PO-CH/NL/0180

P-1B

Chex
Lawson

PART B

SECRET

(Circulate under cover and
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PO -CH /NL/0180

PART B

CHANCELLOR'S PAPERS ON
THE BANK OF ENGLAND
(BOE)

PO -CH /NL/0180
PART B

Begins: 9/12/87
Ends: 21/7/88 (CONTINUED)

DD: 25 years

18/9/95

SECRET

pup

From : D L C Peretz
Date : 9 December 1987

MR A ALLAN

cc Sir P Middleton
Mr Cassell

EXCHANGE MARKET INTERVENTION : LETTER TO THE GOVERNOR

I attach your draft, annotated with Sir Peter Middleton's drafting suggestions (he, Mr Cassell and I discussed these).

2. I have also taken some informal legal advice. The position seems to be there is nothing to prevent us sending the letter, under the Exchange Equalisation Account Act, which says that "The Account shall ... be under the control of the Treasury".

3. The next question is whether in sending the letter we would be subject to judicial review in the English courts because of the EMS agreement. The advice is that the English courts would not hold that the Chancellor is acting illegally under English law, even if he is instructing the Bank of England to carry out an action that would put the Government or Bank of England in breach of an international agreement.

4. As to whether breach of Article 15 of the March 1979 EMS Central Bank Agreement constitutes breach of an international obligation or club rules, the advice is less clear cut. But it seems likely that the Bank, or possibly the Government, could be held to be in breach of an international agreement, under international law. We would argue strongly that this is not a matter of Community law, and therefore not a matter for the European Court of Justice, since the inter-central bank agreement does not involve the Commission or Community expenditure in any way.

5. Given the very clear instruction we had from the Prime Minister, I doubt whether there is anything in this that would make the Chancellor wish to change his mind about writing.

DLCP

D L C PERETZ

psl/43A

SECRET *I suggest the following.*

DRAFT

9 December 1987

Rt Hon Robin Leigh-Pemberton
Governor
Bank of England
Threadneedle Street
LONDON EC2R 8AH

FOREIGN EXCHANGE MARKET INTERVENTION

I am writing to confirm what I told you on the phone this morning. The overriding objective of our foreign exchange market intervention remains to hold the sterling cross-rate against the deutschemark below 3DM. From now on, all intervention to achieve that should be in deutschemarks, and not in dollars ~~[or other currencies]~~. Where it is necessary to intervene in markets where the direct sterling/deutschemark market is thin, and hence for technical reasons intervention has to be in some other currency, the proceeds should be switched into deutschemarks ~~immediately~~ as soon as possible.

I explained to you the reasons for adopting this policy. We have bought enormous amounts of dollars since the Louvre accord, far more than the Bundesbank. Our market intervention in dollars has totalled some $25 billion, compared with intervention by the Bundesbank of under $3 billion; even if allowance is made for the off-market inflows into the German reserves from US military expenditure etc., the amount we have done far outweighs what the Germans have done. In effect, by intervening so

heavily in dollars rather than in deutschemarks, we have relieved the Germans of a large part of the burden of supporting the dollar against the deutschemark. In these circumstances, it is wholly unreasonable for the Bundesbank to object to what we shall be doing. Our objective is to maintain the cross-rate against the deutschemark, and intervening in deutschemarks will be a far more effective way of doing that by intervening in dollars. The Germans will understand that it would make no sense at all for us to allow sterling to rise against the deutschemark.

We have already moved interest rates down by considerably more than the Germans, and hence have narrowed the differential. While some further downward movement cannot be ruled out, it would not be prudent to attempt to stem the intervention by cutting interest rates substantially: that would bring them below the level we both agree is likely to be needed in the slightly longer-term. It would be unnecessarily damaging to do that and then have larger increases in the future. And it would add to the growth of M0, which is already showing signs of accelerating.

I am making sure that my opposite numbers in Germany and France are informed of what we shall be doing.

NIGEL LAWSON

RJP

BANK OF ENGLAND

Wednesday the 9th day of December 1987

ISSUE DEPARTMENT

	£		£
Notes Issued:		Government Debt	11 015 100
In Circulation	13 901 178 975	Other Govt.Securities	9 533 577 597
In Banking Department	8 821 025	Other Securities	4 365 407 303
	13 910 000 000		13 910 000 000

BANKING DEPARTMENT

	£		£
Capital	14 553 000	Govt.Securities	598 894 226
Public Deposits- including Exchequer, National Loans Fund, National Debt Commissioners and Dividend Accounts	88 131 456	Advances and Other Accounts	814 801 053
		Premises, Equipment and Other Securities	1 630 480 797
Special Deposits		Notes	8 821 025
Bankers' Deposits	1 044 035 944	Coin	392 770
Reserves and Other Accounts	1 906 669 471		
	3 053 389 871		3 053 389 871

Dated the 10th day of December 1987

D H F SOMERSET, Chief Cashier

BANK OF ENGLAND

An ACCOUNT pursuant to the Acts 7 & 8 Vict. ch. 32, 18 & 19 Geo. 5. ch. 13 and 19 & 20 Eliz. 2 ch. 24, for the week ending on Wednesday, the 9TH day of DECEMBER 1987.

ISSUE DEPARTMENT

	£		£
Notes issued —		*Government Debt*	11 015 100
In Circulation	13901 178 975	*Other Government Securities*	9533 577 597
In Banking Department	8 821 025	*Other Securities*	4365 407 303
		Coin other than Gold Coin	
		Amount of Fiduciary Issue	£13910 000 000
		Gold Coin and Bullion	
	£13910 000 000		£13910 000 000

Dated the 10TH *day of* DECEMBER 1987.

D.H.F. Somerset *Chief Cashier*

BANKING DEPARTMENT

	£		£
Capital	14 553 000	*Government Securities*	598 894 226
Rest		*Other Securities*	2445 281 850
Public Deposits (including Exchequer, National Loans Fund, National Debt Commissioners and Dividend Accounts)	88 131 456	*Notes*	8 821 025
		Coin	392 770
Other Deposits	2950 705 415		
Seven Day and other Bills			
	£3053 389 871		£3053 389 871

Dated the 10TH *day of* DECEMBER 1987.

D.H.F. Somerset *Chief Cashier*

(3774)

SECRET

From : D L C Peretz
Date : 10 December 1987

MR A ALLAN

cc Sir P Middleton
Mr Cassell
Miss O'Mara

EXCHANGE MARKET INTERVENTION : FURTHER LETTER TO THE GOVERNOR

You asked for the draft of a further letter to be sent to the Governor, following this morning's meeting with the Prime Minister.

2. You also said the Chancellor had asked for this to be discussed in advance with the Bank. In Sir Peter Middleton's absence earlier this morning (and subsequent involvement in meetings) Mr Cassell has discussed the attached draft with Mr George. He is content, and recognises that what is said flows directly from this morning's meeting. But he asked us to pass on two points to the Chancellor :-

i) he would very much like the ecu to be mentioned explicitly. You will see it is in square brackets in paragraph 2 and 3(iii). We too would very much like it to be mentioned, if that is possible in the light of this morning's discussion. Buying a few ecu will help take a "Community" trick; and also, because of the weight of the DM in the ecu, is a way of increasing the proportion of DM we buy.

ii) he would also much prefer the division to be expressed as between the "hard currencies" and the rest. This would mean replacing paragraph 3(i) with the following :-

"purchases of the "hard currencies" - deutschemarks, Swiss francs, and yen - should not amount to less than [60%] of the value of purchases in any week ...".

3. We are less sure about (ii); but in any event it is presumably inconsistent with what was agreed this morning.

4. As I say, Sir Peter Middleton has not yet had a chance to comment on this draft, and you may want to hold it up until he has.

DLCP

D L C PERETZ

SECRET

DRAFT LETTER

From : Chancellor

To : Governor
Bank of England

FOREIGN EXCHANGE MARKET INTERVENTION

I am writing to confirm [the position, following the] what we agreed at our meeting with the Prime Minister this morning.

2. As I told you yesterday, from now on market intervention to maintain the sterling/DM exchange rate below 3 DM should not be in dollars. It was agreed at this morning's meeting that [not all of the] intervention in [need be] in deutschemarks, and that [you may make matching purchases of French francs,] French francs should broadly match intervention; intervention in Swiss francs [and] yen, [and ecu]. would also be permitted. Details of intervention in these currencies should be settled between the Treasury & the Bank.

3. I understand that our officials have suggested that ~~this should be interpreted in the following way~~ the arrangements should be :-

(i) French franc purchases should not exceed purchases of deutschemarks, [and should normally be lower unless that would cause strains within the EMS];

~~[i) deutschemark purchases should not amount to less than half the value of purchases in any week, [measured from Friday London close to Friday London close*].~~

~~ii) if at all possible the proportion should be higher.~~

---

* This may be too detailed a point for the letter, in which case we would agree it with the Bank separately.

iii) decisions on the amounts and proportions of French francs, Swiss francs, yen [and ecu] to be bought should be made in the light of market and other circumstances.

iv) where it is necessary to intervene in markets where for technical reasons intervention has to be in dollars, the proceeds should be switched into one of the currencies mentioned above as soon as possible.

4. I am content with these guidelines.

CH/EXCHEQUER
REC. 15 DEC 1987 16/12
ACTION DRH BOARD
COPIES TO PS/EST
SIR P MIDDLETON
MR CASSELL
MRS LOMAX
MISS NOBLE

BANK OF ENGLAND
LONDON EC2R 8AH

14 December 1987

BF 7/1 or with advice

A C S Allan Esq
HM Treasury
Parliament Street
London
SW1P 3AG

Dear Alex

The Governor has now spoken to the four Directors whose terms expire on 29 February 1988: that is, Dr Atterton, Mr Galpin, Mr Vander Weyer, and Sir Leslie Young. I can confirm that all would be ready to accept a further four-year term if that were offered. The way is now open for you to be in touch with No 10.

Yours

John.

J R E Footman
Private Secretary
to the Governor

J.S. Flemming
Economic Adviser to the Governor
01-601 4963

Bank of England
London EC2R 8AH

15 December 1987

Alex Allen Esq
The Principal Private Secretary
The Chancellor's Office
HM Treasury
Parliament Street
London
SW1P 3AG

CH/EXCHEQUER
REC. 17 DEC 1987 17/12
ACTION
COPIES TO

Dear Alex

BANK OF ENGLAND BULLETIN, FEBRUARY 1988

We are just finalising arrangements for the next issue of our Quarterly Bulletin scheduled for publication on Thursday 11 February. Ideally we would like to send the text to the Chancellor on Thursday 28 January to be returned on Monday 1 February. Please could you confirm if these arrangements are satisfactory.

Yours sincerely

John

BANK OF ENGLAND

Wednesday the 16th day of December 1987

ISSUE DEPARTMENT

	£		£
Notes Issued:		Government Debt	11 015 100
In Circulation	14 654 332 073	Other Govt.Securities	9 772 287 534
In Banking Department	5 667 927	Other Securities	4 876 697 366
	14 660 000 000		14 660 000 000

BANKING DEPARTMENT

	£		£
Capital	14 553 000	Govt.Securities	558 730 271
Public Deposits- including Exchequer, National Loans Fund, National Debt Commissioners and Dividend Accounts	100 179 153	Advances and Other Accounts	1 064 109 916
		Premises, Equipment and Other Securities	1 430 074 076
Special Deposits		Notes	5 667 927
Bankers' Deposits	1 064 080 251	Coin	271 638
Reserves and Other Accounts	1 880 041 424		
	3 058 853 828		3 058 853 828

Dated the 17th day of December 1987

D H F SOMERSET, Chief Cashier

pmy

BANK OF ENGLAND

An ACCOUNT pursuant to the Acts 7 & 8 Vict. ch. 32, 18 & 19 Geo. 5. ch. 13 and 19 & 20 Eliz. 2 ch. 24, for the week ending on Wednesday, the 16TH day of DECEMBER 1987.

ISSUE DEPARTMENT

	£		£
Notes issued —		Government Debt	11 015 100
In Circulation	14654 332 073	Other Government Securities	9772 287 534
In Banking Department	5 667 927	Other Securities	4876 697 366
		Coin other than Gold Coin	
		Amount of Fiduciary Issue	£14660 000 000
		Gold Coin and Bullion	
	£14660 000 000		£14660 000 000

Dated the 17TH day of DECEMBER 1987.

D. H. F. Somerset Chief Cashier

BANKING DEPARTMENT

	£		£
Capital	14 553 000	Government Securities	558 730 271
Rest		Other Securities	2494 183 992
Public Deposits (including Exchequer, National Loans Fund, National Debt Commissioners and Dividend Accounts)	100 179 153	Notes	5 667 927
		Coin	271 638
Other Deposits	2944 121 675		
Seven Day and other Bills			
	£3058 853 828		£3058 853 828

Dated the 17TH day of DECEMBER 1987.

D. H. F. Somerset Chief Cashier

(3774)

psl/83A

APPOINTMENTS IN CONFIDENCE

cc PS/Economic Secretary
Sir P Middleton
Mr Cassell
Mrs Lomax
Miss Noble
Mr D R H Board

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

16 November 1987

J R E Footman Esq
Private Secretary to the Governor
Bank of England
Threadneedle Street
LONDON EC2R 8AH

Dear John

Thank you for your letter of 12 November. The Chancellor is content to recommend Sir Leslie Young's reappointment for a further term.

Yours
Alex

A C S ALLAN

ps2/54M

SECRET

pvp

FROM: MISS M P WALLACE
DATE: 17 December 1987

NOTE FOR THE RECORD

cc Sir P Middleton
Sir T Burns
Sir G Littler

CONVERSATION WITH BALLADUR

The Chancellor spoke to M. Balladur early this afternoon.

2. Balladur expressed dismay at the Bank of England's recent intervention in deutschemarks, and appealed to the Chancellor to put a stop to this. The Chancellor explained his position. Britain had more than done its bit to stabilise the dollar since the Louvre. We would be buying French francs as well as deutschemarks, in order to avoid over-straining the EMS. Balladur said that British actions would make it impossible to stabilise the EMS, and that Britain was taking upon itself an immense responsibility.

3. Balladur said it would be particularly harmful if the Bank was selling dollars. The Chancellor said that this was not happening. Balladur asked if it would be possible for Britain to do something on interest rates. The Chancellor said that here too Britain had done its bit.

4. Balladur expressed disappointment that he had only learnt indirectly of the decision to intervene in deutschemarks. The Chancellor said he regretted that he had not informed Balladur when they met in Brussels, but at the time the priority had been to obtain the Bundesbank's permission.

5. The Chancellor said that the Government would be reviewing the position early in the New Year. Balladur said that he would like to discuss this again with the Chancellor then.

mpw.

MOIRA WALLACE

ps54A

BF Amp 28/1 Andrew

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

18 December 1987

J P Flemming Esq
Economic Adviser to the Governor
Bank of England
Threadneedle Street
LONDON EC2R 8AH

Dear John

BANK OF ENGLAND BULLETIN, FEBRUARY 1988

Thank you for your letter of 15 December. The arrangements you set out seem fine to me.

Yours
Alan

A C S ALLAN

35A/G/LD/FIM3/020

APPOINTMENTS IN CONFIDENCE

FROM: D R H BOARD
DATE: 22 DECEMBER 1987

MR A C S ALLAN

cc Mr Sargent
Mrs Lomax
Miss Noble
Miss Gaseltine

BANK OF ENGLAND: APPOINTMENTS TO THE COURT OF DIRECTORS

The letter of 14 December from the Governor's Private Secretary confirms that the way is now open for you to be in touch with No 10 about the re-appointment of the 4 Directors whose terms expire on 29 February next year. The Chancellor has already expressed himself content (your minute to me of 10 November and your letter to Mr Footman of 16 November).

2. Members of the Court of Directors are appointed by The Queen under section 2(2) of the Bank of England 1946. These appointments are, almost invariably, handled at a high level within the Treasury: so much so that our files do not disclose the normal way in which you consult N0 10. Quite often the first that this Division hears of the matter is the No 10 press release, following by the arrival of the Royal Warrants. The best way forward would therefore be for your office, and Sir Peter Middleton's if appropriate, to check what the form has been in previous years. If this does not solve the problem I would be glad to know fairly quckly, so that we can stratch our heads and put together some suitable procedural advice.

Douglas Board

D R H BOARD

Tim / Jim
Could I have file K8 + earlier related files please
thanks
Douglas 16/12

CH/EXCHEQUER

REC.	15 DEC 1987
ACTION	DRH BOARD 38/G
COPIES TO	PS/EST SIR P MIDDLETON
	MR CASSELL
	MRS LOMAX
	MISS NOBLE

D Board 16/12

BANK OF ENGLAND
LONDON EC2R 8AH

14 December 1987

A C S Allan Esq
HM Treasury
Parliament Street
London
SW1P 3AG

Dear Alex

The Governor has now spoken to the four Directors whose terms expire on 29 February 1988: that is, Dr Atterton, Mr Galpin, Mr Vander Weyer, and Sir Leslie Young. I can confirm that all would be ready to accept a further four-year term if that were offered. The way is now open for you to be in touch with No 10.

Yours

John.

J R E Footman
Private Secretary
to the Governor

MJ

BANK OF ENGLAND

An ACCOUNT pursuant to the Acts 7 & 8 Vict. ch. 32, 18 & 19 Geo. 5. ch. 13 and 19 & 20 Eliz. 2 ch. 24, for the week ending on Wednesday, the 23RD day of DECEMBER 1987.

ISSUE DEPARTMENT

	£		£
Notes issued —		*Government Debt*	11 015 100
In Circulation	14981 881 015	*Other Government Securities*	9663 223 596
In Banking Department	8 118 985	*Other Securities*	5315 761 304
		Coin other than Gold Coin	
		Amount of Fiduciary Issue	£14990 000 000
		Gold Coin and Bullion	
	£14990 000 000		£14990 000 000

Dated the 24TH *day of* DECEMBER 1987.

D H F Somerset *Chief Cashier*

BANKING DEPARTMENT

	£		£
Capital	14 553 000	*Government Securities*	811 799 848
Rest		*Other Securities*	2417 893 984
Public Deposits (including Exchequer, National Loans Fund, National Debt Commissioners and Dividend Accounts)	99 002 909	*Notes*	8 118 985
Other Deposits	3124 586 458	*Coin*	329 550
Seven Day and other Bills			
	£3238 142 367		£3238 142 367

Dated the 24TH *day of* DECEMBER 1987.

D H F Somerset *Chief Cashier*

(3774)

BANK OF ENGLAND

Wednesday the 30th day of December 1987

ISSUE DEPARTMENT

	£		£
Notes Issued:		Government Debt	11 015 100
In Circulation	14 548 163 795	Other Govt.Securities	9 150 008 508
In Banking Department	11 836 205	Other Securities	5 398 976 392
	14 560 000 000		14 560 000 000

BANKING DEPARTMENT

	£		£
Capital	14 553 000	Govt.Securities	636 664 848
Public Deposits- including Exchequer, National Loans Fund, National Debt Commissioners and Dividend Accounts	93 878 884	Advances and Other Accounts	815 427 519
		Premises, Equipment and Other Securities	1 664 276 211
Special Deposits		Notes	11 836 205
Bankers' Deposits	1 085 688 450	Coin	316 110
Reserves and Other Accounts	1 934 400 559		
	3 128 520 893		3 128 520 893

Dated the 31st day of December 1987

G E A KENTFIELD, Deputy Chief Cashier

Dewe Rogerson Limited

3½ London Wall Buildings, London Wall, London EC2M 5SY.
Telephone: 01-638 9571. Telex: 883610. Fax: 01-628 3444.

PMP

cc PPS
PS/FST
Sir P Middleton
Mr Cassell
Mr Moore
Mr Watts
Mr Neilson

Mr R I G Allen

Our ref: CJM/TTC

3rd December 1987

Ms R Lomax
H M Treasury
Treasury Chambers
Parliament Street
Westminster
London
SW1P 3AG

Any comments?
Are IDT getting queries?
RL 4/12

Dear Rachel

The Closing of the Bank of England Offer

I am writing to set out our thoughts on the closing date for the Bank Offer and how we see current developments. I realise that there are many considerations to be taken into account, but I thought I should write as we are, as you know, beginning to receive calls from the media about the closing date of the Bank offer.

The tenor of the questions was quite friendly, simply enquiring whether we yet had any information. However, yesterday they were becoming less warm and starting to take the line of "why don't they say. They must know whether they are going to extend the deadline".

This raises the question of when the closing date will be, given that the 11th December is now not the closing date.

Our own thinking is that around the end of the week commencing 14th December would be ideal, as it strikes the perfect balance between avoiding Christmas but not appearing to be over-eager to close the scheme.

I find it difficult to argue for the beginning of January, as the long Christmas break is going to divert attention and we would be more likely to run the risk of people not noticing and missing the date.

In addition, on the basis that there is a strong likelihood that a significant number of underwriters will be selling to the Bank and that the partly-paid price will fall below 70p straight after the ceiling is removed, there is a lot of merit in having the closing

/Contd ...

2/128/4

date before Xmas so that memories will fade over the Xmas holiday. If the closing date is in January, then there is a much stronger likelihood of the saga continuing to be the subject of media attention throughout January.

To date the Chancellor's scheme has gained considerable praise, but we do believe now that there is a real risk that it will start to pick up not insignificant criticism.

The falling share price doesn't help (not that anyone can do much about it), but more important is (a) the fact that it is starting to look as though events are dictating your response (unfair, but it's their perception) and (b) that only to give five days' notice appears draconian as far as the private shareholder is concerned.

I realise that there are fundamental reasons for keeping flexibility on the cut-off date and that it is probably inappropriate to argue otherwise, but from the point of view of the media/public reaction, I do believe that announcing the cut-off date will help both to demonstrate confidence and to assert your control, i.e. to appear to be in charge and dictating the course of events rather than appearing only to respond at the last possible moment.

When you announce that the offer will not close on the 11th December, the obvious question will be one of "when will it close". It would be advantageous to give indications of when the closing date would be (i.e. before Xmas or after Xmas). I realise that an exact date may not be practical, but any firm indication would be helpful.

How the announcement is handled is clearly going to be quite sensitive. If we can be of any assistance, please don't hesitate to call us.

Kind regards.

Yours sincerely

Cary J Martin

cc: M Neilson (H M Treasury)
A Carlisle

BANK OF ENGLAND

An ACCOUNT pursuant to the Acts 7 & 8 Vict. ch. 32, 18 & 19 Geo. 5. ch. 13 and 19 & 20 Eliz. 2 ch. 24, for the week ending on Wednesday, the 30TH day of DECEMBER 1987.

ISSUE DEPARTMENT

	£		£
Notes issued —		*Government Debt*	11 015 100
In Circulation	14548 163 795	*Other Government Securities*	9150 008 508
In Banking Department	11 836 205	*Other Securities*	5398 976 392
		Coin other than Gold Coin	
		Amount of Fiduciary Issue	£14560 000 000
		Gold Coin and Bullion	
	£14560 000 000		£14560 000 000

Dated the 31ST *day of* DECEMBER 1987.

G.E.A. Kentfield Deputy *Chief Cashier*

BANKING DEPARTMENT

	£		£
Capital	14 553 000	*Government Securities*	636 664 848
Rest		*Other Securities*	2479 703 730
Public Deposits (including Exchequer, National Loans Fund, National Debt Commissioners and Dividend Accounts)	93 878 884	*Notes*	11 836 205
Other Deposits	3020 089 009	*Coin*	316 110
Seven Day and other Bills			
	£3128 520 893		£3128 520 893

Dated the 31ST *day of* DECEMBER 1987.

