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PART 3

15/4/1981 – 30/6/1981

Pages 35-54

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10 DOWNING STREET

MR. MIDDLETON

I propose to send this to the Prime Minister. Can you see anything drastically wrong with it?

Alan

22 April 1981 ALAN WALTERS

cc Mr. Wolfson
Mr. Hoskyns
Mr. Strauss
Mr. Duguid
Mr. Lankester

1079/4

NOTES ON MONETARY BASE CONTROL

Replacement of the Cash Ratio

It seems that the negotiation about finding a form of income for the Bank, other than the income on the 1½% interest free deposits of the Clearing Bank at the Bank of England, is not proceeding very speedily. It is clear why the Bank is reluctant to give up this very secure form of income and is finding difficulty in replacing it with a similar form of income.

At present the Bank is doubly blessed. The deposits of the Clearing Banks expand at roughly the same rate as the money gross national product (probably the rate is slightly slower than the GNP but there is little in it). At least we can take it that they expand in line with the rate of inflation. In short the deposits themselves are indexed. But the rate of interest which the Bank will make by investing that 1½% of Clearing Bank deposits on the market also increases, and in fact of course massively increases, according to the rate of inflation. Market interest rates reflect these rates rather well.

One can see the effect on Bank income of inflation is in fact rather startling. The base, as we have argued above, is indexed. But also if the rate of inflation increases say from 9% to 18%, and interest rates follow those values, then the Bank's income, already indexed, will double over and above that indexing. (This is, of course, something like the experience of the economy over 1978-1980.)

The important point to note here is that the Bank's income is not simply indexed, nor indeed is it doubly indexed, the Bank's indexed income is raised according to the multiple of the inflation rate. Thus if inflation trebled the Bank's indexed income, that is to say the Bank's real income, would be trebled.

Let Ro be 1½% reserves of deposits of Clearing Banks at period 0.

Pt be price index (RPI) based on Po = 1.00 for period t.

Then if Rt = RoPt (that is to say the Clearing Bank deposits expand with the price level)
and if the nominal interest rate is equal to the rate of inflation, the Bank's income is

$$(RoPt)\left(\frac{1}{Pt} \cdot \frac{dPt}{dt}\right)$$

which consists of the indexed income (RoPt) multiplied by the rate of inflation $\left(\frac{1}{Pt} \cdot \frac{dPt}{dt}\right)$ - note this is the rate of inflation and not the level of the price index.

Although the issue of the Bank's income was raised in association with the possibility of movement to monetary base control, there appear to be very strong grounds both in terms of efficiency in Government administration and spending, and in terms of equity for a radical change in the Bank's income. The Bank is one of the few public institutions that not only does not have cash limits but, during inflations, is absolutely showered with cash. This may explain the high salaries and fringe benefits paid to Bank staff.

It is also rather morally ambiguous that the Bank preaches on the one hand the need for stringent controls of Government spending, and on the other hand they ensure that no such limitations appear in their cash accounts. It seems remarkable that the press and media have not pounced on to this anomaly before.

22 April 1981

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H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-233 3000
Direct Dialling 01-233 5627

P E Middleton
Deputy ~~XXXXX~~ Secretary

28 April 1981

A Walters Esq
10 Downing Street
Whitehall

Dear Alan

Thank you for giving me an opportunity for commenting on your note of 22 April about the replacement of the cash ratio. I agree generally with your point that the Bank does very well in terms of income out of what is in effect a tax which they levy on the banking system. But there are one or two points which you might like to take on board.

First, I am not sure that it is true to say that negotiations on the Bank's income are proceeding all that slowly. As I understand it the Governor has just about clinched an arrangement under which the banking system as a whole - not just the clearers - holds a minimum ½ per cent plus working balances with the Bank of England. It is of course true that any such system produces cyclical fluctuations in the Bank's income. Last year's operating profit will be of the order of £70 million compared with between £20 million and £28 million over the last three years, and about half that in the previous five years. But quite what constitutes an excessive income is a matter of judgement, and you do not need me to tell you that this is a matter on which the Bank have exceedingly sensitive feelings.

You ought to mention that the Bank has cash limits on expenditure which it incurs on behalf of HMG - the note issue, transactions in gilts and foreign exchange operations. And for the sake of completeness you ought also to make it clear that the Bank does pay the Treasury each year a dividend. Though I would not pretend this is a perfect instrument both because it has to be negotiated and because there are some issues of principle between ourselves and the Bank about who is entitled to any surplus income which the Bank gets from the banking system - the dividend is a way of ensuring that some of any excess profits come to the Exchequer.

