looking at excess reserves. If we were to use that information however and to move to MBC, then the existence of the cash ratio would matter. When we restricted the supply of base, the banks would have an incentive to reduce their required reserves by reducing their eligible liabilities. They might do this, as you said yesterday, by disintermediation.

3. If we wanted to preserve the cash ratio, but wanted to operate the system as a non-mandatory MBC, we could relate the cash ratio requirement to eligible liabilities well in arrears, or averaged over a long period. In that case there would still, as with any tax, be a continuing incentive to disintermediation, but there would be no possibility of thwarting the authorities' attempts to tighten the base by shifting funds backwards and forwards to and from overseas associates ("disintermediation at the margin").

A J C BRITTON
20 January 1981

984/1

MONETARY CONTROL WORKING GROUP

2/6/03 G

Distribution:
Those present
Mr Middleton
Mr Riley
Mr Grice
Mr Pickford
Mr Shields

Note of a meeting on 15 January 1981

Those present: Mr Monck (in the Chair)

Mr George	)	Mr Britton	)
Mr Goodhart	) Bank	Mrs Lomax	)
Mr Foot	)	Mr Pirie	)
		Mr Turnbull	) Treasury
		Mr H Davies	)
		Mr Culpin	)

The meeting discussed the Bank paper of 13 January on "Prudential and Monetary Control Considerations after the abolition of the Reserve Asset Ratio". This note takes that paper as read. Discussion concentrated on the recommendation that the eligibility of a bank's bills for rediscount should be made conditional on its keeping agreed amounts, on average, at call with the discount houses.

Orders of magnitude

2. The Bank thought that the Accepting Houses, the London and Scottish clearers, and 20 or 30 others would choose to be "eligible bill banks". Between them, they would probably hold about 85% of eligible liabilities.

3. At present, the discount houses held about £4½ billion of call money - roughly half the total reserve assets of the banking system. Under the arrangements the Bank were proposing, "eligible bill banks" might be required to keep about £3 billion at call. This would be a little over 5% of their eligible liabilities. If the requirement to keep £3 billion at call was spread instead over the whole banking system, it would cover about 4½% of total eligible liabilities.

The element of distortion

4. In one sense, the discrimination introduced by requiring some

11021

CONFIDENTIAL

banks but not others to keep money at call could be measured as the difference between a requirement applying to 5% of some banks' eligible liabilities and one applying to 4½% of all banks' eligible liabilities.

5. In a more general sense, any requirement would be a distortion if it caused some or all banks to behave in ways they would not otherwise have done, and so inhibited the authorities from observing banks' natural demand for cash. The Bank's proposal would not necessarily have this effect: for the reasons in paragraph 6 of the paper, the major banks might all choose to keep at least 5% of their eligible liabilities at call, whether there was a requirement or not. In that case, the requirement would be redundant.

<u>Consistency with other objectives</u>

6. The Bank said that the requirement would be publicly justified on monetary rather than prudential grounds. However, it would not be inconsistent with the Bank supervisors' concern with the "quality" of banks' liquidity.

7. Nor would it be inconsistent with a "gradual evolution towards a monetary base system", or indeed with any other changes in monetary control techniques. The Bank could not say what might follow "Stage 1", but nothing would be more difficult than it is now. No option would be closed off. Nor would any arrangements be introduced which could not later be changed.

8. The Treasury's main concern was that in shoring up call money, the proposal would reinforce a feature of the system which would be incompatible with MBC. The proposal might make MBC no more difficult to introduce, but it would not make it conspicuously easier either. It would, for instance, give the discount houses insufficient incentive to diversify out of call money into other liabilities. It might also inhibit the authorities from varying bill rates too aggressively, for fear that the discount houses would not be able to cope.

The alternative

9. The principal alternative to the Bank's proposal would be to run the unquantifiable risk that the supply of call money would dry up, that the bill market would wither and die, and that the Bank would have to intervene instead in the interbank market. The Bank's main objections to this were:-

i. In the interbank market, they would have to negotiate interest rates with the four big clearers. This could scarcely be described as a move towards greater market determination of interest rates. In the discount market, on the other hand, they could if they chose be price takers.

ii. In the interbank market, the clearers were bound to have the advantage, because they were the lenders of last resort to the rest of the system, and would effectively collude with each other: they could engineer market conditions to their advantage, and force the Bank to show its hand. In the discount market, on the other hand, the Bank could if need be take the upper hand, because the discount houses depended on the authorities' good favour, and their day-to-day dealings were not collusive.

10. The Treasury commented that the option of shifting the burden of intervention from the discount market to the interbank market would probably be as unpalatable after "Stage 1" as before. If it was ever to be faced, it was not clear that facing it now would be substantially more difficult than facing it later.

Timetable

11. The Bank said that before they could talk to the banks, they would need agreed negotiating instructions both on

the proposal to make the eligibility of bank bills conditional on banks holding call money with the discount market and on arrangements for financing the Bank. From the time the negotiating instructions were agreed, they expected to need at least two months to finalise arrangements. The supervisors would have to continue parallel discussions on liquidity.

Further work

12. The Treasury undertook to:-

i. tell the Bank within a week whether they had detailed operational comments on the money market paper discussed at the last meeting;

ii. draft a fairly detailed description of the option of intervening, if necessary, in the interbank market, so that Ministers could see what risks would be run if the Bank's proposal was not adopted.

13. The Bank undertook to:-

iii. submit a paper on the system of prudential supervision to follow the reserve assets ratio;

iv. reply in writing to paragraphs 8 and 9 of Mr Monck's letter to Mr George of 23 December;

v. revise the paper on money market operations.

14. In addition:-

vi. there was an inconclusive discussion about the possibility that banks would hold significant excess reserves if the availability and cost of cash to the system was in doubt: Mr Britton has written to Mr Goodhart about this (20 January);

vii. the Bank reported that they had written to the clearers about M2, and hoped for a reply within about two weeks;

viii. the Bank agreed to consider pulling together into one table the various components of the monetary base;

ix. the Bank and Treasury agreed to confer further about the legal implications of abolishing MLR and of changing Treasury bill arrangements.

ROBERT CULPIN

CONFIDENTIAL