G.E.A. Kentfield Deputy *Chief Cashier*

(3774)

BANK OF ENGLAND

Wednesday the 6th day of January 1988

ISSUE DEPARTMENT

	£		£
Notes Issued:		Government Debt	11 015 100
In Circulation	13 666 116 040	Other Govt.Securities	5 800 694 962
In Banking Department	3 883 960	Other Securities	7 858 289 938
	13 670 000 000		13 670 000 000

BANKING DEPARTMENT

	£		£
Capital	14 553 000	Govt.Securities	842 719 848
Public Deposits-including Exchequer, National Loans Fund, National Debt Commissioners and Dividend Accounts	94 193 266	Advances and Other Accounts	839 774 740
		Premises, Equipment and Other Securities	1 622 604 203
Special Deposits		Notes	3 883 960
Bankers' Deposits	1 165 581 492	Coin	314 227
Reserves and Other Accounts	2 034 969 220		
	3 309 296 978		3 309 296 978

Dated the 7th day of January 1988

D H F SOMERSET, Chief Cashier

BANK OF ENGLAND

pwp

An ACCOUNT pursuant to the Acts 7 & 8 Vict. ch. 32, 18 & 19 Geo. 5. ch. 13 and 19 & 20 Eliz. 2 ch. 24, for the week ending on Wednesday, the 6TH day of JANUARY 1988.

ISSUE DEPARTMENT

	£		£
Notes issued —		*Government Debt*	11 015 100
In Circulation	13666 116 040	*Other Government Securities*	5800 694 962
In Banking Department	3 883 960	*Other Securities*	7858 289 938
		Coin other than Gold Coin	
		Amount of Fiduciary Issue	£13670 000 000
		Gold Coin and Bullion	
	£13670 000 000		£13670 000 000

Dated the 7TH *day of* JANUARY 1988.

D.H.F. Somerset *Chief Cashier*

BANKING DEPARTMENT

	£		£
Capital	14 553 000	*Government Securities*	842 719 848
Rest		*Other Securities*	2462 378 943
Public Deposits (including Exchequer, National Loans Fund, National Debt Commissioners and Dividend Accounts)	94 193 266	*Notes*	3 883 960
Other Deposits	3200 550 712	*Coin*	314 227
Seven Day and other Bills			
	£3309 296 978		£3309 296 978

Dated the 7TH *day of* JANUARY 1988.

D.H.F. Somerset *Chief Cashier*

(3774)

APPOINTMENTS IN CONFIDENCE

pup.

FROM: D R H BOARD

DATE: 6 January 1988

BF next RM Watford

MISS LOMAX

APPOINTMENTS OF GOVERNORS

The search which you asked me to do yesterday has not revealed much.

2. The re-appointment of (the then) Sir Leslie O'Brien took place around January 1971. The relevant papers on file do not include a press notice (see Annex A).

3. While I was doing this research, I checked on Richardson. He succeeded O'Brien on 1 July 1973 (for 5 years). In January 1978 his re-appointment for a further 5 years - effective from July 1978 - was announced. But, again, there is no press release on file.

4. The paucity of papers on file results from the long-standing practice of dealing with virtually all aspects of this kind of thing at a very high level, eg see Annex B.

PS/Sir P Middleton

c.PPS

Douglas Board

D R H BOARD

Any further papers are, apparently, in your files (see Jack's minute, attached)

RL.

6/1.

22/155/6

ANNEX A

FHCS pa.

TREASURY
15 JAN 1971
F.H.C.S.

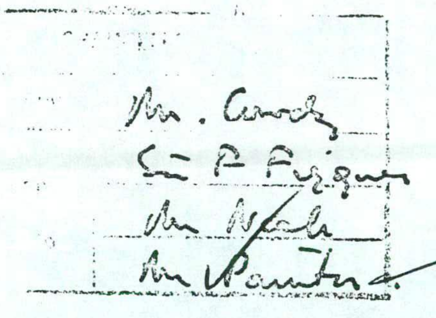
Mr Walters

We spoke about advising Mr Ryrie on the mechanics. Please keep the papers "personal" for the time being.

6/1

APPOINTMENTS - IN CONFIDENCE

10 Downing Street
Whitehall



December 30, 1970

Dear Bill,

This is to let you know that The Queen has now given Her informal approval to the re-appointment of Sir Leslie O'Brien as Governor of the Bank of England for a further term.

You will no doubt wish to think about the timing of an announcement and for setting in motion the arrangements for giving formal effect to this re-appointment.

Yours ever

Robert Armstrong

W.S. Ryrie, Esq.

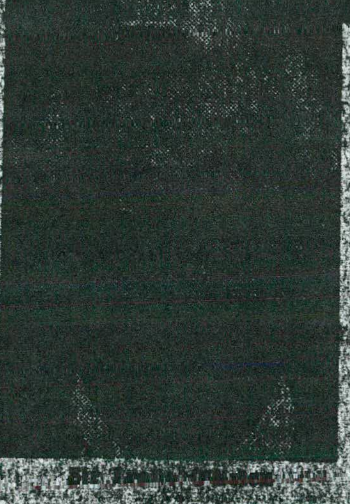
Reference

Second term at the Bank for O'Brien

BY M. H. FISHER

SIR LESLIE O'BRIEN has been reappointed as Governor of the Bank of England for a second five-year term from July 1, 1971.

His reappointment is certain to be widely and warmly welcomed—in the Bank itself, where he is both highly respected and popular, in the City, and not least abroad, where during the first three years of his tenure, with sterling constantly in trouble, he commanded the confidence of his central banking colleagues from other countries. And all economic commentators are in his debt, for under him



Sir Leslie O'Brien

the Bank has become much more informative and approachable.

Yesterday's announcement ends the speculation that the Government might have opted for a change [illegible] to replace Sir Leslie. Rumours mentioning other candidates can now be seen to have been [illegible] more than the talk which inevitably [illegible] Governor's term approaches its end. Certainly it was known that Sir Leslie himself wanted to [illegible].

[illegible] virtual certainty. In five years' time the claims of some of the younger permanent directors on the Court will not be easily denied.

Such [illegible] Government policy [illegible] the Labour Government [illegible] during the [illegible] under the new [illegible] administration he has made it clear when his views differed from those of Ministers on major issues. Last autumn, to cite but one example, he called for an incomes policy.

Obviously Sir Leslie has felt all along that though the Bank is in the last resort subject to the directives of the Treasury, its head should not thereby be prevented from speaking his mind.

Major changes

The process of what might be termed the professionalisation of the Bank, though [illegible] many years ago, has accelerated since he became Governor, and the participation of Bank officials in Whitehall's economic [illegible] exercises and [illegible] leading to policy formulation have been greatly [illegible]. Further [illegible] this trend [illegible] in recent years [illegible] policy as an [illegible] demand management.

There have been [illegible] changes [illegible] of office. The City Take-over Panel was [illegible] and Sir Leslie made it clear that the City was [illegible] policing [illegible] letter to [illegible] August [illegible] approved [illegible] the introduction [illegible].

When [illegible] monetary policy came to be in[illegible] the Bank of England's [illegible] attitude to the [illegible] market changed. Personally [illegible] of an institution he has [illegible] his willingness to accept change.

JAM

HOME OFFICE
Horseferry House, Dean Ryle Street, LONDON S.W.1
Telephone: VICTORIA 6655, *ext.*

FH

Please address any reply to
THE UNDER SECRETARY
OF STATE
quoting: MSC/63 5/11/5
Your reference:

The Secretary
HM Treasury
Great George Street
London SW1

9 February 1971

Sir

I am directed by the Secretary of State to transmit to you, herewith, the Royal Warrant re-appointing the Governor of the Bank of England.

I am Sir
Your obedient Servant

P.R. Hazelgrove.

ENC

ANNEX B

TREASURY
-9 JAN 1978
H. F. C. S.

NOTE FOR THE FILE

2HF 58/254/01 (to April 1975)
HF 58/473/01 (current file).

Papers on the appointment and reappointment of the Governor are held in the Permanent Secretary's Office (Sir Douglas Wass) and can be seen by the Head of HF Group for the time being if necessary.

JMB

J M BRIDGEMAN
19 December 1977

cc Mrs Gilmore

Gordon Richardson
reappointed Jan 78
(for 5 yrs from July 78)

BANK OF ENGLAND

Wednesday the 13th day of January 1988

ISSUE DEPARTMENT

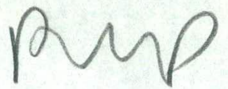
	£		£
Notes Issued:		Government Debt	11 015 100
In Circulation	13 317 980 200	Other Govt.Securities	4 922 927 627
In Banking Department	12 019 800	Other Securities	8 396 057 273
	13 330 000 000		13 330 000 000

BANKING DEPARTMENT

	£		£
Capital	14 553 000	Govt.Securities	922 739 848
Public Deposits- including Exchequer, National Loans Fund, National Debt Commissioners and Dividend Accounts	94 489 272	Advances and Other Accounts	776 839 561
		Premises, Equipment and Other Securities	1 633 631 430
Special Deposits		Notes	12 019 800
Bankers' Deposits	1 095 184 948	Coin	338 590
Reserves and Other Accounts	2 141 342 009		
	3 345 569 229		3 345 569 229

Dated the 14th day of January 1988

G E A KENTFIELD, Deputy Chief Cashier



BANK OF ENGLAND

An ACCOUNT pursuant to the Acts 7 & 8 Vict. ch. 32, 18 & 19 Geo. 5. ch. 13 and 19 & 20 Eliz. 2 ch. 24, for the week ending on Wednesday, the 13TH day of JANUARY 1988.

ISSUE DEPARTMENT

	£		£
Notes issued —		Government Debt	11 015 100
In Circulation	13 317 980 200	Other Government Securities	4922 927 627
In Banking Department	12 019 800	Other Securities	8396 057 273
		Coin other than Gold Coin	
		Amount of Fiduciary Issue	£13 330 000 000
		Gold Coin and Bullion	
	£13 330 000 000		£13 330 000 000

Dated the 14TH day of JANUARY 1988.

G.B.A. Kentfield Deputy Chief Cashier

BANKING DEPARTMENT

	£		£
Capital	14 553 000	Government Securities	922 739 848
Rest		Other Securities	2410 470 991
Public Deposits (including Exchequer, National Loans Fund, National Debt Commissioners and Dividend Accounts)	94 489 272	Notes	12 019 800
Other Deposits	3236 526 957	Coin	338 590
Seven Day and other Bills			
	£3345 569 229		£3345 569 229

Dated the 14TH day of JANUARY 1988.

G.B.A. Kentfield Deputy Chief Cashier

(3774)

SECRET

pup.

Ch
Updated figs below
AA

From : D L C Peretz
Date : 14 January 1988

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir G Littler
Mr Scholar
Miss O'Mara
Ms Goodman

You will have seen from yesterday's evening report that the Bank of England did not join in yesterday afternoon's round of concerted dollar intervention.

2. The Bank of England were told about the operation in advance, like other European central banks, and given the opportunity to join in. They thought it was slightly oddly timed, but the main reason they did not join in is that they judged that by the time they had got clearance from us the moment would have passed. So they did not bother to ask.

3. I attach a table showing purchases of dollars by the main central banks since the pre-Christmas G7 agreement. The figures are for purchases of dollars against yen, DM, or national currency. As you know our $50 million was bought against DM. You will see that the US/Japan/Europe shares are roughly equal, as was envisaged in the G7 agreement. But our share of the non-German European amount (less than 5% of German intervention) is a good deal lower than we originally envisaged.

4. It seems to me we have reached the point where it would be diplomatic to contribute to the next significant round of European concerted intervention, purchasing another $25 million for DM.

5. There could easily be a further round tomorrow, either in advance of the US trade figures or following their publication, and if the Bank were to join in they would need to be given authorisation tomorrow morning. Otherwise, we could touch on this at tomorrow afternoon's meeting.

DLCP

D L C PERETZ

SECRET

$ intervention* from 24 December 1987 to ~~13~~ 19 January 1988

	$m		% of total
US	2154	)	
Canada	~~704~~ 687	)	33.2
Japan	~~2605~~ 2615		30.3
Germany	1248		14.5
UK	50	)	
France	~~524~~ 594	)	
Italy	~~277~~ 364	)	
Holland	~~203~~ 266	)	22.0
Switzerland	~~350~~ 343	)	
Belgium	180	)	
Denmark	309	)	
TOTAL	8,604		100

* against DM, Yen, and national currencies

APPOINTMENTS IN CONFIDENCE

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

15 January 1988

Dear Alex,

THE BANK OF ENGLAND

I am writing to let you know that The Queen has approved the re-appointment of Mr. Rodney Galpin, Dr. David Atterton, Mr. Derek Weyer and Sir Leslie Young as members of the Court of Directors of the Bank of England for a period of four years from 1 March 1988.

As agreed with the Bank we currently plan to release an announcement of the re-appointments to the Press on the afternoon of Thursday, 28 January and I will send you a copy of the Press Notice in due course.

Yours,
Paul

PAUL GRAY

A. C. S. Allan, Esq.,
H.M. Treasury.

APPOINTMENTS IN CONFIDENCE

pnp

BANK OF ENGLAND

An ACCOUNT pursuant to the Acts 7 & 8 Vict. ch. 32, 18 & 19 Geo. 5. ch. 13 and 19 & 20 Eliz. 2 ch. 24, for the week ending on Wednesday, the 20TH day of JANUARY 1988.

ISSUE DEPARTMENT

	£		£
Notes issued —		*Government Debt*	11 015 100
In Circulation	13168 210 755	*Other Government Securities*	3658 547 891
In Banking Department	11 789 245	*Other Securities*	9510 437 009
		Coin other than Gold Coin	
		Amount of Fiduciary Issue	£13180 000 000
		Gold Coin and Bullion	
	£13180 000 000		£13180 000 000

Dated the 21ST *day of* JANUARY 1988.

[signature] *Chief Cashier*

BANKING DEPARTMENT

	£		£
Capital	14 553 000	*Government Securities*	634 395 050
Rest		*Other Securities*	2471 979 177
Public Deposits (including Exchequer, National Loans Fund, National Debt Commissioners and Dividend Accounts)	97 476 834	*Notes*	11 789 245
		Coin	347 405
Other Deposits	3006 481 043		
Seven Day and other Bills			
	£3118 510 877		£3118 510 877

Dated the 21ST *day of* JANUARY 1988.

[signature] *Chief Cashier*

(3774)

PMG

Ch

You were going to have a private word with Gov about his re-appointment (letter to PM saying glad to serve but quite understand if want to appoint new Gov before 5 years up).

AA

674/18

FROM: R I G ALLEN
DATE: 20 JANUARY 1988

CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Sir P Middleton
Mr Scholar
Mr Peretz
Miss O'Mara
Mr Cropper

Can't really stop him presenting it to front door of Tsy.

WAR LOAN: SUNDAY EXPRESS

Patrick Lay (City Editor, Sunday Express) called me about an article which he wrote in his paper a couple of weeks ago (copy attached). This was a "campaigning" piece arguing for a redemption date to be put on War Loan. He claimed that he had received some 500-600 letters from pensioners and others in response to the article.

2. Lay asked me whether he could come to the Treasury tomorrow and formally present the letters, in the manner of a petition. He would bring along a cameraman, and, presumably, make a big splash in the next issue of the paper.

3. Despite the inaccuracies in the original article (which I have pointed out to Lay), I think this is a request we cannot reasonably refuse, particularly as Lay is generally very much a friend of Government policy. He seemed fairly indifferent as to whether the "petition" should be delivered to the main door of the Treasury or to No.11. As he is not pressing on the point, I suggest we agree to the former. I would arrange for one of my people to take delivery.

R I G ALLEN

SUNDAY EXPRESS
CITY 2 Edited by Patrick Lay

23

It is time to say rest in peace to War Loan

IT IS time for War Loan, the most widely-held of all Government stocks, to be laid to rest.

The long-suffering holders should be able to feel there is some prospect of their investment being repaid.

Even at this late stage there is no reason why Chancellor Nigel Lawson should not slip this emotive subject on to the agenda of his Chevening meeting with Treasury ministers and officials this weekend. What a Budget-bonus this could provide.

FEARED

War Loan was originally issued in 1932, but its history goes back even further, for it was offered by the then Government as a substitute for an earlier War Loan issue.

The main difference was that the early issue carried an interest rate of 5 per cent while the replacement reduced the interest rate to 3½ per cent.

Despite the reduction, the offer was snapped up by hundreds of thousands of investors. In those days a return of 3½ per cent on savings was considered so generous that many holders feared it would not be too long before the Government bought it back and offered an even lower-valued stock in its place.

To calm those fears the Government, instead of putting a date at which the stock would be redeemed as with most other stocks, guaranteed that they would not buy back the stock until at least 1952.

That gave the stock a life of at least 20 years; in fact 55 years have passed and still the Government is borrowing most of the original £1,920 million that was raised by the issue at the paltry cost of 3½ per cent a year.

Only £11 million of the original sum has been repaid. Many of today's 250,000 stock holders are those, or the descendants of those, who took up the original offer.

● IF you are a holder of War Loan and believe the time is right for a date to be set for its redemption, why not drop us a line? We could pass your thoughts to the Chancellor.

Write to "War Loan" the Sunday Express, 121 Fleet Street, London EC4P 4JT.

Each £100 worth of stock is now worth £37.25p in the market place and is unlikely to improve much unless a firm date for redemption at its original £100 is decided upon.

There are arguments against redemption, not least of which is that if the Government does not have this source of cheap borrowing then it will have to pay more for its cash and that would be to the detriment of tax payers.

War Loan is also one of the few stocks which can be held overseas and where the dividend is paid free of UK tax, and there are many who have retired overseas who could find their income affected by any change.

However, both objections could be overcome by the Chancellor doing nothing more than announcing that a date for redemption had been fixed—let me suggest the year 2002.

That would give holders 15 years to sort themselves out and would place no additional pressure on Government borrowing for that period.

Critics may argue that the Chancellor is in no position to alter the terms of the issue. On the other hand, the original terms were that the stock was redeemable on or after December 1, 1952 subject to three months notice from the Government.

We are certainly well past that date and the Government has shown its flexibility when it came to providing a safety net for BP underwriters and in providing a guaranteed bonus on "Granny Bonds" when falling inflation made the return on saving in these index-linked bonds unattractive.

It is time for some imaginative thinking along the same lines in regard to War Loan.

SUNDAY 10 JANUARY 1988

11/2

SUNDAY EXPRESS

121 FLEET STREET LONDON EC4P 4JT

TELEPHONE 01-353 8000

Ch

I took delivery of the 500 letters at this morning: there will be a story in next Sunday's paper, plus a photograph.

RA 21/1

The Rt. Hon. Nigel Lawson
Chancellor of the Exchequer
11 Downing Street
London S.W.1.

21st January, 1988

Ch/Draft reply from MG?

MPW 21/1

Dear Chancellor,

I realise there are many requests put to you for special consideration as you plan your Budget. Let me, however, make a special plea for holders of the 3½ per cent War Loan, particularly those who have held on since the issue, and those who have inherited from the original purchasers.

Among the 250,000 holders of this stock there are still several thousand waiting for its redemption at par, even though a 1988 pound does not begin to match up to the buying power of pounds invested in 1932.

X I have today submitted some 500 letters from Sunday Express readers on this matter. Take any half dozen at random and you will see how these people feel they have been let down by successive Governments.

When your predecessor, Neville Chamberlain, exhorted holders of the original 5 per cent War Loan to convert to the new stock containing a 3½ per cent coupon, he called on their patriotism and asked for their sacrifice. Those patriots have paid dearly.

Mr. Chamberlain pointed out that by paying the lower rate of interest, the country would benefit to the tune of £30 million a year in interest payments. By my calculations, the country now has saved £1,650 million on these interest payments alone.

Without wishing to over-egg the pudding, I might add that in 1932 a sum of £1,000 would have bought two pleasant homes in a London suburb and those houses today would have a value of around £75,000 each; the same sum invested in War Loan would have a value of £375.

There sh be a strong reply (There was a quite a good one.) N

/...

Telex No 21841 Cable Address Express London
Registered in London No 141748. Registered office: 121 Fleet Street London EC4P 4JT

d97/1

Ref. SPP6

SUNDAY EXPRESS

121 FLEET STREET LONDON EC4P 4JT

TELEPHONE 01-353 8000

I appreciate that the holders have received dividends each year; I realise that they made a conscious decision to buy the stock and not houses; I know that a lot of stock has changed hands and is now in the hands of institutional investors and overseas holders.

Nevertheless, after 55 years of relatively cheap borrowing - sometimes exceptionally cheap - it would be nice for the long-term holders to know that something was being done.

Your policies have helped restore this nation's economic pride; now let them restore its honour.

Yours sincerely,

Patrick Lay
City Editor

Telex No 21841 Cable Address Express London
Registered in London No 141748. Registered office: 121 Fleet Street London EC4P 4JT

Ref. SPP6

53/2/LPD/3749/018

pmp. PS/CHANCELLOR.

UNCLASSIFIED

Alex

FROM: P D P BARNES
DATE: 22 January 1988

NOTE OF MEETINGS HELD IN ROOM 51/2, TREASURY CHAMBERS, PARLIAMENT STREET ON THURSDAY 21 JANUARY BETWEEN 11.00am AND 1.00pm, 5.00pm AND 6.30pm, AND 7.30pm AND 9.15pm

Those Present:

Economic Secretary
Mrs Lomax
Miss Noble
Miss Wheldon - Tsy Sol
Mr Jackson - Tsy Sol

MINORIES FINANCE LIMITED v ARTHUR YOUNG

Meetings were held to consider the draft Certificate which the Economic Secretary was to sign in respect of certain documents, allegedly relevant to the above case, for which the Economic Secretary was to make a claim of public interest immunity (PII).

2. The Economic Secretary said that since Christmas when the first of the documents had been presented to him, he had read and carefully considered the documents in respect of which a claim to PII was to be made . He had also read the draft of the second affidavit to be sworn by Mr Rodney Galpin of the Bank.

3. During the meetings the Economic Secretary further considered the draft second affidavit of Mr Rodney Galpin, and considered also Mr Galpin's first affidavit sworn on 18 December 1987, and the first draft affidavit of Mr David Walker of the Bank.

4. The Economic Secretary considered at length with officials the draft certificate prepared for his signature. Having taken account of the documents for which a claim to PII was to be made, and having taken account also of the three affidavits or draft affidavits referred to above, the Economic Secretary instructed Mr Richard Jackson of Treasury Solicitor to make amendments to the

draft certificate in accordance with the terms discussed at the meetings, and having taken view of Treasury Counsel, Mr John Laws, and consulted with the Bank's lawyers, to prepare a final revised version of the Certificate for his signature.

PB

P D P BARNES
Private Secretary

cc PS/Chancellor
Sir P Middleton
Mr Scholar
Those Present

'91G.SCB.1778.6

PMP

FROM: N I HOLGATE

DATE: 22 January 1988

1. MISS O'MARA MOM 22/1
2. ECONOMIC SECRETARY

cc:
PS/Chancellor
Sir P Middleton
Sir G Littler
Mr Scholar
Mr Peretz
Mr Grice
Miss O'Mara
Mrs Ryding
Mr Savage (Parliamentary)
Mr Neilson

CENTRAL GILTS OFFICE: SECONDARY LEGISLATION

This submission seeks your approval for two statutory instruments (SIs) which add to the list of stock registers covered by the Stock Transfer Act 1982. They are not controversial.