Just one further point. The Bank's income is of course an important factor in their ability to pay generous salaries. But they argue that they have to compete with the banking system - whose salaries are certainly excessive in my view. This is probably a more important factor in determining pay and perks etc than simply the size of the Bank's income.

Yours ever

Peter

P E MIDDLETON

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Mr Burns
Sir K Couzens
Mr Ryrie
Mr Middleton
Mr Monck
Mr Unwin
Mr Turnbull
Mr Ridley
Mr A Walters) No.10
Mr T Lankester)

NOTE FOR THE RECORD

MONETARY BASE CONTROL

Mr Allan Walters called on the Chancellor this morning at 10.00 a.m. Mr Burns, Mr Middleton and Mr Ridley were also present.

2. Mr Walters said he felt that now the Budget was out of the way, the Government should take the decision to move to Monetary Base Control (MBC). He had no objection to the use of £M3 as an aggregate to be monitored, and he thought it appropriate that £M3 should be the focus of the MTFS. However, in the short run he thought the monetary base should be the control variable. His concern was to de-politicise decisions on interest rate movements; at present it appeared that MLR movements were very substantially affected by the requirements of the political situation. MBC by contrast would allow interest rates to be set by reference to an objective rule. In establishing such a rule, the move to MBC would fill a clear gap in the Government's current policy stance. There should be no particular difficulty about choosing numbers for a monetary base target, although a decision would be needed about the time period over which the authorities would aim to hit a target. Decisions would be needed about the future of the discount market, and perhaps also about the operation of building societies.

3. The Chancellor noted that Professor Griffiths, who had been an advocate of MBC, had recently produced a paper which argued for the retention of £M3 as the target variable. Given the extent of the Government's commitment to £M3, it would be very difficult to move away from this without a major change in the presentation

/of policy.

1337/10

of policy. At the least it would seem sensible to wait until the next Budget; for the current year the £M3 target would have to remain. Although the movement of £M3 during the course of 1980 had given rise to serious problems, £M3 had proved a more reliable current policy in the circumstances of the earlier 1970s. There were reasons for thinking that last year's experience was likely to prove wholly exceptional; the 1979 switch from direct to indirect taxation, coupled with the removal of exchange, price and dividend controls could be seen as having resulted in a once-for-all shift in the demand for money. Mr Walters noted that the monetary base would in practice have given the right signals about interest rate movements in the latter part of 1980; while movements in £M3 gave no support to the interest rate reductions implemented by the authorities, the very slow growth of the monetary base would have provided a clear explanation for them.

4. In further discussion, Mr Burns and Mr Middleton said they thought the substance of the issue was how far the Government wanted to move now towards a situation in which the monetary base was the sole determinant of short-term interest rates. It was questionable how far it would be sensible at this stage to emphasise the monetary base to the exclusion of other factors. So far policy had been cautious and pragmatic, with the authorities seeking to learn from the market's response to each step towards a greater role for them in the determination of interest rates. Given the very slow growth of the monetary base and other narrow aggregates over the last eightee months, it was questionable how far the authorities should now limit the flexibility within which they would operate; it seemed likely that it would continue to be necessary to take some account of movements other aggregates and in the exchange rate.

5. Meanwhile it seemed undesirable for the authorities to commit themselves too deeply to the early introduction of MBC. Further

/work still needed to

work still needed to be done on the relationships between the monetary base and the various monetary aggregates. In these circumstances it would be better to concentrate for the time being on the further steps already outlined by the Chancellor for improving short-run monetary management: the introduction of the (unpublished) band within which interest rates would fluctuate, and the spension of MLR. While it now seemed likely that the cash ratio would have to remain, although transformed into a minimum applicable to all banks instead of an average applicable only to the clearers, the Bank had introduced a useful measure of flexibility into the reserve asset ratio. The best course seemed to be to work towards the successful implementation of these further changes, while at the same time paying close attention to movements in the monetary base and the narrower monetary aggregates. In this way the authorities might hope to learn more about controlling the base and M1 by regarding them as in a sense "shadow targets", without any commitment to a move away from £M3. It was noted that the monetary base seemed to have moved fairly closely in line with M1, and that operating by reference to a six month average of the monetary base might not be very different from using M1 as the target variable. As well as moves to enhance the role of the markets and setting short-term interest rates, further attention should be given to possible funding initiatives in the fields of indexed debt and national savings.

