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PART 9

8/7/1981 – 11/8/1981

Pages 149-166

NOTE OF A MEETING HELD IN THE CHANCELLOR OF THE EXCHEQUER'S ROOM, H.M. TREASURY ON WEDNESDAY, 22 JULY, 1981 AT 2.30 P.M.

Present:

Chancellor of the Exchequer
Sir Douglas Wass
Mr. Burns
Sir Kenneth Couzens
Mr. Ryrie
Mr. Middleton
Mr. Britton
Mr. Monck
Mr. H.J. Davies

Governor
Deputy Governor
Mr. J.S. Fforde
Mr. A.D. Loehnis
Mr. A.L. Coleby
Mr. E.A.J. George
Mr. C.A.E. Goodhart

PRIME MINISTER'S SEMINAR ON MONETARY CONTROL

The Chancellor noted that three papers had been prepared for submission to the Prime Minister, which - subject to any further points emerging from the present discussion - were agreed between the Treasury and the Bank. Mr. Walters had participated in their preparation, but had not shown them to the Prime Minister. The Prime Minister might also be interested in recent moves on debt management and funding techniques, which were the subject of a report prepared by the Treasury and the Bank earlier in the year. He proposed to send her a brief report on these questions, but saw no need for any substantial discussion of them at her seminar on 31 July.

The principle of monetary base control (MBC)

2. It was noted in discussion that the Prime Minister might seek to use the occasion of the seminar to extract a commitment to an eventual move to MBC. However, there was general agreement between the Treasury and the Bank (with Mr. Walters not dissenting that - whatever the merits of MBC as an ultimate objective - it would not be operable now. Given present uncertainties about what MBC would involve, and how it would work, it was essential to avoid any decision in principle in its favour at this stage.

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The Chancellor said he would speak to the Prime Minister about this in advance of the seminar. .

The practical arrangements

3. The Treasury and the Bank were fully agreed on the nature of the new arrangements, and on how they would be operated. It was noted that, although the Reserve Asset Ratio (RAR) would disappear, a development which - by itself - would permit a reduction in the bank total call money with the discount market from £5 billion to £3 billion, the banks had agreed not to make any significant changes in their liquidity until discussions with the Bank of England on prudential supervision had been completed; there was thus no question of the new arrangements precipitating rapid and radical changes in the financial markets. It was accepted that interest rates would continue - as in recent months - to be determined by reference to a variety of ~~factors~~, including movements in the exchange rate and developments in the economy more generally as well as movements in the monetary aggregates.

4. The question was raised whether the 20 August starting date for the new arrangements should be confirmed, despite the absence of the Chancellor and the Governor from their offices at that time. It was agreed, however, that to change this date - which everyone was expecting - would now look very odd; and for the reasons already given, no sharp change in market behaviour was to be expected. Plans should therefore go forward to implement the new arrangements on the present schedule.

Interest rate signals

5. It was agreed that - as previously envisaged - MLR should be suspended when the new arrangements came into effect. It was noted, however, that some mechanism would still be needed whereby the authorities could, if they so wished, enforce an immediate change in the general level of interest rates. This was in no way inconsistent with the general principle of the new arrangements that the structure of short-term interest rates should be determined by the financial markets. There was no question of

the Bank maintaining a continuously posted dealing rate; but it was accepted that the Bank would need to be ready to state its intention to move the level of the rate at which it was willing to deal, even if there was no market shortage on a particular day which would enable the Bank to enforce its view immediately through market operations. This device should be available not only in times of "crisis" (e.g. a sharp change in sentiment in the foreign exchange markets), but also as a policy step to be taken in association with other policy measures, for example in the Budget. New rates, once announced in this way by the Bank, would only be maintained until they were varied in the course of the Bank's market operations.