Background

2. The Central Gilts Office (CGO) computerised service is an assured payments system which usually settles stock transactions on a next day basis. The alternative service for issuers is the Stock Exchange Talisman service, also computerised, which offers seven-day settlement. The 1982 Act provides for regulations to be made authorising certain securities specified in Schedule 1 to the Act to be traded through the CGO. Section 2(3) of the Act empowers the Treasury by order to add to the list of securities specified in Schedule 1.

3. Mr Brook's submission of 17 July 1986 sought your decision on applications to use the CGO from the Inter-American Development Bank, the Government of Australia and the International Bank for Reconstruction and Development. Mr Barnes' minute of 20 July recorded your approval of the necessary SI.

15/22/1

4. If an institution which applies to join the service is not specified under Schedule 1 of the Act, the Schedule must be amended. Whether an institution is specified or not, it must be included in the Stock Transfer Regulations under which the CGO operates.

5. A further dozen institutions have now applied. Six are not covered in Schedule 1 to the Act. The first Order, the Stock Transfer (Specified Securities) Order is required to add securities issued by them to the Schedule. They are:

The African Development Bank
The Asian Development Bank
Caisse Centrale de Coopération Economique
Crédit Foncier de France
Electricité de France (E.D.F.), Service National
Hydro-Québec.

Securities issued by the other six institutions (being governments of overseas territories) are already specified in general terms in paragraph 4 of Schedule 1. They are:

Ireland
Kingdom of Spain
Kingdom of Sweden
Province of Nova Scotia
Province of Quebec
Republic of Portugal.

6. The second Order, the Stock Transfer (Gilt-Edged Securities) (Exempt Transfer) Regulations specifies securities issued by all twelve of these institutions as securities which may be transferred through the CGO Service.

7. I attach the two draft SIs required.

Discussion

8. The Treasury has no reason to oppose further issuers joining the CGO. No additional public expenditure will be incurred as the cost of the work will not be included in the Bank's cash limit. The borrowers are either supra-national development banks; states; provinces; or agencies with a state or provincial guarantee. The Bank will not offer this opportunity to any other borrowing bodies before the summer, so there is little to be said for waiting to add others to the list; and the present clerical procedure is of course less efficient than the computerised one, both for the Bank and for the market practitioners. No new complications arise for the Financial Markets (Clearing) Bill.

Conclusion

9. I recommend that you approve the two SIs attached. The Specified Securities Order is required to be laid before Parliament after being made but is not subject to further Parliamentary procedure. It needs to be made before the second Statutory Instrument, the Exempt Transfer Regulations, which are subject to negative resolution and may come into force after 21 days.

10. FIM agree.

N Holgate

N I HOLGATE

STATUTORY INSTRUMENTS

1988 No.

SECURITIES

The Stock Transfer (Specified Securities) Order 1988

Made - - - -	1988
Laid before Parliament	1988
Coming into force	1988

The Treasury, in exercise of the powers conferred on them by section 2(3) of the Stock Transfer Act 1982(a), and of all other powers enabling them in that behalf, after consultation with the Bank of England, hereby make the following Order:-

1. This Order may be cited as the Stock Transfer (Specified Securities) Order 1988 and shall come into force on 1988.

2. The securities specified in the Schedule hereto shall be added to the list in Schedule 1 to the Stock Transfer Act 1982.

1988.

Two of the Lords Commissioners
of Her Majesty's Treasury.

(a) 1982 c. 41.

SCHEDULE

Article 2

SPECIFIED SECURITIES

Securities issued in the United Kingdom by the African Development Bank, the Asian Development Bank, Caisse Centrale de Coopération Économique, Crédit Foncier de France, Electricité de France (E.D.F.), Service National or Hydro-Québec, being, in each case, securities registered in the United Kingdom.

EXPLANATORY NOTE

(This Note is not part of the Order.)

Provision is made in the Stock Transfer Act 1982 for permitting the transfer in certain cases of specified securities through the medium of a computer-based system established by the Bank of England and The Stock Exchange. Such a system, known as the CGO service, has been established. This Order specifies further securites, in addition to those listed in Schedule 1 to the Stock Transfer Act, to which the provision of the Act may apply.

STATUTORY INSTRUMENTS

1988 No.

SECURITIES

The Stock Transfer (Gilt-edged Securities) (Exempt Transfer) Regulations 1988

Made - - - -	1988
Laid before Parliament	1988
Coming into force	1988

Whereas the securities which are the subject of these Regulations are for the time being specified in the list in Schedule 1 to the Stock Transfer Act 1982(a);

And whereas the person issuing such securities or class of securities has agreed that the securities may be transferred through the medium of a computer-based system established by the Bank of England and The Stock Exchange;

Now, therefore, the Treasury, in exercise of the powers conferred on them by section 1(1) and (4) of the Stock Transfer Act 1982, and of all other powers enabling them in that behalf, hereby make the following Regulations:-

Citation and Commencement

1. These Regulations may be cited as the Stock Transfer (Gilt-edged Securities) (Exempt Transfer) Regulations 1988 and shall come into force on 1988.

(a) 1982 c.41; Schedule 1 was extended by S.I. 1988/ .

Interpretation

2. In these Regulations:-

"the Bank" means the Bank of England;

"the CGO" means the Central Gilts Office of the Bank;

"the CGO Service" means the computer-based system established by the Bank and The Stock Exchange to facilitate the transfer of gilt-edged securities; and "CGO Service member" means a person who is entitled under a contract with the Bank to use the CGO Service.

Exempt Transfers

3. The securities specified in the Schedule hereto may be transferred by a CGO Service member through the medium of the CGO Service.

1988.

Two of the Lords Commissioners
of Her Majesty's Treasury.

SCHEDULE

Regulation 3

SECURITIES

Securities specified for the purposes of regulation 3 of these Regulations are those on registers kept by the Bank which have been issued, or which may from time to time be issued, by the following:

The African Development Bank
The Asian Development Bank
Caisse Centrale de Coopération Economique
Crédit Foncier de France
Electricité de France (E.D.F.), Service National
Hydro-Québec
The Government of the Republic of Ireland
The Government of Spain
The Government of the Kingdom of Sweden
The Government of the Province of Nova Scotia
The Government of the Province of Quebec
The Government of the Portuguese Republic

EXPLANATORY NOTE

(This Note is not part of the Regulations.)

These Regulations specify further gilt-edged securities which may be transferred by CGO Service members through the CGO Service in addition to those specified in the Stock Transfer (Gilt-edged Securities) (Exempt Transfer) Regulations 1985 (S.I.1985/1145) and the Stock Transfer (Gilt-edged Securities) (Exempt Transfer) Regulations 1987 (S.I.1987/1294). Such transfers will be effective under section 1(2) of the Stock Transfer Act 1982 without the need for an instrument in writing.

APPOINTMENTS:
IN CONFIDENCE

Purp.

10 DOWNING STREET

From the Private Secretary

25 January 1988

Dear Alex,

Bank of England

I am writing to confirm that The Queen has approved the re-appointment of Mr Robin Leigh-Pemberton as Governor of the Bank of England.

As you are aware we are proposing to release an announcement of this at the same time as the other re-appointments and I enclose a copy of the Press Notice which has yet to be agreed with the Bank.

Yours,

Paul

Ch
Announced at 3.30 tomorrow
AA

26/1
CH/EXCHEQUER
REC. 26 JAN 1988
ACTION SIR P MIDDLETON
COPIES TO MR R.I.G. ALLEN

A C S Allan Esq
HM Treasury

Bank of England Appointments
Governor and Director

The Queen has been pleased to approve the re-appointment, under the Bank of England Act 1946, of the Right Honourable Robin Leigh-Pemberton as Governor of the Bank of England for a further term of five years from 1 July 1988.

The Queen has also been pleased to approve the re-appointment of Dr David Valentine Atterton CBE, Mr Rodney Desmond Galpin, Mr Deryk Vander Weyer CBE and Sir Leslie Clarence Young CBE as Directors of the Bank on the expiry of their present terms of office for a period of four years from 1 March 1988.

28 January 1988

53/2/MAD/3749/32

UNCLASSIFIED PS/CHANCELLOR pmp

FROM: P D P BARNES
DATE: 25 January 1988

NOTE OF A MEETING HELD IN ROOM 51/2, TREASURY CHAMBERS, PARLIAMENT STREET FROM 11.30 am TO 1.15 pm ON FRIDAY 22 JANUARY

Those present: Economic Secretary
Miss Noble
Mr Jackson, T/Sol

MINORIES FINANCE LIMITED v ARTHUR YOUNG

The Economic Secretary considered amendments to his draft Certificate which had been drafted in accordance with his instructions at the meeting the previous day, following discussions between Treasury officials, Treasury Solicitor, Treasury Counsel, and the Bank of England. After discussion, the Economic Secretary declared himself satisfied with the amended draft Certificate.

2. The Economic Secretary also re-examined the documents for which a claim for PII was to be made. He satisfied himself that each document belonged to a class for which a claim for PII could be sustained.

3. The Economic Secretary instructed Mr Jackson to prepare a final Certificate for his signature on Monday. He also asked for final versions of the affidavit of Mr David Walker and the second affidavit of Mr Rodney Galpin to be produced for him that afternoon, so that he could consider these, along with the first affidavit of Mr Galpin, over the weekend, before signing his Certificate the following Monday.

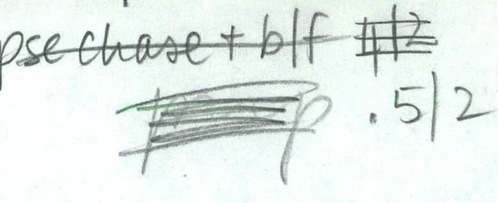
PB

P D P BARNES
Private Secretary

cc PS/Chancellor
Sir P Middleton
Mr Scholar
Those Present

ps2/44M

UNCLASSIFIED



FROM: MISS M P WALLACE
DATE: 26 January 1988

MR S BOWDEN

cc Mr R I G Allen
Miss O'Mara
Mrs Ryding

SUNDAY EXPRESS WAR LOAN CAMPAIGN

... I attach a copy of the letter from Patrick Lay, the Editor of the Sunday Express, which was handed in with the 500 letters about War Loans. The Chancellor would be grateful if you could provide a draft reply for his signature.

MPW

MOIRA WALLACE

SUNDAY EXPRESS

121 FLEET STREET LONDON EC4P 4JT

TELEPHONE 01-353 8000

The Rt. Hon. Nigel Lawson
Chancellor of the Exchequer
11 Downing Street
London S.W.1.

21st January, 1988

Dear Chancellor,

I realise there are many requests put to you for special consideration as you plan your Budget. Let me, however, make a special plea for holders of the 3½ per cent War Loan, particularly those who have held on since the issue, and those who have inherited from the original purchasers.

Among the 250,000 holders of this stock there are still several thousand waiting for its redemption at par, even though a 1988 pound does not begin to match up to the buying power of pounds invested in 1932.

X I have today submitted some 500 letters from Sunday Express readers on this matter. Take any half dozen at random and you will see how these people feel they have been let down by successive Governments.

When your predecessor, Neville Chamberlain, exhorted holders of the original 5 per cent War Loan to convert to the new stock containing a 3½ per cent coupon, he called on their patriotism and asked for their sacrifice. Those patriots have paid dearly.

Mr. Chamberlain pointed out that by paying the lower rate of interest, the country would benefit to the tune of £30 million a year in interest payments. By my calculations, the country now has saved £1,650 million on these interest payments alone.

Without wishing to over-egg the pudding, I might add that in 1932 a sum of £1,000 would have bought two pleasant homes in a London suburb and those houses today would have a value of around £75,000 each; the same sum invested in War Loan would have a value of £375.

/...

Telex No 21841 Cable Address Express London
Registered in London No 141748. Registered office: 121 Fleet Street London EC4P 4JT

497/1

SUNDAY EXPRESS

121 FLEET STREET LONDON EC4P 4JT

TELEPHONE 01-353 8000

I appreciate that the holders have received dividends each year; I realise that they made a conscious decision to buy the stock and not houses; I know that a lot of stock has changed hands and is now in the hands of institutional investors and overseas holders.

Nevertheless, after 55 years of relatively cheap borrowing - sometimes exceptionally cheap - it would be nice for the long-term holders to know that something was being done.

Your policies have helped restore this nation's economic pride; now let them restore its honour.

Yours sincerely,

Patrick Lay
City Editor

Telex No 21841 Cable Address Express London
Registered in London No 141748. Registered office: 121 Fleet Street London EC4P 4JT

Ref. SPP6

53/2/LPD/3749/053

FROM: P D P BARNES
DATE: 26 January 1988

MR HOLGATE

cc PS/Chancellor
Sir P Middleton
Sir G Littler
Mr Scholar
Mr Peretz
Mr Grice
Miss O'Mara
Mrs Ryding
Mr Neilson
Mr Savage

CENTRAL GILTS OFFICE : SECONDARY LEGISLATION

The Economic Secretary was grateful for your submission of 22 January.

2. The Economic Secretary is content to give his approval to the two statutory instruments mentioned in your submission.

PB

P D P BARNES
Private Secretary

90/G.jfw.4565.026

FROM: J W GRICE
DATE: 26 January 1988

MRS RYDING

cc Mr Peretz
Miss O'Mara

GOVERNOR'S SPEECH TO THE NEWSPAPER CONFERENCE : 29 JANUARY

Miss O'Mara passed on to me a copy of the Governor's Speech sent over to Alex Allan and asked me to pass any comments to you.

2. What I am most concerned about in the Governor's Speech is the interpretation that would be placed upon it that we are worried for monetary policy reasons about the growth of credit. The first two-thirds of the speech are written in a way which would be naturally interpreted as official concern about credit. By contrast, we have been very concerned to deny that we have a credit policy or that credit is a factor that we take into account in assessing monetary conditions. It may well be that we shall want to reiterate this point in the 1988 MTFS. The reason for this is that to every debtor corresponds a creditor. Credit itself cannot be a net source of final demand for goods and services: what matters is whether the assets corresponding to the liabilities represented by the credit are willingly held or not. There are one or two points in the Governor's Speech - if one reads it carefully - where this is nearly said. But the point needs to be made much more clearly. My recollection is that the Chancellor put this point quite nicely in the 1986 Mansion House Speech. My advice would be, therefore, that we construct a paragraph based on the Chancellor's Speech and ask the Bank to put it in the Governor's Speech.

3. I have no great difficulties with what is said about the prudential aspects of credit. But, in any case, that is obviously for FIM and not MG.

J W G

J W GRICE

Mr Hudson - this is pretty much along the lines of what I was telling you earlier on. X is the key point to get across to the Bank. I'm not sure that the Mansion House speech helps you that much (copy attached). I wd have thought you cd quote X almost as it is - leaving the Bank to pad it out a bit

Cathy Ryding.

Broad money and credit have been growing fast, and I understand the concern that has been aroused on that score. As I pointed out last year, it was clear that the liberalisation of the financial system, the end of mortgage rationing, and the increased competition between financial institutions would lead to a steady increase in the ratio of broad money to GDP. This, indeed, has been a consistent feature of the 1980s. There is every sign that people are holding the increased amounts of broad money quite willingly. And so long as this is so, its growth is not inflationary.

One aspect of this is that the ratio of personal debt to personal income has risen. But the rise has been matched by a similar growth in personal holdings of liquid assets, and the personal debt ratio is still below the comparable figure in the United States.

So neither broad money nor credit was a trigger for this week's rise in interest rates.

What could not be ignored was that more reliable indicators, such as narrow money, as measured by MO, and in particular the exchange rate, were indicating an easing of monetary conditions.

Given the precipitate collapse of the oil price, it was inevitable and indeed necessary that the exchange rate should fall so as to enable - after the inevitable delay known as the J-curve - non-oil exports to rise to offset at least the greater part of the fall in oil export revenues. But there are clearly limits to the necessary and desirable extent of that fall.

Moreover, the growth of MO, although well within its target range, has edged upwards, and in all the circumstances it seemed desirable to seek to bring it back towards the centre of the range.

COMMENTS

BANK OF ENGLAND
LONDON EC2R 8AH

26 January 1988

The Gov Board of v. important matters. On the other hand, Some gone suggests changes are little more than draft wordsmiths, & I could forget them all

A C S Allan Esq
Private Secretary to
The Chancellor of the Exchequer
HM Treasury
Parliament Street
London
SW1A 3AG

CH/EXCHEQUER
REC. 26 JAN 1988
ACTION Mr Peretz — comments ASAP, pl
COPIES TO PS/EST, Sir P. Middleton, Sir T. Burns, Mr Scholar, Mrs Lomax, Miss O'Mara, Mr RIG Allen, Mr Pickford, Mr Cropper

Dear Alex

I enclose a copy of the speech that the Governor is proposing to give at lunchtime on Friday to the Newspaper Conference, which is a gathering of regional journalists. I should be very grateful to have any comments as soon as possible.

Yours ever

John.

J R E Footman
Private Secretary
to the Governor

C.

Some parts of this need serious attention (see comments marked from MG). But I've seen worse. Joe Grice's point at X (minute attached) is met, to some extent, by David Peretz's addition on p. 3.

AH

2234A

SPEECH TO THE NEWSPAPER CONFERENCE
FRIDAY 29 JANUARY

Mr Chairman, I was delighted to be invited to be the principal guest and speaker at this the annual luncheon of the Newspaper Conference. The UK press is unusual in its high degree of concentration in the national daily newspapers and one can too easily overlook the contribution made by the regional press. In being here today, and in choosing to talk about personal credit, which is a ~~contentious~~ aspect of monetary policy, of great current interest, [I hope that I convey to you some sense of the importance which we at the Bank attach to the regional press].

MG (Cathy)

PUBLISHED VERSION STARTS HERE

Much attention has been drawn recently to the question of lending to the personal sector. You will, for example, have seen - indeed some of you may have written - newspaper headlines such as "accelerating credit growth fuels consumer boom". I should like to spend a few moments this afternoon talking about this aspect of credit, considering in turn its macroeconomic significance, some supervisory implications and the social questions which can arise from the easy availability of consumer credit.

But first, let me say a few words about the role of credit more generally in the economy.

Our attitude to credit is typically ambivalent. There is a tendency to think of credit as something which is intrinsically reprehensible. Most of us carry around somewhere in our subconscious the familiar admonition "neither a borrower nor a lender be". But at the same time it is very hard to envisage the effective functioning of the economy without credit to oil the wheels. Its role is to allow flexibility in the timing of expenditures, enabling them to be separated in time from the receipt of income.

This tends to be more readily accepted in the case of industry and commerce, where credit - to finance an expansion of production through investment or the employment of additional labour or to finance stocks - is taken in anticipation of future sales. But credit performs exactly the same function for consumers, enabling them to make large purchases or investments at a convenient or opportune time, and to pay for them in accordance with their expected pattern of income. I find nothing reprehensible about that in principle - indeed rather the reverse.

So in general I welcome the changes in the financial structure over the last few years which have resulted from, and in, more competition between lenders to the personal sector and in the increased availability of personal sector credit. It must be an advantage for the individual to have more choice between different types of borrowing facility, and greater flexibility over the timing of his expenditure and in the arrangement his portfolio of assets and liabilities. And there are macroeconomic benefits too. For example, with the ending of mortgage queues, activity

in the housing market is less prone to proceed in fits and starts governed by the availability of mortgage finance.

But, like all good things, there can be too much of it.

From the macroeconomic viewpoint, [too rapid] an expansion of credit can lead to [too rapid] a growth of demand in real or financial markets. The persistent pressure of excessive credit growth clearly can produce an over-liquid economy with the added potential for inflation which that entails. So the question is one of degree. Has the growth of credit - and of credit to the personal sector in particular - in fact been too fast?

As you would expect there is not a simple or straightforward answer to that question.

In aggregate bank lending in sterling to the domestic private sector as a whole certainly has been growing very rapidly - accelerating to [well over 20%] a year in the last two years compared with [10-15%] at the beginning of the 1980s. Looking behind the aggregate figures, a principal cause of this acceleration has been a remarkable surge in lending to financial institutions. It has nearly doubled since 1985, to getting on for a quarter of the outstanding total stock of bank lending - though it has tended to grow more slowly since the summer. This development has no doubt a good deal to do with the recent structural changes in our system of financial intermediation and to this extent its significance for the behaviour of the wider economy may be limited.

Bank lending to industrial and commercial companies, although quickening in the last six months or so, has generally been more restrained in recent years as borrowers have found a wide variety of alternative sources of finance in both domestic and overseas money and capital markets.

Bank lending to the personal sector has also grown relatively fast - by [nearly 50%] in the past two years and by over a quarter last year alone, and this is what has attracted ~~To this extent one could argue that~~ the headlines to which I referred earlier ~~were justified~~.

MG

But looking at the banks' personal lending more closely, one finds that the most important and rapidly growing part of it is mortgage lending. The banks' other consumer lending has been growing fairly steadily at a rate of around 18% a year for most of the 1980s. And much of the recent acceleration in the banks' mortgage lending has been at the expense of slower growth in mortgage lending by building societies. Taking banks and building societies together, the total increase in credit granted to the personal sector was [%] in the past two years and [%] in 1987 alone.

Even so, personal sector borrowing in total has been rising a good deal faster than personal incomes for a number of years. This has much to do with more intensive competition between financial intermediaries, particularly in the mortgage field, which has made it easier, for example for homeowners to borrow against the accumulated equity in their houses. Not all of this increased borrowing has fed through ~~immediately~~ into higher consumer spending. Much of it has gone into a parallel increase in the

DLCP

personal sector's holdings of financial assets, including holdings of deposits with banks and building societies. To this degree, therefore, what we have seen is a change in the personal sector's financial behaviour resulting from the freer availability of credit, which may be of less economic significance than would have been implied by earlier relationships between borrowing and spending. Such a shift in behaviour is likely to take some years to complete, but we simply cannot tell how much longer it will take or how far we are away from a new equilibrium.

The point I am making is that the simple credit figures need to be seen in perspective. The monthly bank lending data in particular - which typically attract most public attention - have to be interpreted with great care. They have in our view for some time exaggerated the degree of monetary stimulus given to the economy and the extent to which we have been going through a consumer credit boom in the traditional sense. In these and other respects we need, I think, to be wary of over-simple and over-hasty conclusions.

In making these remarks I do not at all mean to suggest that we can be relaxed about the recent pace of credit growth, including the growth of consumer credit. It has been, and continues to be of concern to the Bank and, together with the associated rapid increase in broad money, it is one of the factors - alongside the strength of domestic demand and the continuing less than satisfactory development of underlying labour costs - which inclines the Bank to a generally cautious monetary stance. But there could be a danger of over-reaction if we simply took the credit figures at their face value.

These developments in personal sector lending, of course, also give rise to a supervisory concern. Historically the risk:reward ratio on lending to the personal sector, particularly on mortgages, has been relatively attractive in this country and it is this past experience as much as anything which has attracted so many new lenders into the field. But the effect of more intense competition must tend to be to encourage lenders to take on higher risks at the same time that lending margins are being squeezed. Past experience may not therefore continue to be an adequate guide to the future; and lenders, and their supervisors, must be conscious of the steeply rising personal sector debt to income ratio which, though broadly paralleled by a rising wealth to income ratio at the macroeconomic level, may well lead to an increasing number of individual borrowers who have difficulty in servicing their debts.