6. It was agreed in the light of the discussion that it would be appropriate to stick to the programme of monetary control changes already outlined by the Chancellor. At Mr Walters' suggestion, <u>Mr Middleton</u> undertook to provide a note setting out a possible timetable for the work needed to reach the necessary further decisions in this field, which could then form the basis for a discussion with the Bank. <u>Mr Walters</u> would thus be associated with the Treasury in keeping up the pressure on the Bank to ensure that they made the promised changes.

JW

A J WIGGINS
28 April 1981

Mr Monck, produce pl. Folder

BAN

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

1 May 1981

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

Dear Peter

MONETARY CONTROL: NEXT STEPS

When we met on Monday of this week I said that we hoped to have by today a progress report on the negotiations we have been conducting on this matter. The report is now ready and is being submitted to the Governors this afternoon. I enclose a copy for circulation in the Treasury. Perhaps we could go over any comments you may have at our next weekly chat.

I will keep you informed of further developments.

Yours ever

John Fforde.

5/5.

THE PROGRESS OF THE MONETARY CONTROL NEGOTIATIONS

A Summary

1 The Bank has now established the provisional views of all the main banking associations, and checked that the Channel Island and Isle of Man authorities are content to co-operate.

2 In general, there has been a reasonably ungrudging acceptance of the principles contained in the two main proposals of "Monetary Control: Next Steps" - namely that:

(a) the banking system should provide adequate income and resources for the Bank;

(b) there should be measures, at least initially, to ensure the continued health and efficiency of the bill markets.

3 We have undoubtedly been helped in the negotiations to date by the fact that it is possible to demonstrate that the proposals promote equality of competition across the banking system. Nevertheless, there have been pleas from several groups for special treatment and definite misgivings, mainly on the part of the London clearers (Chief Executive Officers and Treasurers), about how the proposals for the bill markets might work in practice (see section B below).

4 On the requests for special treatment, a number of those involved have yet to present their case in full. When they have done so, it will be necessary to decide what response to make; but none of the questions at issue threaten the central tenets of "Monetary Control: Next Steps". The London clearers present a more difficult problem; but we think that we can go some way to meet their worries without losing sight of our objectives and hope to conclude negotiations on that basis by mid-May.

5 If so, it should be possible to draft fairly swiftly a definitive set of proposals, taking into account the outcome of the present negotiations. We shall also have to face up to a

number of interrelated questions on statistics and on the timing of the proposed changes and, while these are not directly related to this note, they are illustrated briefly in section C. At the same time, it would be possible to get on with establishing the credentials of those presently ineligible banks who wish to join the arrangements so that their bills became eligible. Here the issue of which countries pass the reciprocity test will have to be settled.

B <u>The position on our proposals in "Monetary Control: Next Steps"</u>

(i) <u>The cash ratio proposal</u>

6 After consultations with the London clearers individually on the likely size of their <u>operational</u> balances, the Bank decided to propose at the outset that the <u>non-operational</u> requirement should be ½% of eligible liabilities (ELs) for banks and Licensed deposit-takers (LDTs) with a de minimis exemption of £10 million of ELs. The detail of the proposal put to the various banking associations - which includes a different treatment for the discount market - is attached as Annex 1 to this paper.[1]

7 The London clearers naturally saw this as a considerable improvement on the existing position. The other banking associations tended to start from the position that the requirement should be based on the level of non-interest-bearing ELs ("because the clearers' current accounts were costless"). However, this is a weak argument and, on the understanding that the required ratio would not be used as a monetary control nor raised except to meet a serious shortfall in the Bank's income, most associations were prepared to accept it - not least because they recognised the strength of the argument that it left competitors within the banking system on an equal footing. There was no serious suggestion that any denominator other than ELs should be used.

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[1] The Channel Islands and the Isle of Man seem prepared to introduce parallel arrangements. We have not yet approached the Giro for their agreement but foresee no problem here.

8 There are, however, four outstanding questions:

(a) the Northern Irish are asking for a remission of this burden, in view of conditions in Ireland. As the Civil Service dispute prevented them from getting to London when they were due, we do not yet know how hard they will press us.