Announcement of the new arrangements

6. It was noted that, if the new arrangements were to come into force on 20 August, an announcement would be required by 5 August. The terms of this announcement would require careful consideration, particularly about what was said on the factors to be taken into account in determining interest rates. In view of previous Parliamentary statements (on 24 November 1980, and in the 1981 Budget) this might conveniently be made by means of a Written Answer on 3 or 4 August, if Parliament were still sitting. Mr. Middleton undertook to arrange for the production of a draft of the announcement, which would take into account the need to "de-politicise" decisions on interest rates to the maximum degree possible.

Conclusion

6. The Chancellor asked Mr. Middleton to review the covering paper for the Seminar, so as to take into account the points made in discussion, and to provide a short report for the Prime Minister on debt management and funding techniques. The papers for the Seminar should be sent to the Prime Minister on 24 July.

JW

A.J. WIGGINS

22 July 1981

Distribution

Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr. Burns
Sir Kenneth Couzens
Mr. Ryrie
Mr. Middleton
Mr. Britton
Mr. Monck
Mrs. Lomax
Mr. Turnbull
Mr. H.J. Davies
Mr. Ridley

PS/Governor of the Bank
of England

MONETARY CONTROL - PROVISIONS

Introduction

1 On 24 November 1980, the Bank published a Background Note describing a number of improvements to be made to the existing framework of monetary control. On 12 March this year, in a paper entitled "Monetary control: next steps", more detailed proposals on a number of the subjects covered in the Background Note were sent to all recognised banks and licensed deposit-takers (LDTs). The present paper sets out the provisions resulting from discussions since then with the various associations, as well as with a number of individual institutions.

The cash ratio

2 A substantial part of the Bank's resources and income in recent years has been provided by the average of 1 1/2% of Eligible Liabilities (ELs) maintained by the London clearing banks in non-interest-bearing accounts at the Bank. This sum has also served as a fulcrum for money market management. The Bank's paper in March proposed that this latter purpose should in future be served by the volume of operational funds which the London clearing banks would retain voluntarily at the Bank for clearing purposes, while the Bank's resources and income should additionally be secured primarily by a uniform requirement on all banks and LDTs to hold non-operational, non-interest-bearing deposits with the Bank. The provisions set out in this section have accordingly been designed to provide, in aggregate, broadly the same amount of non-interest-bearing funds initially as did the previous arrangements with the London clearing banks alone.

3 This non-operational requirement will be 1/2% of an institution's ELs and will apply to institutions covered in paragraph 16(i)-(iii) below having ELs which average £10 million or more in the latest period over which the requirement is calculated. The level of an institution's non-operational balance will be set twice a year in relation to its average ELs in the previous six months[1].

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[1] A deposit calculated in, say, May would relate to the monthly average of ELs from November to April inclusive.

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4 For institutions not on the present statistical list of banks and whose business mainly comprises the provision of fixed rate finance for periods in excess of one year, the Bank accepts that the introduction of the 1/2% cash ratio may present a special transitional problem. The Bank will be prepared to consider individual representations from such institutions for some temporary alleviation of the requirement. In addition, in recognition of the special conditions in Northern Ireland, the Bank has reduced to 1/4% the cash ratio to be observed by institutions for which Northern Ireland is the principal place of business in the United Kingdom. This concession will apply in respect only of the ELs of their Northern Ireland offices and will run for two years, when it will be reviewed.

5 ELs are to be redefined to reflect the changes set out in this paper. In future, offsets will be allowed in the calculation o ELs in respect of:

(i) funds (other than cash ratio deposits or Special Deposits placed with the Bank) lent by one institution in the newly defined monetary sector [1] to any other;

(ii) money at call placed with money brokers and gilt-edged jobbers in the Stock Exchange, and secured on gilt-edged stocks, Treasury bills, local authority bills and eligible bank bills.

6 ELs will be calculated in uniform fashion for all reporting institutions[2] except:

(i) members of the London Discount Market Association (LDMA), whose ELs will be calculated as the total of sterling deposits other than from institutions within the monetary sector and from money-brokers and gilt-edged jobbers in the Stock Exchange.

(ii) certain banks with money trading departments, who will be allowed to omit from their ELs secured money at call placed by other banks with these departments, up to a limit set by the Bank.[3]

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[1] See paragraph 16 below.