Thus far the signs are not discouraging. Certainly, since the ending of hire purchase terms control, we have seen some lentghening in the term of consumer credit; and mortgage lenders have gradually increased the amount that they are prepared to lend both as a proportion of the value of the property and as a multiple of income. I have become aware recently of a number of instances of income multiples of up to four times the primary income which suggests this process is going further. But in parallel with these developments techniques for assessing credit have been improved and for the most part the fuller credit terms are being extended selectively, in cases where the borrower is well known to the lender, who can therefore better judge the risks. My impression at present is that experience of arrears and bad debts on personal sector lending generally is getting no

APH

worse and in some areas is even tending to improve - as indeed it should [in an improving climate for employment.] with unemployment falling rapidly. Welcome though this is, it cannot, of course, be taken as grounds for complacency and you may be assured that we will remain vigilant in this respect in our own supervisory activity.

Let me then turn to the third aspect of personal sector lending which I want to raise this afternoon - its social aspect, that is to say the problem of the easy availability of credit from a multiplicity of sources to the individual borrower who may thereby be tempted to take on more debt than he or she can handle. There have been a number of well-publicised instances of this in recent months, which have quite properly given rise to concern. Because of the real personal suffering which it can involve it is perhaps the aspect of personal sector credit which gives me the most immediate anxiety.

Attitudes to this problem tend to divide between those who believe that the fault lies with the borrowers who need protection from themselves, and those who believe the blame lies with over-zealous lenders, as it were, pushing credit down the unwilling throats of reluctant consumers.

I am bound to say that I find it hard to envisage many instances where the borrower can be spared <u>all</u> respnsibility for his actions and there can be very few cases of a lender consciously making an advance which he knows has little chance of being repaid. But there certainly are cases where the credit assessment is made with insufficient care. It is not for me to take sides in this debate; my purpose is rather to consider the remedies.

There are already legal safeguards to protect borrowers through the Consumer Credit Act and through codes relating to advertising standards, for example; and I myself doubt whether the present problem can effectively be addressed through further legislation. More can no doubt be done in educating borrowers over the longer term. But the possibility for more immediate action probably does lie with the lenders who must - and mostly do - accept a social responsibility to minimise the incidence of over-borrowing by consumers. I would commend to you in this regard the Code of Practice adopted by the Finance Houses Association last year.

There is, however, a corollary to expecting lenders to accept a social responsibility in this form. We must then accept that they will need to be more intrusive in their enquiries into a prospective borrower's financial position, and, in particular, in a world in which a single borrower has access to a vast array of credit sources, that lenders must be able to pool their knowledge of the financial position of individual borrowers. I am glad to say that much progress is already being made in this direction.

Of course, I understand that such arrangements must be subject to appropriate safeguards. They must, for example, ensure that the individuals may have access to such information as far as it concerns them and this is rightly ensured under the Data Protection Act. More generally there must be arrangements to protect the confidentiality of the information except to those participating lenders from whom credit has been specifically requested. I hope that we can collectively make rapid progress in defining those safeguards so reducing the present inhibitions

on faster progress towards pooling credit information, including "white" as well as just "black" information. Without this, Mr Chairman, I am afraid that we are likely to see more instances of that personal distress, which all of us would wish to avoid. We cannot expect lenders to do an effective job in preventing this, if we are not prepared to provide them with the means of carrying it out.

MG

Mr Chairman, I have addressed the role of credit from a number of viewpoints, macroeconomic, prudential and social. ~~Excessive~~ Rapid growth of credit, and the attendant build up of liquidity ~~are~~ will always be ~~a worry from a monetary policy perspective,~~ watched with care by ~~the~~ monetary authorities, particularly in a period of financial innovation and changing behaviour, which add to the difficulties of interpretation of events. There is perhaps nowadays a greater awareness of prudential issues, and in general, a greater degree of vigilance than in earlier times. Perhaps the biggest concerns are the social ones, as individuals and institutions need to adjust their behaviour and attitudes towards the easing in credit availability that has become established in recent years.

Tony D

Please investigate with accounts division & Bank of England

(a) Whether these need to be sent to us or could be sent to accounts division direct

(b) if they do have to come to us, what we should do with them?

Alex

Alex: Re- the attached.

① Accounts division receive a Copy direct from the Bank of England.

② The B of E Only Send us a Copy for Information. We Can Stop receiving our Copy if you Wish.

1. Moira to see Yeehaw!
2. Tony

Many thanks
Please do X!

Alex

BANK OF ENGLAND

Wednesday the 27th day of January 1988

ISSUE DEPARTMENT

	£		£
Notes Issued:		Government Debt	11 015 100
In Circulation	13 178 809 218	Other Govt.Securities	2 764 067 274
In Banking Department	11 190 782	Other Securities	10 414 917 626
	13 190 000 000		13 190 000 000

BANKING DEPARTMENT

	£		£
Capital	14 553 000	Govt.Securities	476 200 051
Public Deposits- including Exchequer, National Loans Fund, National Debt Commissioners and Dividend Accounts	90 035 451	Advances and Other Accounts	900 619 454
		Premises, Equipment and Other Securities	1 727 826 369
Special Deposits		Notes	11 190 782
Bankers' Deposits	1 058 176 897	Coin	358 104
Reserves and Other Accounts	1 953 429 412		
	3 116 194 760		3 116 194 760

Dated the 28th day of January 1988

G E A KENTFIELD, Deputy Chief Cashier

BANK OF ENGLAND

An ACCOUNT pursuant to the Acts 7 & 8 Vict. ch. 32, 18 & 19 Geo. 5. ch. 13 and 19 & 20 Eliz. 2 ch. 24, for the week ending on Wednesday, the 27TH day of JANUARY 1988.

ISSUE DEPARTMENT

	£		£
Notes issued —		*Government Debt*	11 015 100
In Circulation	13178 809 218	*Other Government Securities*	2764 067 274
In Banking Department	11 190 782	*Other Securities*	10414 917 626
		Coin other than Gold Coin	
		Amount of Fiduciary Issue	£13190 000 000
		Gold Coin and Bullion	
	£13190 000 000		£13190 000 000

Dated the 28TH *day of* JANUARY 1988.

G.E.A. Kentfield Deputy *Chief Cashier*

BANKING DEPARTMENT

	£		£
Capital	14 553 000	*Government Securities*	476 200 051
Rest		*Other Securities*	2628 445 823
Public Deposits (including Exchequer, National Loans Fund, National Debt Commissioners and Dividend Accounts)	90 035 451	*Notes*	11 190 782
		Coin	358 104
Other Deposits	3011 606 309		
Seven Day and other Bills			
	£3116 194 760		£3116 194 760

Dated the 28TH *day of* JANUARY 1988.

G.E.A. Kentfield Deputy *Chief Cashier*

(3774)

BANK OF ENGLAND
LONDON EC2R 8AH

27 January 1988

cc ~~Sir G. Littler~~
~~Mr H. P. Evans~~

A C S Allan Esq
Private Secretary to
The Chancellor of the Exchequer
HM Treasury
Parliament Street
London

Dear Alex

I enclose a copy of our February Quarterly Bulletin Assessment and would be grateful for any comments by midday Monday 1 February.

Yours

John

J R E Footman
Private Secretary
to the Governor

Comments by noon Friday 29 January

CH/EXCHEQUER
REC. 27 JAN 1988
ACTION
COPIES TO
~~CST, FST, PMG, EST~~
~~Sir P Middleton~~
~~Sir T Burns~~
~~Mr Scholar~~
~~Mrs R Lomax~~
~~Mr D Peretz~~
~~Mr P Sedgwick~~
~~Mr Odling-Smee~~
~~Mr Culpin~~
~~Mr Pickford~~

BULLETIN ASSESSMENT

Introduction

The events in the financial markets last October can now be seen in greater perspective. An article on p[ ] addresses questions they raised about market structure both here and elsewhere, while a number of reports has already been published in the United States. This Assessment deals with macroeconomic themes and suggests that in that context the fall in the dollar is more important than that of equity prices, at least for the United States' trading partners. It is likely to further the adjustment of international imbalances but also to contribute to a slowing of world growth which in turn calls in question the sustainability of the recent relatively rapid growth of the UK economy. The growth of domestic demand here, which has exceeded that of output, has been sustained by a downward trend in the personal sector's saving ratio, and has contributed to a deteriorating trend in the trade balance.

Further falls in the dollar late last year ...

1 Activity in the seven major industrial countries in the third quarter was stronger than expected, growing at the most rapid rate for over three years. Early indicators for the period following October's stock market crash suggest that much of this momentum has been maintained and that activity is holding up quite well. It is far too early to measure reliably the macroeconomic effects of the fall in share prices; some of them may take a long time to be felt, and they will in any case be difficult to disentangle from other factors. Nonetheless surveys of business confidence in the major economies suggest that spending plans have not been substantially curbed. In part this reflects the willingness of authorities to supply liquidity and reduce interest rates to offset any tightening effects of lower share prices. In the United States, however, where equities are more widely held, there is some evidence that consumer spending has weakened a

little recently, with demand for consumer credit slowing and December retail sales little if at all higher than a year earlier. This is a helpful sign for the resolution of current account imbalances, as slower growth in consumer demand in the United States would help to dampen imports and free resources for the production of exports, and also for investment in additional capacity in the tradables sector.

2 Following the collapse in equity prices, foreign exchange markets have undergone a further turbulent phase, with the dollar falling 10% to the turn of the year. This may have stronger and more immediate effects on the world economy than the preceding share price fall. The G7 communique issued before Christmas had little immediate impact on markets, but strong and visible co-ordinated intervention by the Federal Reserve and other central banks in the New Year underlined their commitment and succeeded in stabilising the dollar. The speed of correction of imbalances has been slower than desired, with terms of trade effects continuing to mask the improvement in volumes. The weaker growth of domestic demand in the United States now in prospect, coupled with the recent additional sharpening of competitiveness, should lead to volume effects beginning to dominate movements in the US trade account during 1988 provided the dollar remains broadly stable through the year. The November trade figures (published in mid-January) were better than anticipated and the dollar recovered by over 2% on the news. But the dollar depreciation in the closing months of 1987 may give additional negative J-curve effects in the months ahead, and experience suggests that a rapid turnround in the nominal deficit is unlikely. Sustained evidence that imbalances are lessening is needed for markets to become more settled.

... highlight the need for policy changes

3 A further sharp fall in the dollar would pose dangers to the world economy. Exchange rate changes alone cannot correct trade imbalances without risk of misalignment, entailing an uncertain climate where price signals are difficult to interpret and it is hard to make sound investment decisions. Supporting fiscal,

provide more balanced adjustment. In the current conjuncture abetter balance of demand growth between the United States and some major surplus countries would reduce the possibility of a recession which would be harmful for developed and developing nations alike. Given the low unemployment and high capacity utilisation there, a major concern in the United States is that there should be a sufficient rise in saving to allow resources to be available to meet additional net external demand. Although the likely slowdown in consumer spending would help, there is limited room for manoeuvre in the economy, given continued, if somewhat reduced, pressure on resources from the public sector. In these circumstances a further fall in the dollar might be largely dissipated in inflation, although encouragingly there are few signs of a pick-up in inflation to date.

4 Already modest growth prospects for Germany have been dampened further by the rise in the deutschemark. Higher demand growth there would raise world activity both directly, and indirectly by reducing the external constraints on other European economies, and would also reduce the risk of dollar overshooting. Monetary policy moves following the stock market collapse have helped, but fiscal policies are barely stimulative at present when cyclical factors are allowed for. Although the German authorities are concerned at the rise in the fiscal deficit, much of this can be accounted for by low growth and the erratic decline in the Bundesbank's profit transfer. The recent announcement of the intention to claw back next year part of this overshoot is not conducive to domestic demand growth. In contrast, the Japanese economy is currently very buoyant, although as in Germany further sharp exchange rate appreciation could dampen activity and investment growth. Structural adjustment of the Japanese economy is proceeding, helped by last year's stimulatory budget, but exports remain quite buoyant. There remains scope for further helpful import liberalisation in Japan. This is also particularly the case in Taiwan and Korea, who have a part to play in the promotion of balanced growth and in reducing the protectionist pressures evoked by their large trade surpluses. Their exchange rate policies have also been unhelpful and Hong Kong's maintenance of its rate against the US dollar has been held to pose a similar threat; but with the territory's trade in rough

5 The main burden of stabilising exchange rates tends to fall initially on monetary policy, before being shared by fiscal and structural actions. There is little scope for further monetary easing outside the United States, as interest rates have already been reduced and liquidity growth, fuelled partly by intervention, remains strong. Indications that the US authorities would be ready to increase interest rates if the dollar were to come under renewed pressure would help to stabilise it. Expansionary fiscal and structural policies in Germany, and in Japan should that economy slow significantly, would then be the more urgent to offset the additional slackening in world activity, which any tightening of US monetary policy might induce.

6 Developing country debtors would benefit from the maintaining of growth and the more stable trading environment, although in the short run higher dollar interest rates, were they to prove necessary, would be damaging. Commitment to sound adjustment measures among major debtors continues to be mixed, emphasising the need for a case-by-case approach. Following an interim financing agreement, Brazil has disappointed the banks by its unwillingness to resume interest payments, while Argentina's external trade position has deteriorated sharply. Both countries have been unable to tighten fiscal policy as required. In contrast, the Mexican authorities reacted quickly in response to pressure on the peso and their readiness to adopt firm measures may enhance the appeal of the debt conversion scheme recently proposed.

At home domestic demand has grown strongly...

7 The UK economy is now known to have been even more buoyant last autumn than was thought at the time. GDP growth in the year to the third quarter is now put at 5%, with manufacturing and construction rising particularly fast. Domestic demand was strong in the quarter, notably personal consumption and stockbuilding, the former implying a continuation of a fall in the personal saving ratio to levels not seen for nearly a generation. Exports too were quite strong, reflecting better-than-expected supply performance in the preceding twelve months, manifest in rapid productivity growth and an improvement in export market share.

Nevertheless, imports rose even more, and the balance of non-oil trade has steadily deteriorated since the early part of last year.

8 The fall in the saving ratio in the third quarter to around 5% may be in part a statistical aberration, but there is no doubt that the ratio has come down considerably in the past seven years, from a peak of over 15% in 1980. As noted in the November Bulletin (page 476), this trend is in part due to lower employer contributions to pension funds, but the fall in the household saving ratio is also very marked. The factors underlying the fall are reviewed in the Commentary (pages 00-0); they include, in addition to the slowdown in inflation, the improvement in employment prospects and readier access to credit. Following these factors, the decline may level out and perhaps even reverse soon. In itself the fall is not necessarily a cause for alarm, but the associated growth of debt may raise prudential considerations for banks and other suppliers of personal sector credit. The sharpness and extent of the recent fall in savings raises questions about the appropriate response of monetary and fiscal policy, which are addressed at the end of this Assessment.

9 On latest indicators, output and demand have continued strong, although the momentum of personal consumption seems to have moderated a little. It is not clear that this is due to the stock market collapse which recent intentions surveys do not suggest is having a marked effect on demand or on spending plans more generally. More concern attaches to the dollar's fall and its implications for industries exposed to US competition. After a period of comparative stability between February and September, the dollar has fallen sharply. While helping to mitigate inflationary pressures here as elsewhere (apart from the United States), this poses some problems for UK activity and the balance of payments. Sterling has risen by approximately 25% against the dollar in the past year but, because of its comparative stability against other key currencies, much less in effective terms. By virtue of its construction the effective rate index (ERI) gives a better guide to influences on UK trade as a whole than any bilateral rate. Although UK cost competitiveness based on the ERI has deteriorated by around 10% since the fourth quarter of 1986, it is still not significantly worse than three years ago, itself a

... but the dollar's further fall...

10 The large movements between the dollar and third currencies means that there have been large differential movements in the competitiveness of particular UK industries and as between different markets. Quite apart from any accompanying deterioration in overall competitiveness such shifts have adverse implications for trade and externally-based activity. Large exchange rate movements create uncertainties that impede long-range planning by industrialists even though they can, at a price, insure against many of the effects, particularly in the short-term. Sharp and substantial shifts in the profitability of different sectors tend to depress overall activity and investment if the losers react by cutting back more quickly than the gainers expand, and the shifting pattern of demand for labour increases the frictional element in unemployment and thus wage pressures at a given level of unemployment. In the past two years, UK producers have tended to lose competitiveness against North American producers while gaining it against continental European and Japanese ones. These conditions are not particularly helpful for UK trade, especially as the growth of our export markets has slowed at the same time. It is therefore the more remarkable that exports have fared well as as they did in the second half of 1987.

11 Dollar depreciation also implies negative effects on the UK invisibles account, principally the investment income element. The high proportion of US investments in the United Kingdom's external portfolio means that the sterling value of interest, profits and dividends receipts will have fallen more in line with the dollar than with the trade-weighted basket of currencies. Such influences are likely to be counteracted in the longer run as UK investments in the United States become more profitable, but the process takes time. Dollar depreciation is also likely to have an adverse effect on net sterling earnings from services like insurance and tourism because the US market for these services is more important to UK businesses than the corresponding market in goods.

... raises questions about the sustainability of rapid growth

12 These developments imply a slowdown in the growth of demand and raise questions about the supply response. On latest forecasts, the prospects are for output to continue to grow but at a rather slower, though still satisfactory, rate in the year ahead. This slowdown reflects less a slowing in domestic demand than a further deterioration in the balance of trade. The deterioration is nevertheless considerably smaller than would have been projected on the basis of relationships ruling a few years ago, owing to the improved supply response.

13 A period of relatively fast output growth is to be welcomed for the contribution it makes to raising living standards, reducing unemployment, and stimulating investment. And the United Kingdom is capable of financing moderate current account deficits for several years; indeed, that is probably a necessary, if modest, contribution to the widely sought improvement in the US external deficit. There must, however, be some question about the sustainability of growth of domestic demand in this country at a rate above that of most other major countries. It will depend on the emergence of a stronger growth of domestic demand in the rest of Europe, as well as on a successful resolution of the major international imbalances; and on a slower growth of domestic costs in the United Kingdom, the underlying rise in which is still excessive in relation to that of most of our competitors, and in relation to our inflation objectives. On present cost trends, there is little prospect of a sustained improvement in UK competitiveness, despite the recent strength of productivity growth.

14 Sustainability of output growth will also depend on the growth of demand at home and that of the economy's capacity to supply coming closer together. There is evidence from the industrial surveys that manufacturing plant capacity is becoming a more widespread constraint on the growth of output and that shortages of some categories of labour are increasingly being felt. So far,

prices and helped to contain the increase in producers' margins. The tightening of the labour market may not have been as marked as the half-million fall in unemployment in 1987 might suggest. Exceptional productivity growth has, in fact, allowed output to rise strongly with a relatively modest, but very welcome, rise in employment (and self-employment). Wage developments are, nonetheless, not reassuring, with no evidence of a downward trend in settlements, and some signs of an increase in the services sector, especially in areas not exposed to international competition.

Monetary developments add to the impression of a strong domestic demand ...

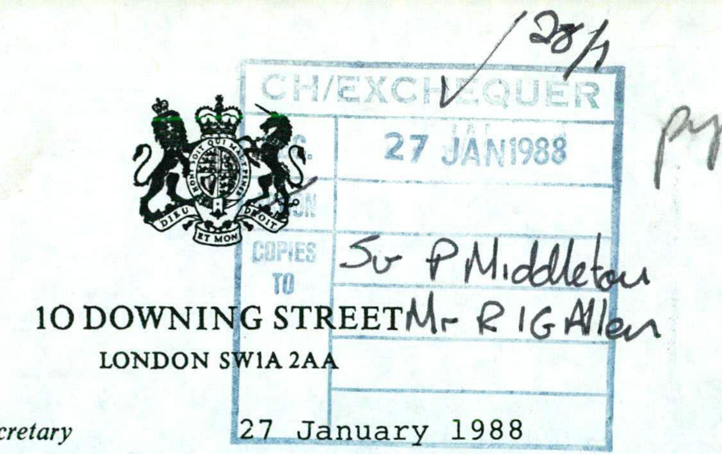
15 Monetary growth remains strong. M0, no doubt reflecting the buoyancy of consumer spending, rose at an annual rate of some 8% throughout the second half of last year, though the 12-month increase remained within the 2-6% target range. The various measures of broad money, too, continued to grow rapidly. Intervention contributed to changes in the month-to-month growth of broad money. However, over the last three months taken together, the impact of intervention on money has been largely matched by a combination of funding and an emerging PSBR surplus, in part representing the sale of BP shares. Broad money growth therefore has reflected the strength of credit demand from the private sector, which remained at the high level of the summer months. Only part of this can be attributed to personal sector borrowing, particularly mortgage borrowing, while the profile of demand through the year has been similar to last year, but with the banks taking a bigger market share. The remainder reflects other aspects of the strength of the real economy, for example, substantial stockbuilding, as well as position-taking associated with takeover and merger activity which persisted even after the stock market fall.

16 For a time after the stock market collapse monetary policy had to pay particular regard to the fragility of financial markets, and to the potential tightening of monetary conditions implied by reduced wealth and costlier equity finance. It was partly in this

third half-percentage point; and yields in the gilt-edged market were also allowed to fall quite sharply notwithstanding a substantial funding requirement to reabsorb the liquidity created by foreign exchange market intervention. The safety-net arrangements to buy back partly-paid BP shares if necessary had also been designed to avoid further damage to confidence in world equity markets. These arrangements came to their scheduled end on 6 January, having served their purpose without a significant quantity of shares being bought in.

... and place a further premium on non-accommodating exchange rate policy

17 The fears that accounted for the response to the events of mid-October have now receded; the latest economic and monetary indicators depict a still buoyant economy amply provided with credit, giving little sign that the pressures from domestic demand will abate soon. In these circumstances it has become all the more important that the exchange rate should remain firm to counter any impression of monetary ease. In the event sterling's effective rate has changed little over the three months to end-January, having been stable throughout against the DM. Maintaining the anti-inflationary thrust of policy will continue to require a non-accommodating rate in the period ahead. This can only be reconciled with the preservation of international competitiveness if domestic costs in the tradables sector of the economy are strictly contained. It will also be important for the preservation of both internal and external balance that the anti-inflationary burden continues to be shared between monetary and fiscal policy. A continuing downtrend in the public sector deficit would be an appropriate accompaniment to the striking decline in the private sector's financial surplus, reflecting mainly a decline in personal saving, which has been a feature of economic developments in recent years.



10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary 27 January 1988

Thank you for your letter of 26 January enclosing comments on the press notice.

I have taken in some of your comments. But, having consulted the Governor's office I have left his name as it was in the original 1982 press notice announcing his appointment. I enclose a copy of the final version of the notice we shall be issuing tomorrow.

I am sending a copy of this letter and enclosure to Alex Allan (HM Treasury).

(PAUL GRAY)

Geoff Croughton, Esq.

Bank of England Appointments

Governor and Directors

The Queen has been pleased to approve the re-appointment, under the Bank of England Act 1946, of the Right Honourable Robin Leigh-Pemberton as Governor of the Bank for a further term of five years from 1 July 1988.

The Queen has also been pleased to approve the re-appointment of Dr David Valentine Atterton CBE, Mr Rodney Desmond Galpin, Mr Deryk Vander Weyer CBE and Sir Leslie Clarence Young CBE as Directors of the Bank on the expiry of their present terms of office for a period of four years from 1 March 1988.