(b) The old group of "10% finance houses" have a particular problem with our proposals, because hitherto they have been allowed to exclude all funds borrowed from banks and bills drawn under acceptance credits in calculating their ELs; they thereby greatly reduced their ELs. As part of the development of more equal competition, we want everyone to calculate ELs in the same fashion (see Annex 1) and ½% cash ratio on ELs defined as we have proposed could come as a major worsening of the climate for these houses. (It is not clear, in fact, just how much the requirement would cost in net terms, mainly because these institutions should find it cheaper to raise money on the inter-bank market: loans to them would qualify as an offset to the lenders' ELs, whereas they do not now.) The Finance Houses Association is pressing a case for the requirement to be delayed in respect of all their members for up to 2 years. Their strongest point in claiming preferential treatment over other banks and LDTs who also pay nothing currently is that much of their lending is fixed-rate and relatively long-term, in contrast to other banks and LDTs whose loan conditions and shorter maturity of loans could permit them to pass on the cost of the requirement more quickly.

(c) Some banks (notably the clearers) are worried that the detail of our proposals would make it worthwhile for non-clearers to window-dress their balance sheets on make-up days, so as to minimise their ½% liability. There is no evidence that the reserve asset ratio - which may often have given a bigger incentive - has led to window-dressing but we are looking to see if the risk can be reduced without overburdening the banks with requests for statistical reports.

(d) Many LDTs are well above the proposed de minimis limit and probably don't yet realise that we shall be asking them to pay. They may not object strongly; if they do, the option of raising the threshold would pose other problems, notably to increase the pressure on us to make the exempt sum an allowance for all rather than a de minimis provision, which would force the Bank to ask fo

While some of these points may not be easy to resolve, they do not raise major questions of principle.

(ii) The bill markets

9 Here too, the Bank provided the associations with somewhat more detailed proposals than were contained in "Monetary Control: Next Steps"; they are attached as Annex 2.

10 The non-clearing banks who are currently eligible accepted the proposals, having established that no bank would be dropped from the present list because its country of origin or ownership did not meet the test of reciprocity. They also had a number of technical questions on the calculation and operation of our limits, for monetary control purposes, on the bills of any one acceptor which the Bank would hold. It was possible to reassure them on these technical points.

11 Associations primarily representing banks not currently eligible had rather different concerns. But it would be fair to say that, with the exception of the main point worrying the clearers (which is discussed below and with which a number of other associations agreed if with less force), concern was not over the price of entry to the "club" but over the size of the hurdles to membership. The question of reciprocity featured regularly and it is clear that, as with the same question in connection with the lead management of sterling capital issues (which is open to foreign issuing houses only if their countries give reciprocal freedom to UK issuers) the process of establishing reciprocity in countries like Japan will take considerable effort.[1]

12 For the rest, most potential applicants were reassured when they realised that we do indeed want the eligibility list extended, for monetary control reasons. The major remaining fear was that the Bank would give limits that were unduly low to newcomers. For our part, it was made clear that there was much to be done before limits could be calculated and it was not clear, therefore, that there would be a problem, even in the case of UK branches of foreign banks who were particularly worried about the way the Bank

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[1] There is also the question of how to treat the consortium banks, who are foreign-owned but who regard themselves as British.

would calculate limits for them[1]. The Bank also pointed out that limits would be reviewed over time.

13 The London clearers (Chief Executive Officers and Treasurers), while supporting our objectives in principle, were much less content with them in detail and at our invitation have formulated counter-proposals of their own. In essence, their objection is that the discount houses would have too much bargaining power under our proposals and thus, at times, would be able to drive down unreasonably the rates they offer to the banks for secured deposits. Similar worries were voiced by several other associations, though these were largely stilled by our explanation of how we saw the system working.

14 We feel that the clearers' concern is misplaced and at our meeting with them drew attention to:

(a) the fact that the proposed minimum and daily average figures for secured funds with the houses are far below the levels currently required from banks under the reserve asset ratio requirement and are likely to be below the levels the houses will be seeking;

(b) the proposed requirement could be met by secured funds of <u>any</u> maturity, leaving the banks free to negotiate on maturity as well as rate;

(c) the houses understand the importance of making the proposed arrangements work properly.

15 The clearers drew up counter-proposals after the meeting. However, these are not acceptable to us, because they would leave banks free to hold large quantities of bills themselves rather than place funds with the discount market. In such circumstances, the houses could not make an adequate market and we could not readily offset prospective cash shortages.