[2] The present arrangements for those finance houses which have observed a 10% reserve asset ratio since 1971 will lapse accordingly.

[3] The banks concerned are: Algemene Bank Nederland, Banque Belge, Charterhouse Japhet, Leopold Joseph and Samuel Montagu. Hitherto, funds placed on this basis, up to a limit set by the Bank, have counted as reserve assets.

7 It would be contrary to the objective of these agreed arrangements for any institution to reduce its ELs deliberately or artificially on reporting dates. The Bank accordingly reserves the right to make a spot check on the level of an institution's ELs on days when it would not normally report.

Special Deposits

8 The Special Deposits scheme remains in place and will apply to all institutions with ELs of £10 million or more at the latest make-up day for which figures are available[1]. As hitherto, calls will be set as a percentage of ELs. The scheme for Differential Special Deposits[2] has lapsed.

Eligibility

9 As set out in its March paper the Bank has judged applications, by recognised banks wishing their acceptances to become eligible for discount at the Bank, according to the following criteria:

(i) whether the applicant has and maintains a broadly based and substantial acceptance business in the United Kingdom;

(ii) whether its acceptances command the finest rates in the market for ineligible bills;

(iii) whether, in the case of foreign-owned banks, British banks enjoy reciprocal opportunities in the foreign owners' domestic market.

A first list of eligible banks is attached.

10 A bank may apply for eligibility at any time. An eligible bank which wishes to renounce its eligibility is free to do so on giving notice to the Bank.

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[1] Hitherto only banks on the statistical list and finance houses observing a reserve asset ratio have been subject to Special Deposits.

[2] Details can be found in the Bank's Quarterly Bulletin for March 1973.

Undertakings by eligible banks

11 From 20 August 1981, each eligible bank undertakes to maintain secured money with members of the LDMA and/or secured call money with money brokers and gilt-edged jobbers[1] - all at market rates appropriate to the nature of the lending - such that:

(i) the total funds so held normally average 6% of that bank's ELs (as defined in paragraph 5);

(ii) the amount held in the form of secured money with members of the LDMA does not normally fall below 4% of ELs (as defined in paragraph 5) on any day.

12 In relation to the above undertaking, each eligible bank will

(i) aim to meet the daily average ratio over either six or twelve month periods (having first notified the Bank of its choice of period), the ratio on any particular day in a banking month being calculated as a proportion of ELs at the last but one make-up day.[2]

and

(ii) to provide monthly returns of its daily figures, which the Bank will use to assess the bank's performance relative to its long-term commitment.

A bank will go below the minimum only in exceptional circumstances and will be ready to explain such action to the Bank when the relevan monthly return is made.

13 The Bank will be prepared to review these undertakings, 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 Bank will also be prepared to discuss particular difficulties, as they arise, with any party to the arrangements.

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[1] The Bank's concern with the adequate availability of funds for the efficient functioning of the gilt-edged market was noted in "Monetary control: next steps". There are six recognise money-brokers - James Capel & Co, Cazenove & Co, Hoare Govett (Moneybroking) Limited, Laurie Milbank & Co, Rowe & Pitman Money Broking and Sheppards and Chase. Secured call money with these firms has hitherto counted as a reserve asset. The amount of such money which these firms can take will continue to be limited by the Bank.

[2] For example, the relevant ELs figure for each day in banking September will be those as at make-up day in banking July.

Prudential considerations

14 The Bank has received the assurances mentioned in the Chancellor' Budget Speech, and in its paper of 12 March "The liquidity of banks", that those institutions in the United Kingdom to whom the reserve asset ratio has applied will discuss with the Bank in advance, in the course of the normal process of prudential supervisio by the Bank, changes in their policies for the management of their liquidity and its composition. The Bank is resuming discussions with the banks on a new prudential regime, on the basis of a new paper on liquidity measurement.