28 January 1988

mjd 4/42An

PWP

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

27 January 1988

cc: PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Peretz
Mrs Lomax
Miss O'Mara
Mr Grice
Mr R I G Allen
Mr Pickford
Mrs Ryding
Mr Cropper

J R E Footman Esq
Private Secretary to the Governor
Bank of England
London
EC2R 8AH

Dear John,

GOVERNOR'S SPEECH TO THE NEWSPAPER CONFERENCE, 29 JANUARY

The Chancellor was very grateful for an early sight of the Governor's speech. This confirms the comments which I gave you on the telephone.

2. There is one point which the Chancellor feels is very important indeed: to make clear that an expansion of credit will not, of itself, lead to an expansion of demand - what matters is whether the assets corresponding to the liabilities represented by the credit are willingly held or not. This point could be made by a brief addition to the second paragraph on page 3: after 'credit' in the first line, add 'unless matched by an equivalent growth in firmly held savings'.

3. Other Treasury points were as follows.

- It might be better to draft round the word 'contentious' in the first paragraph.
- Page 2, first para, 'Our' might be interpreted as referring to the Bank rather than the nation!
- Page 2, second para, last line, delete 'in principle'.
- Page 4, second para, redraft the second sentence along the lines 'and this is what has prompted the headlines to which I referred earlier'.
- Page 4, penultimate line, delete 'immediately'.
- Page 5, middle paragraph, redraft the third sentence along the lines 'They have in our view for some time given a misleading impression of monetary conditions in the economy....'

CHANCELLOR OF THE EXCHEQUER

- Page 5, final para. MG would prefer the first sentence to conclude 'to suggest that we should ignore the pace of credit growth'. We discussed the rest of the paragraph. The key question seems to us whether you want to imply that the monetary stance is already generally cautious, or that it should become more so.

- Page 9, final paragraph, the second sentence might read '....liquidity will always be watched with care by monetary authorities, particularly...'

Yours ever,

Andrew

A P HUDSON

BANK OF ENGLAND
LONDON EC2R 8AH

28 January 1988

c. as before (top page only)

PPS.

Some good stuff here, especially towards the end.

2 points: on p 3, middle paragraph, which Hon-treaty understand, it is liable to be misinterpreted (it already has been, by IR!) Delete.

and on p4, where the 2nd paragraph is pretty strong Gov's eyebrows. Might be better to delete the final sentence about "beggar my neighbour provisioning". "This sort of public arm twisting doesn't look too good, from a banking supervisor (our banks are relatively less well provided than others); and the supervisors may live to regret it (e.g. if the Gov. dept situation deteriorates)"

RL
28/1.

A C S Allan Esq
Private Secretary to
The Chancellor of the Exchequer
HM Treasury
Parliament Street
London
SW1A 3AG

Dear Alex

I enclose a draft of the Governor's speech to the Overseas Bankers Club next Monday, and should be very grateful to have your comments as soon as possible.

Yours

John

J R E Footman
Private Secretary
to the Governor

CH/EXCHEQUER
REC. 28 JAN 1988
ACTION Mrs Lomax — Comments by 6pm today, please
COPIES TO EST, Sir P. Middleton, Sir G Littler, Sir T Burns, Mr Scholar, Mr HP Evans, Mr Mountfield, Mr Peretz, Mr Ilett, Mr RIG Allen, Mr Pickford
Mr Cropper, Mr McGivern IR

16/185/28

COMMENTS

BANK OF ENGLAND
LONDON EC2R 8AH

28 January 1988

A C S Allan Esq
Private Secretary to
The Chancellor of the Exchequer
HM Treasury
Parliament Street
London
SW1A 3AG

A good speech, spoilt for the intrusive and unhelpful para on p8, which should be deleted. The only other changes I would suggest are the removal of all reference to fiscal treatment in the middle para on p3 and the deletion of the sentence at the top of p5.

Dear Alex

I enclose a draft of the Governor's speech to the Overseas Bankers Club next Monday, and should be very grateful to have your comments as soon as possible.

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2231A DRAFT 25. 1.88

SPEECH TO THE OVERSEAS BANKERS CLUB
MONDAY 1 FEBRUARY

[Speaking Version only]

We are particularly fortunate in our principal guest this evening. Karl-Otto Pöhl has been a leading member of the central bankers club for as many years as I care to remember and certainly during all of my time as Governor. His independence, his judgment and his great experience combine to make him a valued colleague in Basle and elsewhere. We have heard tonight with what authority he speaks......

Published version starts here

Convergence of bank capital standards

RIGA notes that this section makes no mention of yesterday's announcement by the Fed of its draft guidelines. I'll pass the thought on to J. Footman.

President Pöhl has referred to the lessons that may be drawn from the recent turbulence in the financial markets, and I too shall have something to say about this in a moment. But it would be wrong to let this occasion pass without reference to the convergence initiative. When I spoke here a year ago, the Anglo-American proposals on the measurement of capital were newly on the table, and I expressed the hope that they would find favour and stimulate further work on the convergence of capital standards, and in particular that our Japanese and European colleagues would feel able to join with us in the creation of a multilateral framework. Very considerable progress has been made

towards this end over the past 12 months, and now we have a set of proposals endorsed by the Committee of G10 Governors as a basis for consultation with international banks from the countries represented in that grouping. So we have already achieved a degree of consensus which, this time last year, many observers doubted was within our roach. To have moved so far and so fast is a considerable achievement.

The lead in this matter has been taken by the G10 countries, but I hope that others will follow once the outcome of the present consultations is known. We have, as you know, recently published our own country paper and I hope the discussions on it will respond to any concerns that our banks here may have. But it is important that we do not delay too long. While our efforts to agree on a common measure continue, off-balance sheet transactions, which are still largely unsupervised, continue to grow rapidly. The events of last year serve as a sharp reminder that new markets and instruments can contain imperfectly understood risks.

The convergence initiative has also greatly enhanced the status and authority of the Cooke Committee. I am reliably informed, as they say, that the discussions in the Committee were at times lively. Some compromises had to be made along the way, most notably in reconciling competing definitions of capital, and in finding acceptable ways of reflecting other elements of strength in a bank's balance sheet, notably provisions or reserves against loans made to troubled debtor countries.

That we should have encountered difficulties in reaching these agreements is scarcely surprising given the very different positions from which we all started. Each of us had, at the outset, a fairly clear view that our existing domestic regulatory systems were not only the most appropriate to our individual national circumstances, but also the right ones. And in practical terms it would be extremely difficult to abandon those systems and move directly to a completely new one. Moreover, the fact is that the new standard does not represent just the lowest common denominator; nor could we pretend that everyone would be able to meet it from the very start. It was for these reasons that the G10 group adopted a transitional period to allow a more gradual and measured move from we were are to where we wish to be.

RL: Delete para. Failing that, amend as shown. Code Cttee will not be recommending changes in taxation. alternatively, strike to ... as amended.

[Of course, there is more to equal competition than setting common capital standards. The effect of differences in [fiscal treatment and, even more fundamentally,] accounting conventions as they apply to banks are [just two of the factors] ~~to~~ which ~~further attention will have to be given; indeed~~ the Committee will be examining [~~these~~ this] during the transitional period.]

I believe that we should continue to try to promote a more equal competitive framework for international banking markets. And we should not forget that free and fair competition in banking markets is an important objective of the European Commission, as is evidenced by the new draft second co-ordination directive. The initiative by the G10 Governors will I am sure provide a useful framework for further work on this proposal.

Provisioning

It has become almost traditional for me to say a few words at this time of year about bank provisioning against problem country debt; and I will not break with tradition in view of the topicality of the subject. This is a matter in which there are considerable variations in terminology, accounting and tax practice as between the major centres; and where there can be marked differences in philosophy as between individual banks. In this country and in others there has been a trend recently to increase provisions against claims on heavily indebted countries. Within an appropriate analytical framework, this is very much to be welcomed, and we have sought to provide such a framework in this country in the form of a matrix to aid provisioning decisions by the banks. The matrix guided our attitude to the provisions charged by the British banks at the half-year, and will, in a regularly updated form, continue to guide our judgments as to the adequacy of such provisions.

RIGA wonders if this will prompt questioning about the NAO & ECGD accounts. Didn't worry about that

Of course in such an uncertain and changing environment there can be no obviously correct view. But I hope that banks will continue to found their provisioning decisions on a sound analytical basis. This is far preferable, in my view, to the haphazard announcement of levels of aggregate provisioning whose relationship to the true underlying risk in the loan portfolio is often rather tenuous. The object of such exercises seems to have more to do with creating a short-term impact on the bank's share price than with the long-term interests of shareholders; and it may at the same time send misleading signals to the debtors

RL has deleted last sentence of this para, & comments "This is a very thinly veiled warning to NatWest & Barclays not to go above the matrix. Delete last sentence... arguably improper & which the Bank could regret..." I agree

See also RL minute.

RL

themselves. ~~Beggar my neighbour tactics may be good fun but they are seldom, if ever, good financial policy.~~

But I hope no one will interpret this as implying that the Bank has set its face against imaginative solutions to the debt problem. On the contrary, I very much welcome the way in which recent initiatives have widened the "menu" of options for banks in deciding how best to manage their problem country exposures. It is surely right for banks and debtor countries to explore together different risk management solutions and for banks to review the attractiveness of these options in the light of their own particular circumstances.

Lessons of the market crash

President Pöhl has spoken this evening about the pace of innovation in financial markets, and the consequences of the recent events in world stock markets. It is still early to assess the full impact of the turbulence the last three months; one hesitates almost to risk declaring it passed! But I know that much work is already in hand to assess the implications both for supervisors of securities firms and banks, and for our ability to contain systemic problems as they emerge.

The sharp fall in equity values on world stock markets offers a clear demonstration of the possible risks for those banks which have pursued a strategy of diversification out of traditional banking markets/ into securities trading on a substantial scale. The growth of these markets, particularly here in London

xx

since Big Bang, has also brought a significant expansion in bank lending to securities companies, representing another dimension to the integration of financial markets.

One message that emerges from recent events is that, on the one hand, banks need to learn more about the activities of the securities companies to which they are committed as shareholders; and that, on the other hand, securities companies need to pay attention to some of the disciplines which have been received wisdom in the banking markets. For example, the risk of counterparty default in the broker community seems not to have been analysed or controlled with the same rigour as has long been the case for bankers. This does seem to be part of the culture gap that was discerned as banks and securities firms merged their operations ahead of the Big Bang.

It also became evident to us that while most banking groups active in market-making knew what was going on in their own home markets in the period immediately following 19 October, they were not so well equipped to know what their position was in the more far-flung markets. The lesson I draw from this is very simple: that for a major international bank active in several markets around the world it is just as important to know what your exposure is to a securities firm's Tokyo office as it is to their London office. Accordingly, I am sure that banks are right to be considering with some urgency the development of control systems capable of monitoring global credit and position risk exposures on a real-time basis.

Communication between banking and securities regulators

On black Monday and immediately afterwards, it was both natural and necessary for there to be close and continuing contact between the two sets of regulators. Our immediate concern, as bank supervisors, was to find out what was going on in various markets, both at home and abroad, as quickly as we could. This concern properly took precedence over the question of formally defined supervisory responsibilities. In order to keep up with these events, we set up a working group bringing together supervisors from different parts of the Bank as well as from the Stock Exchange. In the first weeks after black Monday, this group met two or three times weekly and was in daily contact with bank and securities market regulators in other financial centres around the world. The meetings of this group served as an essential information exchange at a critical point in time, and I believe the markets were comforted to know that we were keeping such a close eye on events.

More generally, in the weeks following 19 October, I perceived that there was unprecedented co-operation between both the banking supervisor and securities supervisor in each of the major countries, as well as between each group of supervisors internationally. ~~These bilateral contacts had to be co-ordinated, and it was natural for the central bank in each country to take a major role in that process.~~

The events of the past year - and one can look back as far as the collapse of the perpetual FRN market last [February] - have also highlighted the systemic risks created by weakening liquidity in

various securities markets. Events in several centres demonstrated the systemic implications when a stable trading environment is no longer being maintained, and regulation is not adequate to remedy this. Recent events must also force us to ask whether some markets, particularly those directed to the control or redistribution of risk, may have been founded upon questionable assumptions about liquidity, and whether participants have allowed themselves too easily to suppose that the markets will allow them to avoid or dispose of risk in an orderly manner and at precisely the time of their choosing. The evidence in London is that markets and systems stood up well, but that was not true everywhere. And even in London, the subsequent dearth of turnover could weaken firms if costs are not trimmed to maintain profitability.

[Central banks reacted to the precipitous falls in word stock markets in October by providing liquidity support and allowing interest rates to decline significantly - even though (in some cases) the main indicators of economic activity and monetary conditions would not normally have ~~indicated such strong~~ given grounds for such strong ~~[given very strong grounds for such]~~ action, ~~[and in some cases would have suggested the opposite.]~~ I say this only to underline the importance to central banks of the financial soundness and integrity of the securities markets and of participants in them.]

The capital adequacy of the securities industry is the concern of the securities supervisors. But banks are involved in this industry, either directly and indirectly and the systemic implications are a matter for central banks, which have a key interest in the efforts of supervisors to minimise the threat. It is self-evident that securities businesses should not through

their market operations and exposures be allowed to put the general system at undue risk - nor to assume that markets will be made safe for them whatever the adequacy or otherwise of their capital. While our interests are mainly systemic and prudential, we must take an interest in other aspects of securities regulation, especially those concerned with market structure, settlement and margins.

This does mean that we will need to look further at how best to develop contact between securities and bank regulators. While I would not wish to devalue the importance of bilateral contact in this matter, I believe the we need also to think about how we might develop a common framework for more regular communication between bank and securities supervisors. I have no blueprint to offer for such a framework, but just as the Herstatt crisis gave birth to the Basle Committee of supervisors, there is an obvious question about whether a similar multilateral forum is not necessary in the light of the events of last October.

If we are able to achieve closer communication, through whatever channel, this may ultimately encourage the co-ordination of the different national approaches towards the monitoring and control of the risks emanating from securities business. It is clear that this objective makes sense for all G10 countries at this stage, and it is undoubtedly more attractive to those supervisors, like ourselves, which are faced with regulating in increasingly globalised markets. The idea of greater co-ordination between securities and banking regulators is not entirely novel, but it is one that I find increasingly attractive as I ponder the lessons of October and the fruits of our experience with convergence.

BANK OF ENGLAND
LONDON EC2R 8AH

28 January 1988

A C S Allan Esq
Private Secretary to
The Chancellor of the Exchequer
HM Treasury
Parliament Street
London
SW1A 3AG

Dear Alex

I enclose a draft of the Governor's speech to the Overseas Bankers Club next Monday, and should be very grateful to have your comments as soon as possible.

Yours

John.

J R E Footman
Private Secretary
to the Governor

SPEECH TO THE OVERSEAS BANKERS CLUB
MONDAY 1 FEBRUARY

[Speaking Version only]

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Convergence of bank capital standards

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towards this end over the past 12 months, and now we have a set of proposals endorsed by the Committee of G10 Governors as a basis for consultation with international banks from the countries represented in that grouping. So we have already achieved a degree of consensus which, this time last year, many observers doubted was within our reach. To have moved so far and so fast is a considerable achievement.

The lead in this matter has been taken by the G10 countries, but I hope that others will follow once the outcome of the present consultations is known. We have, as you know, recently published our own country paper and I hope the discussions on it will respond to any concerns that our banks here may have. But it is important that we do not delay too long. While our efforts to agree on a common measure continue, off-balance sheet transactions, which are still largely unsupervised, continue to grow rapidly. The events of last year serve as a sharp reminder that new markets and instruments can contain imperfectly understood risks.

The convergence initiative has also greatly enhanced the status and authority of the Cooke Committee. I am reliably informed, as they say, that the discussions in the Committee were at times lively. Some compromises had to be made along the way, most notably in reconciling competing definitions of capital, and in finding acceptable ways of reflecting other elements of strength in a bank's balance sheet, notably provisions or reserves against loans made to troubled debtor countries.

That we should have encountered difficulties in reaching these agreements is scarcely surprising given the very different positions from which we all started. Each of us had, at the outset, a fairly clear view that our existing domestic regulatory systems were not only the most appropriate to our individual national circumstances, but also the right ones. And in practical terms it would be extremely difficult to abandon those systems and move directly to a completely new one. Moreover, the fact is that the new standard does not represent just the lowest common denominator; nor could we pretend that everyone would be able to meet it from the very start. It was for these reasons that the G10 group adopted a transitional period to allow a more gradual and measured move from we were are to where we wish to be.

X Of course, there is more to equal competition than setting common capital standards. Differences in fiscal treatment and, even more fundamentally, accounting conventions applying to banks are just two of the factors to which further attention will have to be given; indeed the Committee will be examining these during the transitional period.

I believe that we should continue to try to promote a more equal competitive framework for international banking markets. And we should not forget that free and fair competition in banking markets is an important objective of the European Commission, as is evidenced by the new draft second co-ordination directive. The initiative by the G10 Governors will I am sure provide a useful framework for further work on this proposal.

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Of course in such an uncertain and changing environment there can be no obviously correct view. But I hope that banks will continue to found their provisioning decisions on a sound analytical basis. This is far preferable, in my view, to the haphazard announcement of levels of aggregate provisioning whose relationship to the true underlying risk in the loan portfolio is often rather tenuous. The object of such exercises seems to have more to do with creating a short-term impact on the bank's share price than with the long-term interests of shareholders; and it may at the same time send misleading signals to the debtors

themselves. Beggar my neighbour tactics may be good fun but they are seldom, if ever, good financial policy.

But I hope no one will interpret this as implying that the Bank has set its face against imaginative solutions to the debt problem. On the contrary, I very much welcome the way in which recent initiatives have widened the "menu" of options for banks in deciding how best to manage their problem country exposures. It is surely right for banks and debtor countries to explore together different risk management solutions and for banks to review the attractiveness of these options in the light of their own particular circumstances.

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The sharp fall in equity values on world stock markets offers a clear demonstration of the possible risks for those banks which have pursued a strategy of diversification out of traditional banking markets. Into securities trading on a substantial scale. The growth of these markets, particularly here in London

since Big Bang, has also brought a significant expansion in bank lending to securities companies, representing another dimension to the integration of financial markets.

One message that emerges from recent events is that, on the one hand, banks need to learn more about the activities of the securities companies to which they are committed as shareholders; and that, on the other hand, securities companies need to pay attention to some of the disciplines which have been received wisdom in the banking markets. For example, the risk of counterparty default in the broker community seems not to have been analysed or controlled with the same rigour as has long been the case for bankers. This does seem to be part of the culture gap that was discerned as banks and securities firms merged their operations ahead of the Big Bang.

It also became evident to us that while most banking groups active in market-making knew what was going on in their own home markets in the period immediately following 19 October, they were not so well equipped to know what their position was in the more far-flung markets. The lesson I draw from this is very simple: that for a major international bank active in several markets around the world it is just as important to know what your exposure is to a securities firm's Tokyo office as it is to their London office. Accordingly, I am sure that banks are right to be considering with some urgency the development of control systems capable of monitoring global credit and position risk exposures on a real-time basis.

Communication between banking and securities regulators

On black Monday and immediately afterwards, it was both natural and necessary for there to be close and continuing contact between the two sets of regulators. Our immediate concern, as bank supervisors, was to find out what was going on in various markets, both at home and abroad, as quickly as we could. This concern properly took precedence over the question of formally defined supervisory responsibilities. In order to keep up with these events, we set up a working group bringing together supervisors from different parts of the Bank as well as from the Stock Exchange. In the first weeks after black Monday, this group met two or three times weekly and was in daily contact with bank and securities market regulators in other financial centres around the world. The meetings of this group served as an essential information exchange at a critical point in time, and I believe the markets were comforted to know that we were keeping such a close eye on events.

More generally, in the weeks following 19 October, I perceived that there was unprecedented co-operation between both the banking supervisor and securities supervisor in each of the major countries, as well as between each group of supervisors internationally. ~~These bilateral contacts had to be co-ordinated, and it was natural for the central bank in each country to take a major role in that process.~~

The events of the past year - and one can look back as far as the collapse of the perpetual FRN market last [February] - have also highlighted the systemic risks created by weakening liquidity in

various securities markets. Events in several centres demonstrated the systemic implications when a stable trading environment is no longer being maintained, and regulation is not adequate to remedy this. Recent events must also force us to ask whether some markets, particularly those directed to the control or redistribution of risk, may have been founded upon questionable assumptions about liquidity, and whether participants have allowed themselves too easily to suppose that the markets will allow them to avoid or dispose of risk in an orderly manner and at precisely the time of their choosing. The evidence in London is that markets and systems stood up well, but that was not true everywhere. And even in London, the subsequent dearth of turnover could weaken firms if costs are not trimmed to maintain profitability.

Central banks reacted to the precipitous falls in word stock markets in October by providing liquidity support and allowing interest rates to decline - even though the main indicators of economic activity and monetary conditions would not normally have given very strong grounds for such action, and in some cases would have suggested the opposite. I say this only to underline the importance to central banks of the financial soundness and integrity of the securities markets and of participants in them.

The capital adequacy of the securities industry is the concern of the securities supervisors. But banks are involved in this industry, either directly and indirectly and the systemic implications are a matter for central banks, which have a key interest in the efforts of supervisors to minimise the threat. It is self-evident that securities businesses should not through

their market operations and exposures be allowed to put the general system at undue risk - nor to assume that markets will be made safe for them whatever the adequacy or otherwise of their capital. While our interests are mainly systemic and prudential, we must take an interest in other aspects of securities regulation, especially those concerned with market structure, settlement and margins.

This does mean that we will need to look further at how best to develop contact between securities and bank regulators. While I would not wish to devalue the importance of bilateral contact in this matter, I believe the we need also to think about how we might develop a common framework for more regular communication between bank and securities supervisors. I have no blueprint to offer for such a framework, but just as the Herstatt crisis gave birth to the Basle Committee of supervisors, there is an obvious question about whether a similar multilateral forum is not necessary in the light of the events of last October.

If we are able to achieve closer communication, through whatever channel, this may ultimately encourage the co-ordination of the different national approaches towards the monitoring and control of the risks emanating from securities business. It is clear that this objective makes sense for all G10 countries at this stage, and it is undoubtedly more attractive to those supervisors, like ourselves, which are faced with regulating in increasingly globalised markets. The idea of greater co-ordination between securities and banking regulators is not entirely novel, but it is one that I find increasingly attractive as I ponder the lessons of October and the fruits of our experience with convergence.

MR HUDSON

From : D L C Peretz
Date : 28 January 1988

cc Economic Secretary
Sir P Middleton
Mr Scholar
Mrs Lomax
Miss O'Mara

GOVERNOR'S SPEECH TO OVERSEAS BANKERS CLUB

As I have already mentioned on the telephone, my only comment on this draft is on the middle paragraph on page 8.

2. It seems to me a mistake for the Governor to suggest that in some countries in the absence of the Stock Exchange crash interest rates should have been raised, particularly in the presence of Herr Pohl. I would have thought in both the case of the UK and Germany a reading of monetary conditions before the crash, taking account of the exchange rate as an indicator of monetary conditions, might well have suggested some decline in interest rates, though not as sharp a decline as was subsequently implemented.

3. So I suggest redrafting the end of this sentence to read something like:-

> "...and allowing interest rates to decline significantly - even though in some cases the main indicators of economic activity and monetary conditions would not normally have given grounds for such strong action."

