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PART 10

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Pages 167-186

AMENDMENTS TO MONETARY CONTROL: THE NEW ARRANGEMENTS

Paragraph 3: after (II) delete "Transitional problems:" and insert "Suspending" to read:

"(II) Suspending Minimum Lending Rate."

Paragraph 33: in the fourth sentence delete "will shortly be" and replace with "is" to read:

"The Bank is resuming discussions with the banks ..."

Before paragraph 35 after (II) delete "Transitional Problems:" and insert "Suspending".

Paragraph 35 should end after the first sentence. The rest of that paragraph becomes new paragraph 36.

Old paragraph 36 becomes new paragraph 37.

Delete existing paragraphs 37 and 38 and substitute the following paragraph 38:

"38. There may be occasions when a substantial change in short-term interest rates is either required immediately or needs to be timed to coincide with policy action in other fields. The Bank of England's open market operations could not be relied on to ensure that such changes would occur to the right extent and at the right time. In such exceptional circumstances, when the Authorities consider that an immediate signal about such a move is necessary, it will still be possible to give one by announcing in advance the rate at which the Bank will provide cash on the next available occasion. Thereafter the normal arrangements, under which no advance announcements about rates would be made, would be resumed."

was non-monetary in origin: the increase in world export prices in 1973-5 was preceded by a sharp rise in world monetary growth in 1971/72, echoes of which can be seen in the UK for both the broad and narrow aggregates.

9. This explanation does not resolve all the problems about the monetary origins of the 1975 inflation, but it casts doubt on the popular view that the behaviour of £M3 and M1 in the early '70's proves conclusively that, for the UK, broad aggregates are more economically significant than the narrow ones. The period 1972-75 aside, M1 has been slightly better than £M3 in predicting the rate of inflation and since 1978, M1 has been distinctly better, with £M3 showing a marked tendency to under-forecast the rise in prices that occurred.

10. The more important point, however, is that simple relationships between money (and money alone) and prices are not very good at tracking movements in inflation over periods as short as 2-5 years, though they may be adequate for explaining long run trends. Inflationary shocks of various sorts - stemming from movements in world oil prices changes in tax policies, income policies and their aftermath etc. - may significantly affect the speed with which prices respond to movements in the money supply. Even though these fluctuations may be ironed out in the long term, they can be very important in determining prices in the short to medium term. But over the long term, as noted above, the various monetary aggregates tend to move fairly closely together.

11. This suggests that it is not possible to discriminate adequately between the different monetary aggregates on the basis of their relationship with prices. Restraining the rate of inflation by controlling the money supply is a fairly long run policy and, over this time horizon, one aggregate will broadly do as well as another.

Sir Douglas Wass

cc Financial Secretary
Mr Burns
Sir Kenneth Couzens
Mr Monck
Mr Britton
Mr Lavelle
Mrs Lomax
Mr Peretz
Mr H Davies
Mr Pirie
Mr Ridley
Mrs Gilmore

MONETARY CONTROL: DRAFT STATEMENT

I attach an opening shot at a statement on monetary control, assuming that things go all right at the seminar. I have also sent a copy to the Bank for their comments. I would be grateful for any comments by close of play tomorrow.

P E MIDDLETON
27 July 1981

Enc

1. The Chancellor of the Exchequer said in the Budget Speech that a number of improvements in monetary control would come into effect later in the financial year. The Bank of England has now completed its discussions with the financial institutions about the detailed arrangements which are set out in a note issued by the Bank today. They will come into effect on 20 August - the first day of banking September.

2. We have been going through a period of transition to the new arrangements since last November. The Bank now relies mainly on open market operations - buying and selling bills - rather than direct lending to the money markets. Dealing rates are no longer quoted; the Bank responds to bids and offers from the market, making public the rates at which it has done business.

3. The Authorities will, in future, keep very short term interest rates at the very short end of the market within an undisclosed band which will be moved from time to time. An announced minimum lending rate would be incompatible with the new arrangements. So MLR will be suspended from 20 August, though the Authorities will retain the option, in exceptional circumstances, of signalling the rate at which they will provide cash to the market.

4. The new arrangements will reduce the "bias to delay" in changing interest rates - in both directions - which was

identified in the Green Paper on Monetary Control.
And the market will have a greater role in determining the term structure of short interest rates. Market pressure will show itself mainly in movements in rates at the longer maturities which the Authorities do not influence so directly - and this experience of market conditions will be one of the factors taken into account in deciding on the position of the interest rate band.