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(1) Branches, of course, have no capital. The Bank propose to calculate a notional capital for the UK branch of a foreign bank by allocating its worldwide capital between the UK and elsewhere in the ratio of its UK sterling business to its business elsewhere.

16 In our turn, we shall now be putting revised proposals to the clearers. In part these will represent a clarification and extension of our earlier analysis, for when we met them we were unable to explore the implications for them of the Bank's open-market operations in the new arrangements in support of the interest rate band. These operations should in fact prevent short-term rates falling away, except at the end of the day (when the Bank has stopped dealing) and thereby encourage the houses to bid up for funds. Further, when the Bank is selling bills to support very short interest rates, we shall offer bills to both the houses and the banks, thereby giving the latter a direct alternative to the discount market for surplus funds. At present only the market appreciates this (and accepts it); when the clearers do, it should ease their concern. We shall also be offering a series of minor concessions to the clearers. These involve understandings that we will review the working of the arrangements when sufficient experience has been gained and that we are open at any time to representations about abuse of the system. We shall also be offering a very limited "escape clause" from the minimum daily requirement, a longer period over which the average requirement has to be met and the public statement in the final proposals that "secured loans to the discount houses should be at a suitable market rate". This last "concession" is empty of content but it seems the clearers place value on it. On this basis we hope to reach agreement.

(iii) Finance for the gilt-edged market

17 Only the London clearers have raised objections to the Bank's proposal and their counter-proposal here too is unacceptable to the Bank. However, it is doubtful whether the clearers attach much weight to this point and a clarification of the way we propose to operate the requirement should reduce their concern still further.

(iv) Miscellaneous points

18 One plea for special treatment which does not fall naturally in sub-sections (i)-(iii) above is a request by the five money-trading banks to be allowed to keep their present privilege of having a limited amount of the secured funds placed with them treated on a

par with similar funds placed with the discount market[1]. By this they mean, for example, that the supervisors should regard such funds as high quality liquidity. Discussions are continuing; the amount of money involved - some £100 million - is small, but there are intrinsic difficulties for the supervisors in meeting their request.

19 A second point to note is that the supervisors are having no difficulty in getting the assurances requested in their last paper as to banks' liquidity management once the reserve asset ratio is abolished.

C Looking ahead to questions of the timing of changes and the introduction of statistical changes

20 The broad question of when to abolish the reserve asset ratio requirement, and to introduce cash ratio and eligibility proposals raise issues beyond the confines of this note but will need to be discussed in the near future. However, on purely statistical topics, the following points are worth noting:

(a) the full implementation of the cash ratio requirements involves a major recalculation of ELs by all banks currently reporting and the extension of at least some of our reporting requirements to a substantial number of banks and LDTs - perhaps about 80 - unfamiliar with our statistical needs. Transitional arrangements involving a certain amount of rough and ready justice are possible but it is clear that the system cannot be fully implemented quickly.

(b) The arrangements in support of the bill and gilt-edged markets cannot be introduced until a new list of eligible banks has been created. Work is already in hand on this.

(c) There is the question of when the new Monetary Sector (including all recognised banks and LDTs) might be introduced (in principle and in practice). Much of the process of redefining ELs will be a vital input to the "creation" of the Monetary Sector but there are also other important questions - such as the treatment of the Trustee Savings Banks - closely associated with the timing of the consequent break(s) in the £M3 series

(1) Currently, such funds - within strict limits - rank as reserve assets.

(d) Finally, there is the question of how the changes considered above fit with the Bank's proposed Review of Banking Statistics, where the potential agenda is already extensive. The presumption must be that the implementation of the more urgent changes proposed in "Monetary Control: Next Steps" cannot await the outcome of the Review but this will leave the statisticians (and the banks) with a number of problems.

21 The implication of the above is that, before publication of our definitive proposals on monetary control, we shall need - so far as possible - to agree a timetable (including transitional arrangement where appropriate) for the changes proposed and for the closely related statistical questions of the new Monetary Sector.

22 If the reserve asset ratio is to be abolished quickly, it would seem best to devise an interim scheme under which the ½% cash ratio and the arrangements in support of the discount market could be introduced - and the reserve ratio dropped - using current statistical coverage and definitions. This could, for example, involve adjusting reporting banks' ELs insofar as existing information allows, applying the cash ratio initially to all those who currently complete statistical returns, and publication of a provisional list of "eligible" banks. The implications of such an interim step are being investigated but it might be possible to implement it from make-up day in June or July.