DLP

D L C PERETZ

BANK OF ENGLAND
LONDON EC2R 8AH

28 January 1988

CH/EXCHEQUER
28 JAN 1988

28/1

Zcc CST, FST, PMG, EST
Sir P Middleton, Sir T. Burns, Sir G. Littler
Mr Scholar, Mr Peretz, Mrs Lomax
Mr R I G Allen, Mr Pickford
Mr Cropper, Mr Tyrie, Mr Call

Andrew Hudson Esq
Chancellor's Office
HM Treasury
Parliament Street
London
SW1A 3AG

Dear Andrew,

I enclose for your information the Governor's latest speaking programme.

Yours

John

J R E Footman
Private Secretary
to the Governor

C.

To see. N.B. enthusiasm for Feb + early March!

AH

0344D ANNEX

GOVERNOR'S SPEAKING PROGRAMME

Items shown in **Bold** are likely to attract press coverage

Date	Occasion	Title - Content	Drafter
29 January	**Annual Luncheon of the Newspaper Conference**	**Monetary**	**Mr George**
1 February	**Overseas Bankers Club**	**Convergence**	**Mr Quinn**
3 February	Insurance Golfing Society		GPS
11 February	**City University Business School**	**Stockmarket Crash, post-mortem**	**Mr T A Clark**
24 February	Institute of Bankers City Centre		GPS
29 February	NEDC Conference	Industy & Stockmarket	GPS
9 March	**Cornhill Club**	**Monetary**	**Mr George**
30 March	Association of American Correspondents in London		GPS
17 June	Talk to Practical Banking Course	Internal	GPS
14 July	Worshipful Company of Pattenmakers		GPS
11 October	Centenary Dinner of Kent Reliance Building Society	Toast of the Society	Governor
12 October	Dinner with Wax Chandlers		GPS
20 October	**Mansion House**		**Mr Flemming**
29 October	Annual Dinner Canterbury Branch, Men of Kent and Kentish Men Association	Toast of the Branch	Governor

GOVERNOR'S SPEAKING PROGRAMME

15 November	?Forex Conference
24 November	Dinner with Vintners Company
29 November	?Institute of Bankers, Bristol

1989

January	Institute of Bankers in Scotland, Biennial Dinner

- oOo -

ROBIN LEE PEMBERTON - INTERVIEW ON RE-APPOINTMENT (POLICY EXTRACT)

Transcript from: ITV Channel 4, Business Daily, 29 January 1988

INTERVIEWER: (MARK ROGERSON) ..... What about relations between the Bank and the Treasury, typically they're portrayed as being almost at daggers drawn?

PEMBERTON: Now this is the traditional attitude to take. I think it's mistaken. First of all I don't think it's factually true. Secondly, it's destructive and I don't think either of us want a destructive situation. And what in fact happens between us I think is that in our discussions about the operation of policy or o;bjectives even we have different views. These are discussed in a thoroughly objective fashion and we're able to discuss them in a way that is freed of that sort of contentiousness which prevents people talking to each other. And as a result of this I think that the outcome usually is the right one, policy wins. And people say to me well did the Bank or did the Treasury win, I don't think that matters so much.

Ch see also Gov's speech w/e below AH

INTERVIEWER: Well on a particular matter of economic issue, what are your fears as far as overheating in the economy is concerned?

PEMBERTON: I don't know whether fears are right. I think we've got a situation where any central bank must be alert to the potentialities of the situation. The monthly figures show that bank lending is growing, our trade figures show that there is a monthly deficit of a naggingly constant figure now, the level of domestic demand is clearly high in relation to production. And therefore you have got the elements of a resurgence of inflationary pressure.

INTERVIEWER: What are the policy implications of that?

PEMBERTON: Well the policy implications of that are that we may have to tighten monetary policy. And that quite frankly means raising interest rates and dampening down - let's describe it the heat that is generated by the economy at the moment.

INTERVIEWER: Soooner rather than later?

PEMBERTON: Well I'm not going to answer when the timing will be - if it will be. This is a matter for judgement and this is just on this sort of point that the Treasury and the Bank are able to have thoroughly realistic objective discussions freed, as I said, from competitiveness and contentiousness.

INTERVIEWER: We talked about the domestic economy. If we look towards the international dimension and the currency, particularly the fluctuations we've seen in recent months, G7 - is it alive, if so why is it not breathing very loudly?

PEMBERTON: Well I think G7 is alive and has breathed quite loudly enough. You say we've had big currency movements in the last few months. This currency movement's actually been confined solely to the US $. That is at the centre of the difficulties that G7 is dealing with. Now what has happened since the G7 made their declaration just before Christmas? We've seen concerted intervention with the Federal Reserve Bank of the United States prominent in those operations and therefore a recovery in the $. So that I think you're not being fair to G7 or what we're achieving there by talking about breathing or not breathing.

INTERVIEWER: Moving on to the international banking dimension and the provisions that the British banks, along with all the others, have made as far as third world debt is concerned. Is the banking system now in a position to manage the burden of third world debt?

PEMBERTON: It's in a much stronger position than it was either when the debt problem first emerged - what's it nearly 5 1/2 years ago - or indeed a year ago. I think the level of provisions that the banks have been able to make is a tribute to the strength that those banks have developed in their balance sheets since the debt problem first emerged. And therefore puts them in a much stronger position as banks

weigh their balance sheets. Some people argue well this would eman that it's easier for the debtor countries in some way to slide out of their obligations. I don't think that applies at all and I don't think they're using that at this moment. I regard the situation as that much the better since the banks have been able to provision at these sort of levels.

INTERVIEWER: Governor if I could finish on a personal question, are you now a central banker forever or does the commercial world outside still beckon?

PEMBERTON: I don't think it'll have much chance in my life now. I'm 61. I've been given a 5 year renewal term of office. I should think by the time that's over I don't suppose I'll be all that attractive to anybody.

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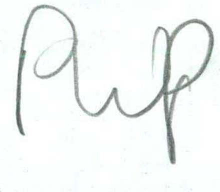

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

29 January 1988

J R E Footman Esq
Private Secretary to the Governor
Bank of England
LONDON EC2R 8AH

Dear John,

GOVERNOR'S SPEECH TO THE OVERSEAS BANKERS CLUB, 1 FEBRUARY

The Chancellor was grateful for a sight of the Governor's Speech for Monday. He would delete the middle paragraph on page 8, which he thinks would wreck the flow and distract attention from the rest of a good speech.

He has a couple of other comments.

- In the middle paragraph on page 3, he would take out the reference to "fiscal treatment". His preference would be to delete the paragraph altogether. Failing that, he would redraft the second sentence to read "Differences in accounting conventions applying to banks are a matter to which further attention will have to be given; indeed the Committee will be examining this during the transitional period."
- He would also delete the first complete sentence on page 5.

One further thought which you may already have on board: the first couple of pages make no mention of the Fed's announcement of its draft guidelines, which would be a topical reference.

Yours ever,

Andrew

A P HUDSON

91G.SCB.4316.13

pmp

FROM: CATHY RYDING

DATE: 29 January 1988

MR BUSH

cc: PS/Chancellor
PS/EST
Sir P Middleton
Mr Scholar
Mrs Lomax
Mr Peretz
Mr Grice
Miss O'Mara
Mr Pickford
Mr Cropper

GOVERNOR's SPEECH TO NEWSPAPER CONFERENCE

I attach a copy of a speech the Governor is giving to the Newspaper Conference of regional journalists today

2. As you know, our line has been that while the growth of personal borrowing in recent months may appear at first sight to be high

this is nothing to be alarmed about.

3. The Governor's speech makes some helpful comments in support of this line which you will want to draw to press attention. The most important (which the Chancellor attaches great importance to) is that expansion of credit will not, of itself, lead to an expansion of demand - what matters is whether the assets are willing held or not. As the Governor says:-

".... too rapid an expansion of credit unless matched by an equivalent growth in firmly held financial assets can lead to excessive growth of demand in real or financial markets."

Also:-

"Simple credit figures need to be seen in perspective. The monthly bank lending data in particular ...... have to be interpreted with great care. They have in our view for some

time given a misleading impression of monetary conditions in the economy and the extent to which we have been going through a consumer credit boom in the traditional sense. ..... we need .... to be wary of over-simple and over-hasty conclusions."

And:-

"There could be a danger of over-reaction if we simply took the credit figures at their face value."

4. As a general reminder our press line on consumer credit runs as follows:

- no evidence that the rate of lending to consumer has been accelerating in recent months.

- bulk of personal borrowing takes the form of mortgages which represented ¾ of outstanding personal debt at the end of 1986.

- consumer credit only some 15 per cent of total personal debt and less than 5 per cent of personal debt takes form of credit card lending.

and - as Chancellor said in FHA speech, 17 June 1987, Access and Barclaycard estimate that at least 40 per cent of their customers pay their bills before any interest is incurred.

Cathy Ryding

CATHY RYDING

Bank of England
Press Notice

Press Office
Threadneedle Street
London EC2R 8AH
Telephone 01-601 4411

FOR RELEASE ON
DELIVERY AT 14.00 HRS

Speech given by

THE RT HON ROBIN LEIGH-PEMBERTON
GOVERNOR OF THE BANK OF ENGLAND

at the Annual Luncheon of the Newspaper Conference
on Friday 29 January 1988

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Press Office
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PERSONAL CREDIT IN PERSPECTIVE

... much attention has been focussed recently on lending to the personal sector. You will, for example, have seen - indeed some of you may have written - headlines such as "Accelerating Credit Growth Fuels Consumer Boom". I should like to spend a little time this afternoon on this aspect of credit, considering in turn its macroeconomic significance, some supervisory implications and the social questions which can arise from the easy availability of consumer credit.

But first, let me say a few words about the role of credit more generally in the economy.

As a nation, our attitude to credit is typically ambivalent. There is a tendency to think of credit as something intrinsically reprehensible. Most of us carry around somewhere in our subconscious the familiar admonition "neither a borrower nor a lender be". But at the same time it is very hard to envisage the effective functioning of the economy without credit to oil the wheels. Its role is to allow flexibility in the timing of expenditures, enabling them to be separated in time from the receipt of income.

This tends to be more readily accepted in the case of industry and commerce, where credit - to finance an expansion of production through investment, the employment of additional labour or a build-up of stocks - is taken in anticipation of future sales. But credit performs exactly the same function for consumers, enabling them to make large purchases or investments at a convenient or opportune time, and to pay for them in accordance with their expected pattern of income. I find nothing reprehensible about that - indeed rather the reverse.

So in general I welcome the changes in the financial structure which, over the past few years, have resulted from, and in, more competition between lenders to the personal sector, and which have led to the increased availability of personal sector credit. It must be an advantage for the individual to have more choice between different types of borrowing facility, and greater flexibility over the timing of his expenditure and in the arrangement of his portfolio of assets and liabilities. And there are macroeconomic benefits too. For example, with the ending of mortgage queues, activity in the housing market is less prone to proceed in fits and starts, governed by the availability of mortgage finance.

But, like all good things, there can be too much of it.

From the macroeconomic viewpoint, too rapid an expansion of credit, unless matched by an equivalent growth of firmly-held

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financial assets, can lead to excessive growth of demand in real or financial markets. The persistent pressure of excessive credit growth clearly can produce an over-liquid economy, with the added potential for inflation which that entails. So the question is one of degree. Has the growth of credit - and of credit to the personal sector in particular - in fact been too fast?

As you would expect there is not a simple or straightforward answer to that question.

In aggregate, bank lending in sterling to the domestic private sector as a whole certainly has been growing very rapidly - accelerating to over 20% a year in the last two years. Looking behind the aggregate figures, a principal cause of this acceleration has been a remarkable surge in lending to financial institutions. It has nearly doubled since 1985, to getting on for a quarter of the outstanding total stock of bank lending - though it has tended to grow more slowly since the summer. This development has no doubt a good deal to do with the recent structural changes in our system of financial intermediation and to this extent its significance for the behaviour of the wider economy may be limited.

Bank lending to industrial and commercial companies, although quickening in the last six months or so, has generally been more restrained in recent years as borrowers have found a wide variety of alternative sources of finance in both domestic and overseas money and capital markets.

Bank lending to the personal sector has also grown relatively fast - by nearly 50% in the past two years and by over a quarter last year alone. This is what has prompted the headlines to which I referred earlier.

But looking at the banks' personal lending more closely, one finds that the most important and rapidly growing part of it is mortgage lending. The banks' other consumer lending has been growing fairly steadily, at a rate of around 18% a year for most of the 1980s. And much of the recent acceleration in the banks' mortgage lending has been at the expense of slower growth in mortgage lending by building societies. Taking banks and building societies together, the total increase in credit granted to the personal sector was 40% in the past two years and less than 20% in 1987.

Even so, personal sector borrowing in total has been rising a good deal faster than personal incomes for a number of years. This has much to do with the more intensive competition between financial intermediaries, particularly in the mortgage field, which has made it easier, for example, for homeowners to borrow

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against the accumulated equity in their houses. Not all of this increased borrowing has fed through immediately into higher consumer spending. Much of it has gone into a parallel increase in the personal sector's holdings of financial assets, including deposits with banks and building societies. To this degree, therefore, what we have seen is a change in the personal sector's <u>financial</u> behaviour resulting from the freer availability of credit, which may be of less economic significance than would have been implied by earlier relationships between borrowing and spending. Such a shift in behaviour is likely to take some years to complete, but we simply cannot tell how much longer it will take or how far we are away from a new equilibrium.

The point I am making is that the simple credit figures need to be seen in perspective. The monthly bank lending data, in particular - and these typically attract most public attention - have to be interpreted with great care. They have in our view for some time given a misleading impression of monetary conditions in the economy, and of the extent to which we have been going through a consumer credit boom in the traditional sense. In these and other respects we need, I think, to be wary of over-simple and over-hasty conclusions.

In making these remarks I do not at all mean to suggest that we can be relaxed about the recent pace of credit growth, including the growth of consumer credit. It has been, and continues to be of concern to the Bank and, together with the associated rapid increase in broad money, it is one of the factors - alongside the strength of domestic demand and the continuing less than satisfactory development of underlying labour costs - which inclines us to our <u>present</u> generally cautious monetary stance. But there could be a danger of over-reaction if we simply took the credit figures at their face value.

These developments in personal sector lending, of course, also prompt a supervisory interest. Historically the risk:reward ratio in lending to the personal sector, particularly on mortgages, has been relatively attractive in this country, and it is this past experience as much as anything which has attracted so many new lenders into the field. But more intense competition must tend to encourage lenders to take on higher risks at the same time that lending margins are being squeezed. Past experience may not therefore be an adequate guide to the future; and lenders, and their supervisors, must be conscious of the steeply rising ratio of personal sector debt to income. Although broadly paralleled by a rising wealth-to-income ratio at the macroeconomic level, this may well lead to an increasing number of individual borrowers having difficulty in servicing their debts.

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Thus far the signs are not disturbing. Certainly, since the ending of hire-purchase terms control, we have seen some lengthening in the term of consumer credit; and mortgage lenders have gradually increased the amount that they are prepared to lend, both as a proportion of the value of the property and as a multiple of income. I have become aware recently of a number of instances of income multiples of up to four times the primary income, which suggests this process is going further. But in parallel with these developments, techniques for assessing and monitoring credit have been improved; and for the most part the fuller credit terms are being extended selectively, in cases where the borrower is well known to the lender, who can therefore better judge the risks. My impression at present is that experience of arrears and bad debts on personal sector lending generally is getting no worse and in some areas is even tending to improve - as indeed it should, given the improving climate for employment. Welcome though this is, it cannot, of course, be taken as grounds for complacency, and you may be assured that we will remain vigilant in this respect in our own supervisory activity.

Let me then turn to the third aspect of personal sector lending - its social aspect: that is to say the problem of the easy availability of credit from a multiplicity of sources to the individual borrower, who may thereby be tempted to take on more debt than he or she can handle. There have been a number of well-publicised instances in recent months, which have quite properly given rise to concern. Because of the real personal suffering which can be involved, it is perhaps this aspect of personal sector credit which gives me the most immediate anxiety.

Attitudes to this problem tend to divide between those who believe that the fault lies with the borrowers, who need protection from themselves; and those who believe that the blame lies with over-zealous lenders - pushing credit, so to speak, down the unwilling throats of reluctant consumers.

I am bound to say that I find it hard to envisage many instances where the borrower can be spared <u>all</u> respnsibility for his actions, and there can be very few cases of a lender consciously making an advance which he knows has little chance of being repaid. But there certainly are cases where the credit assessment is made with insufficient care. It is not for me to take sides in this debate; my purpose is rather to consider the remedies.

There are already legal safeguards to protect borrowers through the Consumer Credit Act and through codes relating to advertising standards, for example; and I myself doubt whether the present problem can be effectively addressed through further general legislation. More can no doubt be done in educating borrowers

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over the longer term. But in the immediate term we have to look to the lenders, who must - and mostly do - accept a social responsibility to minimise the incidence of over-borrowing by consumers. I would commend to you in this regard the Code of Practice adopted by the Finance Houses Association last year.

There is, however, a corollary to expecting lenders to accept a social responsibility in this form. We must then accept that they will need to be more intrusive in their enquiries into a prospective borrower's financial position, and, in particular, in a world in which a single borrower has access to a vast array of credit sources, that lenders must be able to pool their knowledge about the financial position of individual borrowers. I have spoken about this in the past, and I am glad to say that much progress is already being made in this direction.

Of course, I understand that such arrangements must be subject to appropriate safeguards. They must, for example, ensure that the individuals may have access to such information as far as it concerns them, and this is rightly ensured by the Consumer Credit Act. More generally there must be arrangements to protect the confidentiality of the information, and to ensure that it is available only to those participating lenders from whom credit has been specifically requested. I do understand the difficulties and sensitivities, but I hope that we can collectively make rapid progress in defining those safeguards, and thus reduce the present inhibitions on pooling both "black" and in time I hope also "white" credit information. Without this, I am afraid that we are likely to see yet more instances of personal difficulty and distress. We cannot expect lenders to do an effective job in preventing this, if we are not prepared to provide them with the means of carrying it out.

Mr Chairman, I have addressed the role of credit from a number of viewpoints - macroeconomic, prudential and social. Rapid growth of credit, and the attendant build-up of liquidity will always be watched with care by the monetary authorities particularly in a period of financial innovation and changing behaviour, which add to the difficulties of interpretation of events. There is perhaps nowadays a greater awareness of prudential issues, and in general a greater degree of vigilance than in earlier times. But the social issues do I think represent the largest concern; and with the easing of credit availability that has become established in recent years, we must encourage both individuals and institutions to adjust their behaviour and attitudes.

the department for Enterprise

01 FEB 1988

BF 8/2 to M.

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The Hon Francis Maude MP

Direct line
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Date

Peter Lilley Esq MP
Economic Secretary
HM Treasury
LONDON
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ECONOMIC SECRETARY	
REC'D	01 FEB 1988
ACTION	Mrs Lomax
COPIES TO	PS/Chancellor PS/PMG Sir P Middleton Sir G Littler Mr Scholar Mr Edwards Mr Peretz Mr R.G. Allen Miss Noble Mr Mortimer Mr Ilett Mr Kroll Ms Wheldon (TSol).

29 January 1988

Dear Peter

As you know, during the negotiation on the Bank Accounts Directive DTI officials kept in touch with yours and with the Bank of England. These negotiations ended with the adoption of the Directive on 8 December 1986, under the UK Presidency.

2. The purpose of the Directive is to adapt the requirements of the Fourth Company Law Directive on company accounts and the Seventh Directive on consolidated accounts to the special characteristics of banks, Member States are required to implement the Directive by 31 December 1990. They may, however, defer the application of the legislation so that it first applies to accounts for financial years beginning in 1993.

3. I propose that my officials should work closely with yours and those of the Bank of England, consulting others in the process as necessary (for example the accounting profession, the Building Societies Commission, the British Bankers Association), to produce a joint DTI/Bank of England consultative document on implementation. I also hope that they can proceed generally on the following lines:

(a) the consultative document should be written on the basis that the UK does not intend to exercise the option to continue to permit banks to have hidden reserves. These hidden reserves are now maintained in the UK by only a few merchant banks and by a few

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banks with overseas holding companies. Views should be invited on the proposal in the Directive that they be phased out over a period and on whether to exercise the option to permit banks to have a fund for general banking risks available to cover losses not in existence at the balance sheet date;

(b) in general we should adopt a conservative approach to the way in which we exercise the options in the Directive so as to minimise disturbance to present accounting standards and the law. However, the question of foreign currency translation (dealt with in the Directive) is somewhat complex and while the Member State options allow current practice in the United Kingdom (as set out in SSAP 20) to continue, discussions prior to the publication of the consultative document could provide an opportunity for us to consider whether to invite views on possible changes of practice;

(c) comments should be invited in the consultative document on whether the provisions of the Directive should be applied not only to institutions authorised under the Banking Act 1987 and to building societies but also to other financial institutions which do not explicitly fall within the scope of the Directive. Because of the difficulty of defining a 'financial institution' (there being no definition in the Directive) a strong preference should be expressed for the Directive to be implemented to apply to a readily defined and identifiable category of institution (namely banks and building societies) while leaving open the possibility to expand its scope at a future date.

4. I do not think we should commit ourselves at this stage to how far the consultative document needs to explore issues which go beyond these matters which we cannot avoid dealing with for the purposes of implementing the Directive.But I note that the Bank of England believes that discussion of implementation of the Directive could be the occasion to consider a number of other changes to the accounting requirements for banks which see as desirable in the interests of shareholders and creditors and that the consultative document could perhaps seek views on such aspects. In particular they consider that:

(a) the scope and structure of the Directive has remained fundamentally unchanged since it was first mooted and therefore does not fully reflect some developments in the banking sector over the last decade including the recent trend towards additional disclosure in bank accounts on sources of income, analysis of loans, details of bad debt provisions etc;

(b) consideration could be given to supplementing the Directive's requirements so that banks' accounts reflect existing best market practice in the preparation and presentation of financial statements;

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the department for Enterprise

(c) the valuation and accounting treatment of many new off-balance sheet treasury instruments (such as currency and interest rate options and forward (or future) rate agreements) which are not explicitly covered in the Directive may need to be addressed in the consultative document. However, my inclination is that we should not go beyond the minimum provisions of the Directive, but I see no harm in testing the water on these aspects.

5. Before the consultative document is published therefore it will be desirable for DTI, Bank of England and perhaps Treasury officials to have informal discussions with interested parties, including representatives of the British Bankers' Association (BBA) on implementation matters and on associated issues such as the ones to which I have referred. In the light of these preliminary discussions we can decide how far the consultative document needs to discuss issues that go beyond the strict requirements of the Directive. If these discussions indicate that there are no difficulties about a basically minimalist implementation of the Directive the consultative document could be produced on the basis of a draft statutory instrument under the Companies Act 1985. I hope it will be possible for issues which go beyond the requirements of the Directive to be dealt with mostly in a Statement of Recommended Practice (SORP) or Statement of Standard Accounting Practice rather than in legislation. With the encouragement of the Bank of England, representatives of the BBA and of the Institute of Chartered Accountants in England and Wales have already agreed to set in motion work for the preparation of a SORP for certain detailed aspects of banks' accounts, which would need to be franked in due course by the Accounting Standards Committee if the latter were satisfied both with the technical quality of the final statement and the process by which it had been developed. My officials and those at the Bank will liaise closely with the working group preparing this SORP.