5. The bands will be changed primarily in response to the requirements of the medium term strategy and the annual monetary targets together with the range of factors referred to in the Budget Speech. [The principal indicators of which they will take account are:

- the current trend of sterling M3, considered in retrospect over a period of about six months, together with the prospect, insofar as it can be discerned, for at least a similar period ahead;

- movements of other monetary aggregates, in particular, of M1 and the wide monetary base;

- the growth of nominal incomes, as measured by the value of gross domestic product at current prices;

- inflationary pressure, as evidenced by movements in the exchange rate and the level of wage settlements.]

6. Another change coming into effect on 20 August is that the Reserve Asset Ratio, which has complicated monetary

control, will be abolished and cease to be a minimum requirement. The institutions to which they are applied will discuss in advance with the Bank, as part of normal prudential supervision, any changes in their policies on liquidity management.

7. The cash ratio arrangements will also be changed. The fulcrum for money market operations will now be the operational balances which the London clearers hold with the Bank on a scale they judge adequate for clearing purposes. The Bank's resources and income will be mainly derived from a uniform requirement that all banks and licensed depositors should deposit with the Bank ½% of their eligible liabilities as non-operational non-interest bearing deposits. The Bank will have broadly the same total of non-interest bearing funds as the old requirement on the London clearers alone to hold 1½% of their ELs with the Bank.

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P E Middleton
Deputy Secretary

27 July 1981

C McMahon Esq
Deputy Governor
Bank of England
Threadneedle Street
LONDON EC2

Dear Kit,

I agreed with John Fforde that we would have a go at preparing a statement on the new monetary control arrangements, on the assumption that things go as we hope at the seminar. I attach a first draft. The Bank of England note referred to in para 1 is the one entitled "Monetary Control: Provisions" sent to me by John Fforde on 24 July.

Perhaps the main uncertainty concerns how much detail we want to go into about the factors other than £M3 which we propose to take into account in setting short term interest rates. It would be possible to do without the section in square brackets.

I am copying this letter to Tony Coleby.

Yours ever,

Peter

P E MIDDLETON

Enc

CHANCELLOR OF THE EXCHEQUER

cc Financial Secretary
Chief Secretary
MST(C)
MST(L)
Sir D Wass
Mr Ryrie
Sir K Couzens
Mr Hancock
Mr Middleton
Mr Kemp
Mrs Lomax
Mr Turnbull
Mr H Davies
Mr Lavelle
Mr Collinson
Mr Pirie
Mr Peretz
Mr Riley
Mr Grice
Mr Shields
Mr Bennett
Mr Ridley

THE PRIME MINISTER'S SEMINAR ON MONETARY CONTROL

The final version of the Bank's document "Monetary Control: Provisions" is attached. It will probably be issued on 5 August.

N MONCK
28 July 1981

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.

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 of 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)]

[(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 relevant 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 recognised 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.

30.7.81

SIR DOUGLAS WASS

cc Financial Secretary
Mr Ryrie
Mr Middleton
Mr Britton
Mr Monck
Mr Turnbull (o/r)

PRIME MINISTER'S SEMINAR ON MONETARY CONTROL: THE NEW M2 SERIES

I attach a note by the Bank's statisticians on the state of play on the new M2 series, as background to the Seminar. The important points to note are:

(1) The Chancellor announced the intention to compile a new series for retail deposits (to be called M2) in his November Statement. Discussions between the Bank and the clearers on the definition of this series are now complete and statistics should be collected from mid-October. Publication will probably be from the turn of the year, as the Bank would like an opportunity to inspect the statistics and iron out obvious difficulties first.

(2) Much of our original interest in the series was as a potential control aggregate in a mandatory system of monetary base control, and this could be deduced from the context of the announcement. But this has been played down in the discussions with the clearers who are firmly hostile to the idea. It would anyhow be some years before we could seriously consider using a brand new aggregate in this way. M2 should also be an interesting indicator of monetary conditions in its own right, since we hope it will be a more satisfactory measure of transactions balances than M1.

(4) The new series raises the issue of building society deposits, many of which are retail in nature. The Bank propose to construct two retail deposit series, one relating only to the banks and the other, more approximate, series which will include estimates of broadly comparable building society deposits. This should leave completely open the question of how to treat the building societies if we ever decided to use some version of M2 as a target aggregate for monetary control purposes.

RL

RACHEL LOMAX
30 July 1981

Encl.