NON-OPERATIONAL CASH RATIO PROPOSALS

(a) The requirement should apply to all recognised banks and licensed deposit-takers (LDTs) subject to a de minimis threshold of ELs of £10 mn; except, in the case of the members of the London Discount Market Association, where the Bank propose that they should contribute ½% of their deposits other than from UK banks, subject to the same threshold.

(b) Funds lent by any institution covered in (a) to any bank or LDT (including those below the de minimis threshold) or to Channel Island or Isle of Man banks could be counted as an offset to the lender's ELs (subject to suitable arrangements being made with the Channel Island and Isle of Man authorities and institutions).

(c) A number of changes to the present method of calculating ELs ar proposed: notably

(i) all funds with discount houses, plus secured call money with money brokers and jobbers, could be offset against ELs. (At present, only non-reserve lending to discount houses can be offset.)

(ii) Operational balances at the Bank should also be offsettable against ELs (currently these balances are reserve assets and are not offsettable).

(iii) all institutions would calculate their ELs in a common fashion; those finance houses currently subject to credi control and who calculate their ELs as the sum of their non-bank deposits would switch to the standard form.

(d) The level of an institution's non-operating cash balance should be set every March or September, on the basis of the average of its ELs on the six previous monthly make-up days.(1) (This would avoid the need to review every institution's deposit every month.)

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(1) The change to be made on, say, the fourth Monday after the last relevant mid-month reporting date.

THE MECHANICS OF THE SECURED DEPOSIT RATIO

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

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

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

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

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

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

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

17

MR MIDDLETON

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

MONETARY CONTROL: NEXT STEPS

You asked for advice on the progress report Mr Fforde sent you on 21 May. He suggested that you should go over any comments with him at your weekly talk. I think there is little in this progress report that is new or that causes either surprise or concern.

2. One striking omission from our point of view is that the report no where estimates the income that the new requirement for non-operational balances equal to ½% of ELs will yield or compares it with the old arrangement. I asked Mr George last week to let us have a simple statement containing this comparison. He agreed, but I suggest you mention that we must have a written and quantitative statement along these lines. Under the new arrangements the ½% requirement would provide the Bank with non-interest bearing balances approaching £350 million (not the full amount because of the "offsetting" rules under special arrangements for the discount houses described in Annex 1). In addition the Bank will benefit from the voluntary operational balances of the clearers which will start at about £150 million. My impression is that this will leave the Bank in roughly the same position as it is now. Mr George thought it would be slightly less well off.

3. Secondly, you might welcome the attitude to the timetable expressed in paragraphs 20 and 22. I am sure it is right to operate "an interim scheme" using current statistical coverage and definitions rather than wait for everything to be sorted out. Even so, it would have taken from last November to make-up day in June or July even to reach that stage.

4. Thirdly, you might check that there is no question of relaxing the effective cash requirement that the clearers and any other banks with operational balances have to hold with the Bank on a daily basis. Since the ½% of ELs is a non-operational balance which cannot be varied, the minimum is effectively zero and depends on the Bank refusing an overdraft.

I think they intend to do this in all but exceptional circumstances. What I am not sure is whether the exceptional circumstances are sufficiently exceptional to be acceptable. They certainly will be rare in view of the £150 million of voluntary balances the clearers intend to hold on average.

5. You might also take the opportunity to take up with Mr Fforde the inadequacy of his letter of 10 April which replied to yours of 11 March (see paragraphs 2-5 of Mr Turnbull's note of 16 April).

6. Two points of interest in the progress report which do not need to be raised with Mr Fforde are:

a. the clearers' concern that the ½% requirement would not be used as a monetary control (see paragraph 7 of the progress report). I do not see that there is any prospect of this and I think we can accept the understanding that it will not be;

b. although in paragraph 15 the Bank rejects the clearers' proposal that they should be free to hold large quantities of bills themselves rather than place funds with the discount market. But paragraph 16 says that when the Bank is selling bills to support short interest rates, they will offer bills to the banks as well as to the discount houses.

7. If anyone else has points on the progress report, perhaps they could let you have them in time for your talk with Mr Fforde, which I understand may take place this evening.

NM

N MONCK
11 May 1981