I hope that you agree to our proceeding on the above lines.

FRANCIS MAUDE

J04DEN

888-273

BANK OF ENGLAND

An ACCOUNT pursuant to the Acts 7 & 8 Vict. ch. 32, 18 & 19 Geo. 5. ch. 13 and 19 & 20 Eliz. 2 ch. 24, for the week ending on Wednesday, the 3RD day of FEBRUARY 1988.

ISSUE DEPARTMENT

	£		£
Notes issued —		*Government Debt*	11 015 100
In Circulation	13236 813 398	*Other Government Securities*	2622 325 019
In Banking Department	3 186 602	*Other Securities*	10606 659 881
		Coin other than Gold Coin	
		Amount of Fiduciary Issue	£13240 000 000
		Gold Coin and Bullion	
	£13240 000 000		£13240 000 000

Dated the 4TH *day of* FEBRUARY *1988.*

D. H. Somerset *Chief Cashier*

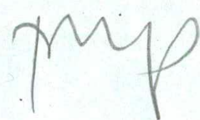
BANKING DEPARTMENT

	£		£
Capital	14 553 000	*Government Securities*	471 537 552
Rest		*Other Securities*	2587 180 708
Public Deposits (including Exchequer, National Loans Fund, National Debt Commissioners and Dividend Accounts)	85 970 751	*Notes*	3 186 602
		Coin	318 097
Other Deposits	2961 699 208		
Seven Day and other Bills			
	£3062 222 959		£3062 222 959

Dated the 4TH *day of* FEBRUARY *1988.*

D. H. Somerset *Chief Cashier*

(3774)



74B2/SB/2623/008

FROM: P BEECROFT
DATE: 8 February 1988

1. MR SCHOLAR
2. CHIEF SECRETARY

cc: PS/Chancellor
Sir Peter Middleton
Mr Anson
Mrs R Lomax
Mr Peretz
Miss Noble
Miss O'Mara
Mr L Watts
Mr Griffiths
Miss S Chalk

BANK OF ENGLAND CASH LIMIT 1988-9 (BoE 1)

This minute seeks the agreement of the Chief Secretary to a non-voted cash limit of £88.7 million for Treasury payments to the Bank of England in 1988-89. This figure was included in the Treasury's baseline PES approved by the Chief Secretary on 23 October 1987. The 1988-89 provision represents a 2.5 per cent increase over 1987-88.

2. Three activities are carried out on our behalf for which payment is made:

a. Note Issue: £50.0 million for the supply of new notes, examination and destruction of old ones and experimental work on the currency;

b. Debt Management: £34.1 million. The main element of this is the Registrar's Department for necessary work

(registering the transfer of stock, paying dividends etc on British Government Stock);

c. Exchange Equalisation Account: £4.6 million for the operating costs of exchange market intervention, reserves management etc.

Payments are made from the National Loans Fund for items a. and b. above and from the EEA for item c. Expenses are not borne on a Treasury vote.

3. We are satisfied that there is no scope for reduction in 1988-89. Some of the existing printing machinery will be replaced at the Printing Works in the coming year. The Registrar's Department is staffed to deal with the large British Transport Stock redemption in 1988. Casual staff will also be employed to deal with peak demand. Once the big redemption is out of the way it is expected that, following the Bank's recent restructuring, costs should fall. No adjustment has yet been made for the planned re-location of the Registrar's Department from London to the provinces.

4. Following the revision of the Memorandum of Understanding which set out the basis of Treasury/Bank relationships on public expenditure etc we have pursued with the Bank questions on value for money. The Bank has for the first time produced a series of aims and objectives for each of the cash limited areas. These have been subjected to scrutiny. Our aim for 1988 is to continue to ensure that the Bank works as efficiently, economically and effectively as possible.

5. I recommend you to approve a total of £88.7 million as the Bank of England cash limit for 1988-89. This submission has been agreed with GEP2.

P Beecroft

P BEECROFT

PWP

BANK OF ENGLAND
LONDON EC2R 8AH

9 February 1988

A C S Allan Esq
Private Secretary to
The Chancellor of the Exchequer
HM Treasury
London
SW1A 3AG

Dear Alex

I enclose a draft of the speech which the Governor is to give on 11 February. It will provide a companion piece to the Bank's Quarterly Bulletin article on the equity market crash, a copy of which is also enclosed. As you know, the Stock Exchange are releasing their report on the equity market crash to the press on Wednesday for official publication on Friday; Sir Nicholas Goodison is giving a speech at the City University on Wednesday. We are obviously co-ordiinating the Governor's speech with Sir Nicholas Goodison's; the coincidence is awkward but was discovered only rather late in the day.

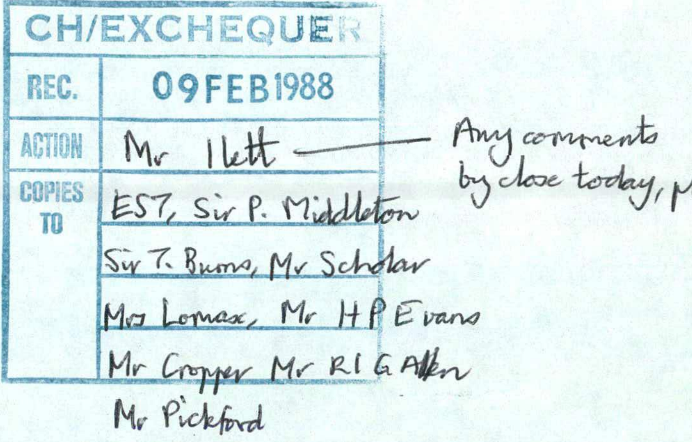
Yours ever

John.

J R E Footman
Private Secretary
to the Governor

BANK OF ENGLAND
LONDON EC2R 8AH

9 February 1988



Any comments by close today, pl.

A C S Allan Esq
Private Secretary to
The Chancellor of the Exchequer
HM Treasury
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Yours ever

John.

J R E Footman
Private Secretary
to the Governor

C.

1. Nick Ilett has no real problems with the speech - few small things annotated. You may just like to know it's happening.

2. The BEQB Article, he says, is just a collection of facts & says nothing new.

AH

Ch/ also brief note by officials on Stock Exchange report behind

MPW 9/2

2273A

SPEECH TO THE CITY UNIVERSITY ON THE CRASH

Speaking version only

1 I am delighted to have this opportunity to meet such a select group as the alumni of the City University evening MBA programme. In the five years of its existence the programme has proved its worth both to the City institutions whose staff have attended, and for those of you who have, if I may put like this, done all the hard work. I can imagine just how much pressure is involved in a commitment of this kind. All of the students, and certainly those from the Bank, have been doing fairly taxing jobs in the daytime, and I can only marvel at and applaud their taking on an intensive course of study in the evenings as well. It must all be excellent training for a career in our 24-hour markets! But I know that there is far more to an MBA than endurance, and your subsequent careers have amply demonstrated the real contribution that such a programme can make. The City University, and Ian Jones, are to be congratulated for placing us so firmly in the vanguard of management education.

Published version start here

2 In an article last week on the events of October, the Financial Times remarked on how little official analysis of the crash appeared to have been produced here, and observed that the Americans had pulled ahead of us to the extent of several stout volumes of analysis and prescription. In fact we may now be reducing the gap: the Bank released today a fairly detailed

account of the crash in the Quarterly Bulletin - although it is certainly not intended to be a "UK Brady Report"; the Stock Exchange will be officially releasing their own report tomorrow; and some of you may have heard Sir Nicholas Goodison's excellent speech yesterday to another City University audience. But I was never, to be honest, very concerned about our apparent slowness to engage in elaborate post-mortems, or to leap in with proposals for structural change in the markets or in their regulation. "Post-mortem", in any event, seems scarcely the appropriate term, given that the world's equity markets appear to have been restored, if not to rude health then at least to a reasonably stable condition.

N. Ilett (NJI) Looks complacent

NJI: still nervous.

3 But with our own assessment now completed and published, it is I think appropriate for me to offer some comment on the causes and consequences of the market crash, to suggest some of the areas that may repay further study, and perhaps to offer some very preliminary conclusions at least for our markets in the United Kingdom.

A portrait of the crash

4 Let me begin by recalling briefly the history of the bull market which came to an end so abruptly last autumn. In London, prices began to rise in a sustained way in early 1982, when the FT 30 share index stood at around 550. Over the succeeding five years the index moved up to about 1850, an increase of almost three and a half times. After allowing for inflation, the real increase in prices was still of the order of 170%. This

represented one of the strongest and most prolonged bull markets since the Second World War.

4a At the beginning of last year, when the bull market had already been running for some time, the pace quickened appreciably. By June, the FT 30 share index was about 35% above its level at the beginning of the year. There was then a moderate adjustment but by mid-August prices were again beginning to rise quite briskly. In the months before the crash, earnings yields on UK equities had fallen to the lowest level since 1973, some three percentage points below the yield on government bonds.

5 The pattern of price movements in New York and Tokyo was similar to that in London although there were differences in the timing of the periodic peaks and breaks in the continuing bull market. The Dow Jones index rose by a factor of three and a third and the Nikkei-Dow by a factor of three and a half over the five years to mid-1987 - very close, therefore, to the increase in London. London and New York continued broadly in step during the subsequent fall, and having at one stage been 35-40% higher, they finished the year about where they began it. In Tokyo, however, while the increase in prices during the first three quarters had been similar to that in London and New York, the subsequent decline was only half as large; and in dollar terms the Tokyo market was almost unchanged over the fourth quarter.

6 As to the causes of the decline, it seems fairly clear that an underlying concern about prospects for the world economy, especially focussing on the external imbalances between the major countries, coupled with a more immediate worry about the

possibility of a collapse in the dollar and rising interest rates, brought about a break in market psychology in October. But the extent of the decline in prices was out of all proportion to the economic news then emerging, and this does suggest that the fall was indeed a correction, the bursting of a bubble. If it is true, as many would argue, that equity prices had by last October reached levels which were conspicuously out of line with the so-called fundamentals, it is perhaps not very instructive to try to pin responsibility for the crash on particular short-term factors.

8 But the crash has provoked a great many questions about the way markets operated and the way investors behaved. I will address just three: the adequacy and robustness of trading mechanisms; the interaction of the cash and derivative product markets; and finally, some implications for prudential supervision, including in particular the assessment of capital adequacy and of credit exposure.

Market structure

9 The trading mechanism in New York depends heavily on the "specialist", who occupies a position which in some respects is similar to that of a traditional London jobber. Each specialist has privileges and obligations in relation to a particular group of shares. These include a commitment to make, as principal, a two-way price on the Exchange floor, and to act to moderate volatile movements. With the approval of the Exchange authorities, a specialist can, for example, delay the opening of

trading if the imbalance of orders would indicate a price significantly different from the previous day's close.

9a In London, the jobbing system has given way to a new system that emphasises competition between a number of market makers, each of whom is obliged to make, during market hours, continuous two-way prices in the stocks in which he is registered. The system can perhaps be seen as giving priority to continuous liquidity rather than to price stability. Since the Big Bang a further and important difference has emerged, as between London and New York, in the typical corporate structure of the firms involved. Most London market makers are now part of much larger financial groups and as such have relatively flexible access to additional capital; the New York specialists, on the other hand, are mostly independent firms.

10 These differences were reflected in behaviour during the crash. In New York, trading in many stocks halted altogether on 20 October in the face of huge imbalances in the orders received by the relevant specialists. Some firms suffered pressure on their capital resources, which in turn made banks wary of extending further credit or led them to recall existing loans. In the absence of a ready source of new capital several firms were forced into mergers. In London, on the other hand, any disruption of trading seems to have been manifest only in the sense that market makers were sometimes difficult to reach on the telephone; but this does not seem to have prevented record volumes of trading on the days when this was said to be happening. Pressure on market makers' capital was reflected in capital injections from their parents during, or shortly after,

the crash. But although London's experience in October was perhaps less obviously traumatic than New York's, the abnormality of trading conditions was certainly reflected in a substantial widening of spreads. This seems to have affected particularly alpha stocks, for which the "touch" roughly doubled, but was also true for the less liquid beta and gamma stocks.

Derivative and cash markets

11 Trading in derivative products associated with the equity markets has been identified by some as a major factor contributing both to the speed of the decline in, and the volatility of, cash market prices. The use of such products in this country is very limited and the volume of stock-index related business is small. It seems unlikely, therefore, that these markets played any significant direct role in the crash in London.

12 In New York, however, a good deal of attention has focussed on so-called "trading strategies" or "program trading", of which two forms appear to have been particularly important: index arbitrage between stock index futures and cash stock; and non-arbitrage strategies, notably the purchase and sale of futures instead of cash stock to take advantage of faster and cheaper execution, or "portfolio insurance" which, if implemented in the futures markets, involves selling futures as a hedge against a cash holding.

13 It has been argued that the extensive use of these trading strategies can give rise to a "cascade" effect: stock prices decline for some "external" reason; investors sell futures to

lock in a price; the futures price falls in relation to the price of cash stocks; arbitrageurs buy futures and sell stocks; stock prices fall further; more futures are sold; more arbitrage takes place; and so on. In theory, arbitrage activity - by putting upward pressure on futures prices and downward pressure on stock prices - should limit and eventually halt this cycle. Furthermore, institutional rules in some markets - for example, the "short-sales" rules in New York - are also intended to choke off any incipient cascade effect. On the other hand, halts in trading in either the cash or the futures markets are likely to cause distortions both in stock indices and in arbitrage activity related to them, thereby perhaps interrupting the self-balancing arbitrage mechanism.

14 The role of derivative products in the US market crash seems far from clear. The Brady Report, for example, says that portfolio insurers and other institutions sold in both the cash market and the futures market, and that selling pressure was transmitted between the two by the mechanism of index arbitrage. The report concludes that, although index arbitrageurs were not the primary cause of price movements in the stock markets, they could be described as "the transmission mechanism for the pressures initiated by other institutions". The report commissioned by the New York Stock Exchange , and the SEC's more recent report, also conclude that the futures markets may have contributed to the speed of the fall in prices. On the other hand, the reports from the US futures exchanges present a rather different picture. The Chicago Mercantile Exchange, for example, argues that index arbitrage transferred to New York only a fraction of the total selling pressure experienced in Chicago and

that, without the stock index futures markets, selling pressure on the NYSE would have increased and resulted in further price declines. It is interesting that the London Stock Exchange report, in the light of pricing anomalies between the cash and derivative markets, argues for greater use of index arbitrage in our markets.

15 These differences of view, or at least of emphasis, suggest to me that we should weigh the evidence of October very carefully before reaching any conclusions on what action, if any, should be considered in London. It has been suggested that formal arrangements for trading stoppages should be instituted, and there may be something in the argument that if a market is going to be closed, it is better done in an orderly and well-understood way rather than coming about as the result of haphazard and unpredictable failures in the trading system. Equally, however, as the US studies recognise, closing one market may simply exacerbate the pressures on another. Before endorsing proposals for market closure, "circuit breakers" or limits on price movements, we would want to be very clear that they address, rather than simply delay or even compound, the problem.

Supervision

16 This carries me to the last of the three issues I identified, regulation and supervision. How much capital should be held against a particular "book" is a difficult matter involving many different considerations - some technical, some judgmental. But in most assessments, the price volatility of the securities involved is of key importance. The regulatory regime that we are

now putting in place in the UK was conceived and legislated for wholly within the period of a bull market; that background may to some extent have conditioned views about what constituted "reasonable" or "likely" price variations. It is salutary, and perhaps in the long run healthy, that we have been reminded how violently markets can move just as our new arrangements are coming into force. Some may be inclined to dismiss October as a "one-off", which will not be repeated for a very long time. That may be true; but we cannot discount altogether the possibility that some of our domestic markets, perhaps as a by-product of improved liquidity, globalisation and technological change, have become permanently more volatile, and that this will have implications for the capital resources that participants must be required to maintain.

16a The question of capital adequacy did not, of course, arise all of a sudden with the crash: it had been debated widely and at great length beforehand. Equally, one aspect of prudential supervision which the crash served to emphasise - the need to keep firm control of credit exposure - had been a focus of attention for some time.

16b In this context it is worth noting that a characteristic of the Stock Exchange account arrangements in London is that they can contribute to an accumulation of counterparty exposure. At the time of the crash, which took place in mid-account, such exposures, compounded with those represented by unsettled bargains from previous accounts, gave rise to worries in the market about a number of firms and clients - which fortunately in the event turned out to be misplaced. But in circumstances where the whole

system is under strain, the likelihood of contagion is far greater if firms are disproportionately exposed to particular counterparties. There is another feature of the present account arrangements which may be worth examining, namely the extent to which they facilitate the shorting of stock within the period of an account. For both reasons, I believe that a reconsideration of the role of the account could be helpful.

17 There is one further aspect which I will mention only briefly, as I have spoken about it at length on other occasions. One of the most important issues facing financial regulators today is the development of means of domestic and international co-operation. This need is particularly acute in circumstances such as those of the crash, so that all concerned can establish an accurate and timely picture of what is going on. It was reassuring to see how quickly and effectively arrangements were put in place in October to reinforce this collaboration - both among domestic groups of supervisors and between those authorities and their counterparts overseas. We shall be building on those arrangements.

Conclusions

19 I have focussed this evening on the events in New York and London, and have suggested some features of interest and significance which would repay further study. I have sought to avoid drawing firm conclusions at this stage, and as I indicated at the outset I am wary of premature judgments in this area. But I would like to offer some brief observations on the experience of the past few months.

o It is fair to say that the new dealing systems which came into being in London at the time of the Big Bang have acquitted themselves well. Trading in London continued with little interruption despite extremely heavy volumes. This suggests, I believe, that in adopting a competing market-maker system, rather than one of the more formal and less flexible alternatives, the Stock Exchange chose wisely. And while there were some understandable early hitches in the SEAQ system, its performance during October and November reflects very great credit on the Stock Exchange.

o I do not think that we should allow ourselves to be unduly dazzled by the complexity and ingenuity of the derivative products markets, or to exaggerate their capacity to originate or [perpetuate particular trends in the cash market.] They may have changed the style and language of trading, but there has, I think, been a tendency to overstate their impact on the substance, both in this country and even in the United States. I would not wish to dismiss the dangers too lightly, but if we have been seeing some form of electronic stampede, we should remember that the "herd instinct" has always been a feature of stock market movements.

NJI: Not proven, & nobody in this country has been unduly.

o I have yet to be persuaded of the need for more artificial breaks in the markets. I can see that they might impose a semblance of orderliness, but this would be at the expense of what must be the key feature of any market, which is to provide liquidity.

- The events of last year have reinforced very strongly my concern that we should promote much closer and possibly more formalised links between supervisors internationally, both in the banking and securities fields. If the markets have become more complex volatile, and if the risks are less than perfectly understood, then our concern as supervisors must be with the soundness of all the participants in the major centres.

- I have focussed very much on the market aspects of the crash. But I believe it would be wrong to portray what happened last October purely in technical market terms. Underlying the events in London, New York and Tokyo were, quite clearly, long-standing and deep-rooted concerns about imbalances at the macro-economic level, paricularly of course the US fiscal and external deficits. Refining market mechanisms may be a way of addressing some concerns, but reducing these imbalances must I think be a pre-requisite of longer term stability.

19a I hope that in conducting this post-mortem I have avoided on the one side complacency and on the other undue alarm. In any event, I have certainly not been comprehensive, and there are many other aspects that deserve examination. So far, at least, the financial system seems to have weathered the storm passably well; but there are certainly lessons in what happened which we should identify and study, which before an audience of MBAs cannot be an altogether discouraging conclusion.

The equity market crash

The dramatic fall in equity prices on most of the world's stock markets last October brought to the fore a number of questions on the markets' structure and functioning. Studies are under way in several centres which aim to explore the causes of the crash, the way that different markets—in particular the futures and options markets and the cash markets—reacted with one another, and the way that different groups of investors behaved. Some of these studies have already been published and include recommendations for changes to present arrangements. Others are still in preparation. This article[1] does not attempt a detailed analysis of the crash, nor does it present specific policy recommendations, but it draws out features that are of interest and importance. The first part of the article describes the events of the crash in the London, New York and Tokyo markets; the second part examines some structural issues highlighted by the crash.

Share price movements

Background

The view was increasingly being taken well before the slump in share prices last October that equity markets were overvalued and that an adjustment was likely, especially given growing concerns about the US trade and fiscal deficits and the rise in US bond yields. As Chart 1 shows, the upward trend in share prices in New York and London faltered in April; and by June in Tokyo, July in London and August in New York, the bull market was fairly clearly losing momentum. Nevertheless, by the end of September all three markets had resumed their upward course. At its peak, the London market was 46% above its level at the beginning of the year, compared with 44% in New York and 42% in Tokyo.

The bull market led to a substantial reduction in earnings yields in all three countries (Chart 2). As the chart shows,

Chart 1
Equity price indices[(a)]

(a) Figures in local currencies.
(b) London—FT-SE 100.
(c) Tokyo—Nikkei Dow.
(d) New York—Dow Jones Industrial Average.

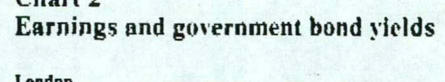
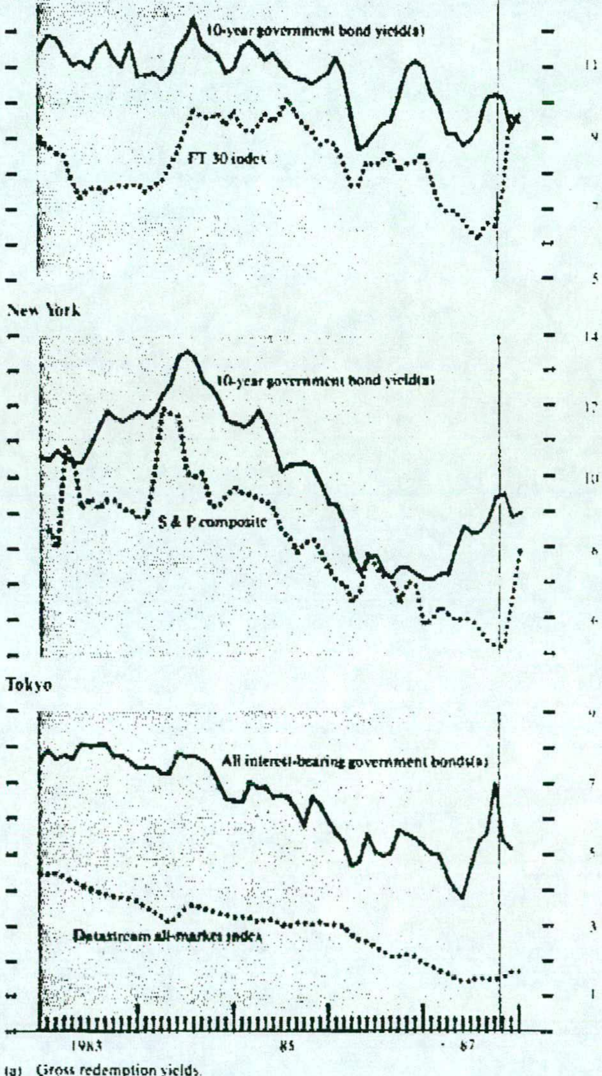


Chart 2
Earnings and government bond yields



(a) Gross redemption yields.