28. 7.81

RETAIL DEPOSITS - A NEW MONETARY AGGREGATE

Discussions on the future course of monetary policy last autumn identified a need for new statistics on retail deposits. It was thought that these might be more stably related to nominal incomes and prices than either M1 or sterling M3. M1 excludes very liquid deposits (eg, clearers' seven day deposits) which, although nominally requiring notice of withdrawal, in practice are available on demand with very little penalty and are therefore likely, in part at least, to be used to purchase goods and services. Sterling M3 on the other hand includes investment balances which are close substitutes for less liquid and non-monetary instruments such as bills and local authority deposits, and which are relatively unlikely to be spent on goods and services in the UK. Accordingly, in the Chancellor of the Exchequer's statement on 24 November 1980, and in the 'Background note on methods of monetary control' issued by the Bank at the same time, it was announced that discussions would be held with the banks regarding the collection of additional statistics on retail deposits. It was envisaged that these would provide further useful information on monetary conditions that would be worthwhile collecting in any case, but that they might also, if that subsequently seemed appropriate, become the denominator of a cash ratio associated with a mandatory monetary base system.

The Bank, in consultation with the Treasury, considered various alternative criteria for defining retail deposits and came to the conclusion that the most promising definition would be one that attempted to identify types of deposit that might be used for transactions purposes. In particular, it was felt that these should comprise:*

(a) all non-interest bearing sight deposits;

(b) all other chequable accounts and accounts from which regular payments may be made;

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* Initially, it has been decided that these will be restricted to sterling deposits (excluding interbank deposits) but that, unlike the present aggregates, they will not be restricted to those held by UK residents. Should changing circumstances make it seem likely that foreign currency deposits were being used for transactions purposes, it may be necessary to reconsider this definition.

other deposits subject to si and maturity cut-offs. (Selection of appropriate cu offs is necessarily an arbitrary process, but in co ultation with the banks, the cut-offs have been set as de sits of less than £100,000 with a residual maturity of ss than one month on the reporting day.)

In agreeing to provide this inform ion, the banks expressed strong reservations at the prospect that might be used for a mandatory form of monetary base control, th ase for which they did not consider to have been made out. it was so used, the particular definition might bear unfairly on rtain institutions. The Bank are committed to further consultat n with the banks, in advance, should it seem likely that the sta stics would be used for this purpose.

The banks were alert furthermore t the fact that the majority of building society deposits were so retail in nature and asked specifically whether both banks' building society deposits would be included in a single aggregate. They were told that the authorities accepted analytically at most building society deposits were of a retail nature and that intended to present figures for building societies alongside thos of the banks but that, for timing and other reasons, it may be impr ticable to construct a single consistent aggregate, at least at esent.

The Building Societies Associatio re in the course of revising their classification of types of share reflect recent developments in the movement and will shortly be coll ing new information from the top 17 societies. This should make possible to estimate a series of building society deposits that is oadly comparable with that collected from the banks. The s es will exclude term shares and high interest accounts on which n ce of withdrawal conditions are enforced, or where there are sign cant withdrawal penalties, as well as those accounts subject to minimum size. The definition will not be precisely the same as plied to banks and nor will the information be available in respe of the same dates. It is proposed therefore, to construct retail deposits series. One will relate to banks only (initially, s will be restricted to the 70 or so largest banks who conduct t majority of retail business). The second will be a more approxim e series. It will include building society deposits which will be onverted onto a mid-month basis broadly comparable to the bank figures in a similar way to the existing private sector liquid y series, PSL2.

Discussions with the banks on tails of the new figures are now virtually complete and the Bank expects to start collecting figures from mid-October.* There may of course, be some teething troubles but it is likely that some fig s will be available by the end of the year. At present, no dis sions have been held or commitments made on when and how these fig s might be published. There may be some difficulty initially in interpreting them as it will not be possible to calculate reliable asonal adjustment until a substantial period of data has en assembled. Furthermore, over longer periods interpretation m y be hindered by the, as yet unresol problem of how to adjust the si cut-off: lack of indexation may t to bias the aggregate downwards yet frequent indexation would burde the banks with an ever-changing statistical requirement, unlikely to correspond precisely with actu usage.

In view of the likely difficult s of interpretation, there is a good case for refraining from p lishing the new aggregates until a number of months' figures have en collected.

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* It is possible that some of t banks may require rather more time to rearrange their accounting ystems to provide some of the detailed breakdowns required.