Statistical changes

15 The present banking sector, as defined for the purposes of calculating the monetary aggregates, contains those institutions included in the statistical list of banks and the list of discount market institutions. These lists were drawn up prior to the Banking Act and are no longer appropriate to current circumstances. They exclude a number of recognised banks, many LDTs, and also the trustee savings banks(1) (who are evolving towards banking status and who will become subject to cash ratio and Special Deposit requirements when they cease to be exempt institutions under the Banking Act).

16 A new monetary sector will therefore be defined, to include

(i) all recognised banks and LDTs;

(ii) National Girobank;

(iii) those banks in the Channel Islands and the Isle of Man which opt to join the cash ratio scheme described earlier in this paper;

(iv) the trustee savings banks (TSBs);

(v) the Banking Department of the Bank.

17 Although the population of the monetary sector will be considerab larger than that of the "statistical list", the statistical effect will be comparatively modest since the present business of many of the new contributors is relatively small. In total, the

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(1) The Central Trustee Savings Bank (CTSB) is a recognised bank.

initial once-for-all adjustment to the stock of the main monetary aggregate, £M3, will probably be of the order of £8 billion (13%), of which the TSBs account for around £6 billion (9 1/2%).

18 Institutions in the monetary sector having either eligible liabilities totalling £10 million or more, or a balance sheet of £100 million or more, will be asked to supply the full range of statistics (comprising both the monthly and other returns); other institutions will be asked to report only at end-calendar quarters.(1)

The timetable for change and the transitional arrangements

19 The essential features of the new arrangements can be brought rapidly into effect. This section sets out the sequence of developments.

20 On 20 August 1981:

(i) the Reserve Asset Ratio will be abolished;

(ii) the acceptances of all banks in the first list (attached) of eligible banks will become eligible for discount at the Bank;

(iii) all the banks covered in (ii) above will begin to observe the undertakings set out in paragraph 11 above;

(iv) the agreement with the London clearing banks, whereby they keep an average of 1 1/2% of their ELs at the Bank, will lapse;

(v) the Bank will receive the first deposits under the cash ratio requirement.

21 On this date, the first cash deposits will be placed by institutions on the present statistical list of banks and by members of the LDMA; the statistics necessary to include other institutions are not yet available. These initial deposits will relate to the average of institutions' ELs on the monthly make-up days in the period January-June 1981 inclusive, ELs being defined on a transitional basis: ie calculated for 'statistical banks' as at present except that offsets will be allowed in respect of all lending to the discount market and all secured money

(1) The TSBs will continue, for the time being, to make returns on the existing consolidated basis.

at call placed with money-brokers and gilt-edged jobbers and money-trading banks.[1] These initial deposits will remain unchanged until sufficient figures using the new definition of ELs are available (see paragraph 22 below). Thereafter, these deposits will be adjusted every six months. The undertakings by eligible banks as set out in paragraph 11 will take effect on 20 August 1981, also on the transitional definition of ELs and in respect of their level as at 15 July.

22 As soon as possible thereafter, (probably in respect of the make-up day in banking November) currently reporting institutions will be asked to produce figures for one reporting date both on the basis used hitherto and on the basis of the enlarged list of institutions comprising the new monetary sector. At the same time, those seventy or so institutions which are not currently on the statistical list of banks and which are above the cut-off points for full statistical reporting will join the full reporting network. They will be asked to place cash deposits with the Bank when two months' figures have been obtained, if their ELs are £10 million or more on average.

23 Monetary aggregates will be calculated on both bases for this one reporting date; thereafter statistics will only be collected on the basis of the new monetary sector.

24 The remaining institutions not currently reporting and below the cut-off points set out in paragraph 18 will be brought into the reporting network only when the current review of banking statistics has been completed (which is unlikely to be before the second half of 1982).

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[1] The Bank can calculate these offsets for listed banks from statistics already provided. The ELs of members of the LDMA will be calculated as set out in paragraph 6 above, except that no allowance will be possible in this transitional period for deposits by money-brokers and gilt-edged jobbers in the Stock Exchange.

CONFIDENTIAL

Chancellor of the Exchequer

cc Financial Secretary
Chief Secretary
Minister of State (L)
Minister of State (C)
Sir Douglas Wass
Mr Ryrie
Mr Burns
Sir Kenneth Couzens
Mr Hancock
Mr Britton
Mr Monck
Mr Kemp
Mrs Lomax
Mr Turnbull
Mr H Davies
Mr Lavelle
Mr Peretz
Mr Riley
Mr Grice
Mr Shields
Mr Bennett
Mr Ridley

THE PRIME MINISTER'S SEMINAR ON MONETARY CONTROL

I attach a revised covering brief, in the form in which it was sent over to No 10. The other papers are as circulated on 10 July. You will however need to substitute the attached pages in Papers I and II.

P E MIDDLETON
24 July 1981

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SEMINAR WITH THE PRIME MINISTER: NOTE BY OFFICIALS

1. In his Budget Statement the Chancellor said:

"Discussions are now to take place with the financial institutions about these and other changes, including the future of the cash ratio. When they are complete, the Bank will aim to keep very short-term interest rates within an unpublished band, and in due course suspend altogether the practice of having an announced MLR, which would by then have lost its operational significance."

2. The purpose of the seminar is:

a. to take note of the new arrangements. Some elements are in place already; a further set of changes will come into effect on 20 August.

b. to consider how the unpublished bands should be determined.

3. There are 3 papers which:

I. Describe the new arrangements and explain how they work.

II. Discuss the role which the narrow aggregates could play in monetary policy decisions.

III. Explain how the considerations set out in the Budget Speech might be brought together in taking interest rate decisions.

The papers have been prepared by a Working Group of officials from the Treasury and the Bank. Mr Walters (No 10) was a member of the Group.

The Arrangements (Paper I)

4. The arrangements follow from decisions taken at the Prime Minister's seminar last November. They were first described in the Chancellor's November 1980 statement and were carried forward in the 1981 Budget. They reflect extensive discussions with the financial institutions culminating in the Draft Provisions issued by the Bank in June (and shown to the Prime Minister by the Chancellor on 19 June). The Draft Provisions are attached for the sake of completeness, but all the relevant points are covered in

the paper.

5. There is no dispute about the form of the arrangements which are due to go into operation on 20 August. The intention behind the changes is to give the market a greater role in determining the term structure of interest rates and to enable the authorities to exercise influence over short term rates in a more flexible and less prominent fashion.

6. The Prime Minister particularly asked about the timing of the suspension of Minimum Lending Rate. Giving the market more of a role means giving the authorities less. Putting MLR into suspense is part of the new approach. We therefore recommend that MLR should be suspended on 20 August. This would gain the maximum presentational and operational advantage from the new arrangements. The Authorities' role in influencing some of the more politically sensitive rates, would become less direct and obvious.

7. But when this has been done the Authorities will be unable to give such clear signals about their immediate interest rate intentions. In particular they will have considerably less direct influence over base rates and mortgage rates.

8. There may however be occasions when the Authorities will wish to signal changes in interest rates before a change in the Bank's market operations can become fully effective. The most obvious circumstances would be in response to sharp fluctuations in the foreign exchange markets. These occasions will be exceptional. But, in presenting the new arrangements, it will need to be made clear the Authorities will retain the capacity, on occasion, to signal in advance the rate at which they will provide cash to the market.

This issue is considered in paras 35-38 of Paper I.

Setting Short Term Interest Rates

9. The other two papers discuss the crucial issue of how we first set, and then change, the band within which very short rates (ie up to 14 days) are allowed to fluctuate.

10. The Government is presently committed to £M3 as the basis for its medium term strategy.

11. The Government also restated its annual targets in terms of £M3 in the Budget, while recognising that other factors needed to be taken into account in determining short-term interest rates.

12. The Prime Minister in her minute of 4 June to the Chancellor of the Exchequer said that she believed that we must switch to a system of quantitative control sooner rather than later. So the group has concentrated on those changes which seem to be practical possibilities for immediate implementation.

13. The new arrangements are consistent with a widening of the interest rate bands and moving to monetary base control. But none of us is advocating an immediate move to a monetary base regime which would exclusively determine short-term interest rates. The changes we have considered are those which to quote the Budget Speech are:

> "Desirable in their own right and consistent with a gradual evolution to monetary base control."

14. The immediate issue, as we see it, concerns the determination of the band for short-term interest rates. Broadly speaking there are two options:

a. Make this decision depend primarily on one or other of narrow aggregates - essentially the choice is between M1 and the wide monetary base. This would mean abandoning the annual £M3 target. We do not regard the option of dual targets - eg for M1 and £M3 - as viable.

b. Retain an annual target for £M3 and set the interest rate band on the basis set out in the Budget Speech. This said:

> "Decisions about short-term interest rates will continue to take account of the whole range of monetary indicators referred to earlier and other factors that affect the significance of the numbers, especially the progress of inflation."

The other factors included: the narrow aggregates, the exchange rate and the real cost of borrowing.

We all agree that whichever option is adopted it would be necessary to retain some discretion to depart from the set criteria, in special circumstances.

The Narrow Aggregates (Paper II)

15. The paper sets out the implications of moving to the narrower aggregates:

a. the narrow aggregates are not demonstrably inferior to £M3 in predicting long run trends in inflation. Like all aggregates, however, they show large and erratic short-run variations which are not closely associated with movements in nominal incomes.

b. M1 would be easier to influence by changes in the level of short term interest rates than £M3. But it does not have the same obvious links with expenditure and tax policy. And the response of M1 to interest rates is still subject to a margin of error.

c. M_o, the monetary base, would be more difficult to control by changing the level of interest rates than M1 (and possibly than £M3).

d. It would be possible (subject to the qualification in b above) to relate interest rate decisions to a quantitative objective for the growth of M1 over 6-9 month periods.

e. An immediate move to M1 would mean either adopting figures which seem high both in relation to the £M3 targets and to nominal incomes, or accepting high real interest rates.

f. Such an objective for M1 would make it difficult and sometimes impossible to meet, at the same time, an annual target for £M3. There might also be some conflict with the medium term £M3 targets; these would cease to have much day to day operational significance though they would remain very important at Budget time.

g. In the event of a narrow aggregate deviating from target, the presumption would be - much more clearly than with £M3 -

that the initial response should be to change the level of short-term interest rates. This instrument would not, therefore, be available to meet other objectives, without adverse implications for achieving the target for the narrow aggregate.

£M3 Plus Other Factors (Paper III)

16. The paper explains the implications of retaining the annual £M3 target and the associated considerations set out in the Budget Speech:

a. It follows directly from the Budget Speech, and is more obviously consistent with the MTFS. It would not need a new announcement, though we might wish to give more explanation of how the various factors were to be taken into account.

b. It provides a less clear guide to changes in the interest rate bands. £M3 responds to the structure of interest rates as well as the general level of interest rates. It can be unpredictable in the short term, and can take a long time to respond.

c. The additional factors to be taken into account are difficult to quantify.

d. Decisions would be taken with a longer forward timescale in mind, and in practice are likely to be taken less frequently.

e. It appears to be more flexible because it gives the authorities greater discretion, whereas an M1 approach might look more rigid. This flexibility will however be seen as a disadvantage by those who want to give maximum weight to preventing shocks coming through on to the money supply.

17. In one way or another a range of factors will be taken into account in arriving at decisions on interest rates; this has been stated repeatedly by Ministers since the Green Paper on Monetary Control. The choice between the two approaches is one of emphasis in determining the bands - primacy to M1 or primacy to £M3.

Presentation

18. If interest rates are to fluctuate more, changes in the interest rate bands should be seen as a natural response to the criteria by which interest rates are set. We need to do everything we can to ensure that changes, whether up or down, are not seen as overt political acts. So far as possible Ministers need to stick to the line taken by the Prime Minister in Ottawa and avoid commenting on particular actions by the Authorities in the money markets or on changes in particular interest rates.

PEM
24 July 1981