(1) This article was prepared by the Bank's Financial Markets and Institutions Division with the help of unpublished data provided by the International Stock Exchange.

they reached levels during 1987 substantially below those characteristic of the previous four years. The reverse yield gap—the excess of the gross redemption yield on government bonds over the earnings yield on equities—also widened sharply in the first three quarters of 1987.

The market collapse

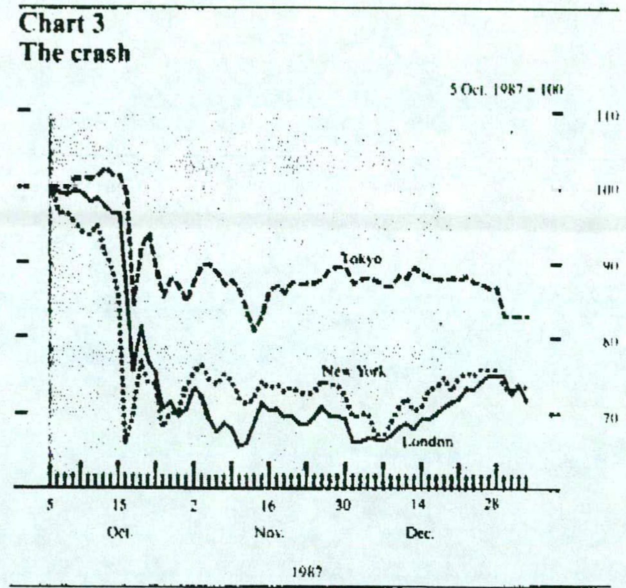
The downturn began in New York on 6 October. The Dow Jones index fell 92 points, 3.5%, apparently triggered by a modest tightening in German monetary policy and rumours of discord between the US and German authorities over the Louvre agreement. In London the FTSE index fell 1% while the Nikkei Dow in Tokyo rose by 0.3%. In the next seven days both the New York and London markets declined almost continuously, though the pace of the fall was much faster in New York. By contrast, the Tokyo market continued to rise, reaching a new record on Wednesday 14 October. On the same day, however, in response to poor US trade figures for August and the announcement of likely tax changes affecting the financing of corporate takeovers, the New York market fell by a record 95 points. This was followed by falls of 58 points on 15 October and 108 points on 16 October (the largest-ever one-day decline at the time).

The hurricane effectively closed most UK markets on 16 October. On Monday 19 October the FTSE opened 138 points down and closed 250 points (11%) down, having at one stage been off by 302 points. Triggered by rising US interest rates and fears of a slump in the dollar, the Dow Jones fell an unprecedented 508 points, 23%, taking the index 34% below its 5 October level. In Tokyo, by contrast, where the markets closed before New York opened, equity prices fell only 2%. On 20 October Tokyo declined by 15% and London by a further 12%. When the New York market opened there was an initial rise in prices which seems to have owed much to Federal Reserve Chairman Greenspan's statement that the Federal Reserve would provide liquidity to support the financial system. But the morning rally did not last and, by mid-day, selling pressures in cash and futures markets had all but halted trading. In the early afternoon, buy orders brought a resumption of trading and a recovery in the Dow Jones index. Although the reasons for this are not entirely clear, it appears to have been associated with the upturn in the Major Market Index futures contract.

During the last week in October and the first in November, New York and Tokyo fluctuated quite widely from day to day, but showed little net change. London, on the other hand, tended to drift lower, partly because of concerns about the prospective position of member firms of the International Stock Exchange (ISE) on the 2 November account day, when deals for the period of the crash were due to be settled. There were persistent, albeit unfounded, rumours that two equity market makers were in difficulties, and also worries about possible defaults by private investors. In addition, the BP issue at the end of October contributed to market uncertainty, although this was mitigated by the announcement of the Bank of England's repurchase arrangements.

London reached its lowest point (34% below 5 October) on 9 November and there was no substantial change

Chart 3
The crash



thereafter in either London or New York. New York was at its lowest on the day of the crash itself, 19 October. The low point in Tokyo came on 11 November, but the cumulative decline from 5 October was only 19%. Thereafter, the Nikkei Dow recovered, and by end-December it was only 17% below the 5 October level. The corresponding figures for New York and London were 27% and 28% respectively.

The drop in share prices on the three major exchanges was matched by falls elsewhere. The main continental exchanges reached a low point within two days of the London trough. The magnitudes of the declines from 5 October to the troughs in Paris, Frankfurt and Zurich were 34%, 40%, and 38% respectively. These markets had risen much less than London and after their decline they stood well below the levels at the beginning of 1987.

The figures quoted above are in local currencies. Taking account of the significant shifts in exchange rates during the fourth quarter of 1987, the pattern of price changes for foreign investors from the beginning of the crash to end-year was significantly different. Table A shows the even more marked fall in the New York market when prices are expressed in sterling and yen. In dollar terms, prices in Tokyo actually rose slightly.

Table A
Change in equity indices in different currencies
Percentage changes from 5 October to 31 December

	London	New York	Tokyo
In sterling	*−28.2*	−36.5	−13.3
In dollars	−16.9	−26.6	+ 0.3
In yen	−31.4	−39.3	*−17.1*

BANK OF ENGLAND GPS 01 601 4953 P.04

As Chart 2 illustrates, the equity market crash led to substantial increases in earnings yields in London and New York, narrowing the reverse yield gap considerably, and at one point eliminating it entirely in London. The upward shift in earnings yields in Tokyo, although much less marked, came after three years of virtually uninterrupted decline. It coincided with a reduction in government bond yields, which meant that in Tokyo, too, the reverse yield gap narrowed.

Movements in futures compared with the underlying stock indices are shown in Chart 4. In London, on 19 October, the FTSE futures contract traded at a discount (on a cash and carry arbitrage basis—that is, reflecting the different costs of holding cash and futures positions) to the FTSE index. But thereafter the index and the future moved more closely in line. In New York, on the published figures, the S&P 500 futures contract dropped noticeably below the underlying index on 19 and 20 October. But the cessation of trading in a large number of stocks in the cash market made it difficult to establish an accurate value for the index and at times on 20 October trading in stock index futures was suspended. In Tokyo, an equivalent stock index futures hedging mechanism was not available.

Chart 4
Comparison of indices and futures prices

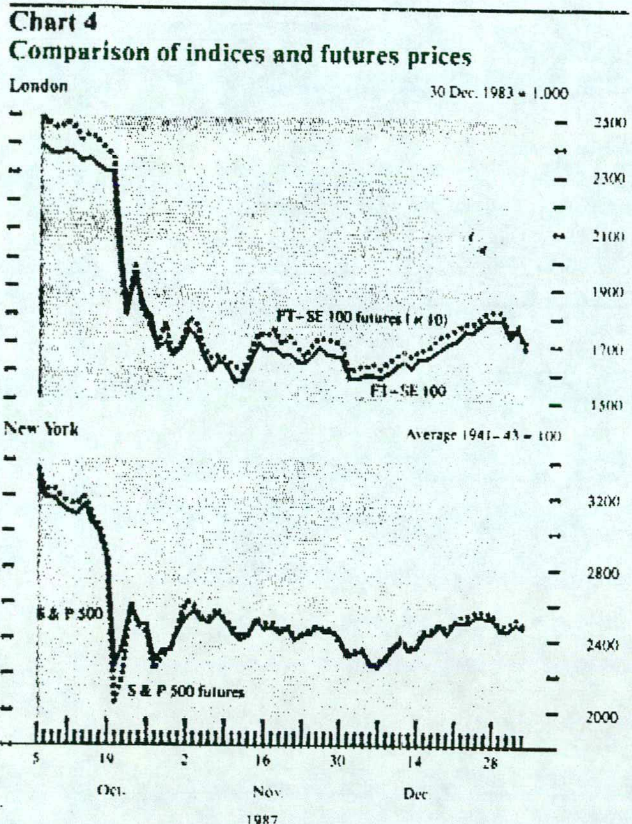


Table B
Price volatilities[a]

	FTSE	Dow Jones	Nikkei Dow
5 October to 12 November(b)			
Close-to-close	4.15	5.49	3.88
Open-to-close	2.08	3.66	..
Third quarter			
Close-to-close	0.91	0.93	1.10

.. not available.

(a) Standard deviation, as a percentage of index, of daily price movements over the period shown

(b) The period from the beginning to the end of the 'October' fall in share prices.

Price volatility

It is difficult to measure price volatility adequately in a single statistic, in particular during a period which includes something close to a step change in prices. There are, in particular, questions about how 'close-to-open' changes should be treated and about whether intra-day (say, hour-by-hour) or day-to-day changes are more significant.

Table B presents two of the simplest measures of volatility, the standard deviation of daily close-to-close and open-to-close price movements. On the close-to-close measure, volatility was nearly six times higher than the third quarter average in New York, over four times higher in London[1] and over three times higher in Tokyo. The figures also suggest that the volatility of the Dow Jones was higher during the crash than that of either the FTSE or the Nikkei Dow. This contrasts with the third quarter data which show little difference in the price volatility in each market.

The crash also saw a large increase in *intra-day* volatility in London. Between 19 and 23 October, when the gross movement in the FTSE index was about 1800 points, volatility (calculated analogously to the measures in Table B) was 3.3% per hour. This compares with intra-day volatility of only 0.3% per hour immediately pre-crash (between 5 and 16 October) and of 0.7% per hour between 12 and 30 November, when share prices were comparatively steady.

It has been suggested that the prices of the most liquid stocks were the most volatile, but this is not borne out by the evidence. In the United Kingdom, alpha[2] stocks are the most liquid; yet the data seem to indicate that they have been no more, and perhaps slightly less, volatile than the less 'visible' categories. This appears to hold true both before and after Big Bang and before and after the crash.

Trading and market structure

The second part of this article examines some aspects of trading behaviour and market structure which had a

(1) Part of the difference is accounted for by the fact that the decline in prices in New York was heavily concentrated on a single day, 19 October, whereas in London, for example, the decline was divided more evenly between 19 and 20 October.

(2) *Alpha stocks* are the most actively traded UK equities. Market makers are obliged to make continuous, firm two-way prices in a minimum size of 5,000 (previously 1,000) shares during mandatory trading hours on SEAQ (see below). Market makers have the option of posting firm quotes for deals of larger sizes.

Beta stocks are less actively traded than alphas, although registered market makers must still display continuous firm price quotes as for alphas.

For *gamma stocks* registered market makers post firm or indicative (previously only indicative) two-way prices on SEAQ.

Delta stocks are the least liquid category. The SEAQ screen does not show quotes for delta shares, but gives names of registered market makers and accredited dealers who are committed to quote a price on enquiry.

SEAQ is The Stock Exchange Automated Quotation System, introduced on 27 October 1986. It is the screen-based trading system which has replaced the Stock Exchange floor as the means for transmission of equity price information.

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bearing on the course of the crash in London, New York and Tokyo. They are: the pattern of buyers and sellers; the particular role of foreign investors in each of the markets; dealing systems; and the interaction of futures and options markets with the 'cash' market.

Trading patterns

During the crash, trading volume increased very sharply in London, and even more so in New York, in Tokyo it fell. In London the number of shares traded in the week following the crash was some 40% above the daily average in the first nine months of 1987. There were over 100,000 customer bargains transacted on each of two days of the week beginning 19 October, more than twice the daily average over the same period. But the pace moderated abruptly: by the end of the month the daily number of bargains had returned to its pre-crash level, and thereafter continued to decline. During November, the daily average number of bargains was close to 30,000, about two thirds the average since Big Bang. The decline in trading since the crash has been particularly marked in beta and gamma stocks.

The distribution of trading between participants in the London market also altered during the crash. Customers accounted for 60% of all trades compared with the usual 50:50 split between customer and intra-market deals.

After the initial downturn, over 80% of the customer transactions were buy orders, but most of these were small. The institutions appear to have been net sellers.

Chart 5
Daily turnover on the major stock exchanges

Average number of shares: Jan.-Sept. 1987 = 100

London

New York

Tokyo

5 19 2 16 30 14 28

Oct. Nov. Dec.

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This is consistent with average bargain sizes. The normal bargain size averages about £22,000. The average size of purchase bargains from 21 October was distinctly lower, on some days only £12,000, while the average bargain size for sales was sometimes over £50,000. Private clients seemed on balance to be responding to the plunge in prices in a fairly measured way: a survey conducted by the ISE in early November suggested that very few of them planned to sell in the immediate future.

One reason for this pattern of trading may have been that UK institutions had been encouraged by the long bull market to take on an unusually large proportion of equities, both UK and overseas, compared with levels typical over the previous decade (see Table C). The rise in equity holdings was reinforced by the volume of new issues in the year, by commitments under the BP

Table C
Equity proportion in portfolios of UK insurance companies and pension funds

Percentages

End-period	1982	1983	1984	1985	1986	1987 Q3(a)
UK equities	34	35	39	39	41	44
Overseas equities	8	10	10	11	12	14

(a) Estimated.

sub-underwriting arrangements and also, for some pension funds, by a reduction in net inflows as a result of contribution holidays. The relatively high proportion of equity holdings in institutional portfolios meant that some of those which might otherwise have been purchasers after the first decline in prices were not in practice in a position to buy. A subsidiary factor may have been that some insurance companies, expecting heavy claims after the storm on Friday 16 October, were anxious to preserve liquidity.

The decline in intra-market business, from 50% to 40% of the total, has been attributed to uncertainty which discouraged firms from trading on their own account, especially during periods when a 'fast market' was declared—that is, when prices were moving particularly rapidly, and during which SEAQ price quotations for alpha and beta equities became indicative rather than binding. It is difficult, however, to establish such a link with any certainty: fast market conditions were not declared after 22 October, yet intra-market business remained depressed. At the same time, intra-market business through inter-dealer brokers (IDBs) increased threefold from 20 October compared with pre-crash experience; the increased use of IDBs may have reflected greater
sensitivity, in the unsettled market conditions, about giving competitors clues to the shape of a firm's book.

On 19 October, there were net customer sales of over £250 million, which the market makers took on and which added to their already long positions. Thereafter, the market makers were generally net sellers, although many were effectively obliged to remain long in the least liquid equities. The inability to shift these positions may have been associated with the post-crash decline in trading volume and continuing wide price spreads. While the detailed pattern of trading is uncertain, it seems possible that a halt to purchases by private clients, a halt to significant net sales by institutional investors and a continuing weakness in intra-market dealing left market makers with limited trading opportunities.

As in London, but to an even more marked degree, the New York market saw record volumes of trading during the crash. On 19 October the number of shares traded on the NYSE was more than three times the daily average for the year to end-September. According to the Investor Activity Report, published by the Securities Industry Association, each sector's share of total activity was little changed in October.

Institutions had been net sellers of equities on the NYSE in August and September. In October their net sales reached a new monthly record, 35% above the previous peak in April 1987 (the only other month in 1987 when institutional investors were net sellers). Institutions were heavy net sellers on most days in October; but they were actually net buyers on 19 and 20 October. The specialists[1] were heavy net buyers on 19 October, but sold an almost equal value of stock the following day. The non-specialist ('upstairs') member firms on the NYSE were also record net sellers in October. Their average net sales rose to 2.1 million shares a day from 1.3 million in September. The retail sector (including both private investors and corporate repurchase programmes) was a net purchaser in October of 6.4 million shares a day, compared with 600,000 shares per day in September and average daily net *sales* of 1.1 million shares in the first nine months of 1987.

One factor which gave support to the US market after the initial downturn was the issue of statements by a number of US corporations that they intended to buy back their own shares. Between 19 October and mid-November more than 800 US companies announced such buy-back programmes. In the past, major repurchase programmes appear to have had some effect in supporting stock prices, although on this occasion relatively few shares actually seem to have been bought.

By contrast with London and New York, turnover in Tokyo declined immediately after the fall in equity prices. There was little trading on 20 October, in part reflecting the large imbalance of selling over buying orders at their 'guideline' floor prices on that day.[2] The number of shares traded in Tokyo on 19 and 20 October was, on an average daily basis, some 50% below the level for the first nine months of 1987.

(1) The function of specialists on the NYSE is described in the next section.
(2) On the Tokyo Stock Exchange, there are limits, expressed in absolute amounts of yen, on how far the prices of individual shares may move in any one day.

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In some respects the pattern of buyers and sellers in the Tokyo market resembled that in London and New York. The major net purchasers in the two weeks after the crash were private clients. There was a substantial increase in purchases on margin. There were also small net purchases by exchange members totalling ¥14 billion. Japanese banks, other financial institutions and non-financial corporations also made net purchases. The main selling in Tokyo appears to have been by foreigners. Underlying the Tokyo market are special characteristics which may make it less sensitive to market disturbances than other stock markets. For example, proportionally more stocks are firmly held by Japanese financial institutions and other major Japanese investors than in other markets.

The role of foreign investors
This section questions how far there was a tendency during the crash for investors to dispose disproportionately of foreign shares. The direct evidence is, at present, limited, but in Japan, for example, net sales of equities by foreigners totalled some $13 billion in October (compared with less than $2 billion in September). In other cases, the statistics available at present do not give as clear a picture.

The evidence in the United Kingdom from the quarterly transactions flow figures is that UK pension funds were heavy purchasers of overseas equities in 1987 (an estimated 35% of the increase in the cash value of their net assets to end-September being placed in overseas, mainly US, equities). Japanese investors were net purchasers of foreign stocks during the first three quarters of 1987, largely reflecting portfolio diversification out of US Treasury bonds and into blue chip US equities. In the United States, on the other hand, in the first three quarters of 1987, investors were net sellers of Japanese equities and net buyers of UK and other European equities; overall net sales of foreign equity totalled $1 billion in that period.

These positions could have meant a readiness to sell foreign equities. As already noted, data from Japan support this inference. In addition, there is plentiful anecdotal evidence that there was heavy selling of European equities in the London market during the crash. So far as US investors are concerned, the Brady Report suggested that some foreign selling may have been to take advantage of time zone differences, with investors selling in whichever market was open. Thus US mutual fund managers seem to have been heavy sellers of US stocks in London on 19 October before the NYSE market opened.

UK and US equity dealing systems
The specialist system in New York and the market-making system in London operate with somewhat different priorities. The specialist in New York assumes an obligation to act to prevent volatile price movements in the shares in which he has the sole obligation to make a market. As one element in this, he can delay, with the approval of the exchange, the opening of trading whenever the imbalance of orders would require a price significantly different from the previous day's close, and can halt trading during the day, again with the agreement of the exchange, if such an imbalance occurs. The UK structure, on the other hand, emphasises competition between a large number of market makers who are obliged to make two-way prices continuously throughout the trading day. It gives priority to liquidity rather than price stability. In fact, however, prices during the crash were no less stable in London than in New York. As for liquidity, certain stocks were at times untradable in New York. This was not a new phenomenon: trading halts have occurred on the NYSE on previous occasions when the market has fallen sharply—for example, in 1974–75 there were 900 trading halts.

The ISE remained open throughout the crash, although there were complaints that market makers' price quotes were not available for significant periods. On NASDAQ,[1] which is also a screen-based telephone market, some dealers shut up shop completely. In January 1988 NASDAQ announced a ban on market makers for a period (20 days) if they stop making markets for small orders (1,000 shares); in London the penalty imposed by ISE rules is three months suspension.

The capital resources readily available to the London market makers allowed them, in the initial stages of the crash at least, to absorb substantial amounts of stock. The market imbalance was spread among all the major firms active in the equities market, three quarters of which are part of well-capitalised financial conglomerates. In New York, on the other hand, there was pressure on specialist firms from a shortage of resources which could not be so easily remedied. When it became clear on 19 October that the NYSE specialists had been overwhelmed by sell orders and that the capital of some firms had been significantly eroded, banks were reluctant to extend further credit and some may have recalled loans. This led to several mergers during the crash. Serious consideration was given by the relevant authorities to a temporary halt in trading on the NYSE, because the positions accumulated by the specialists on 19 October and during the previous week placed them at financial risk. In the event, the NYSE announced on 22 October that trading would cease two hours early on each of the three following working days to enable firms to catch up with the backlog of paperwork.

Although London's experience during the crash was perhaps less obviously traumatic, there were departures from normal market practice in a number of respects. In the first place, market prices were changing so rapidly that on several occasions the ISE declared a 'fast market' and market makers were permitted to trade at prices which differed from the normally firm prices for alpha and beta equities quoted on SEAQ. The total duration of 'fast

(1) The National Association of Securities Dealers Automated Quotations, the US over-the-counter market and precursor of SEAQ.

market' conditions was, however, only some six hours in the week beginning 19 October. Second, the market makers in London responded to the trading conditions by increasing their spreads. The 'touch'—the spread between the highest bid and the lowest offered price—widened in all categories of stocks (Table D). During November the touch remained wide in the most liquid (alpha) stocks and widened further in the less liquid beta and gamma stocks. The touches in all equities remained high in December. Third, market makers reduced the size of bargain for which they were willing to quote. By 21 October, average quote sizes, at £145,000, were half their level a week earlier, and they remained at low levels into November. Finally, there was criticism that market makers were in some cases tardy in answering telephones, thus evading their obligation to make markets in all conditions.

Table D
The touch[a] on bargains of normal market size

	1986		1987					
	July	Oct.	Aug.	Sept.	Oct. (19–23)	Oct.	Nov.	Dec. (1–18)
Equity classification								
Alpha	0.8	0.7	0.9	0.9	1.2	1.4	2.0	1.7
Beta	1.8	1.3	1.5	1.5	1.9	1.9	3.5	2.1
Gamma	3.4	2.6	2.5	2.6	3.6	3.5	5.9	3.8

(a) The difference between the best bid and best offer price, expressed as a percentage of the average of the two.

The most serious concern in connection with 'structural' arrangements in London related to settlement. There were two aspects. First, an account period began on 12 October with a settlement date, for trading during the succeeding two weeks, of 2 November. As the period progressed, there was growing anxiety about the accumulation of counterparty risk and the possibility of defaults by private investors on account day. In the event the fears proved unfounded. A second aspect was the longstanding backlog of unsettled bargains, which again contributed to counterparty exposure. By October, however, the number of unsettled bargains was 50% below the August peak (and reduced trading volume in the weeks following the crash in fact facilitated a further marked improvement). Concern about counterparty exposure is nonetheless thought to have contributed to depressed sentiment in the London market.

In Tokyo, as already noted, the market was calm on 19 October and little trading took place on the following day; the special 'guideline' arrangements meant that the Tokyo market was not tested in the same way as London and New York.

Interaction of derivative product and cash markets

It has been argued that trading in derivative products associated with the equity markets contributed to both the speed of the decline in, and the volatility of, cash market prices, particularly in the United States. This is a complex issue and no attempt is made here to reach a conclusion on how the dynamics of the interaction worked in practice.

Particular attention has focused on the use of 'trading strategies', often triggered by computer programmes, of which two forms appear to have been particularly important in the United States: *index arbitrage programmes,* under which traders substitute a basket of the underlying stocks for stock index futures or vice versa depending on the relative prices and expected returns; and *non-arbitrage strategies,* such as those employed by investors trading on the direction of the stock market as a whole (who buy and sell index futures on the basis that futures can be executed more cheaply and quickly than the underlying stocks) and also 'portfolio insurance', which is designed to allow institutional investors partially to protect their portfolio if the market falls. Portfolio insurance, if implemented in the futures markets, involves selling futures as a hedge against a cash stock position. When stock prices decline, portfolio insurers normally increase their futures hedges relative to their underlying holding of stock.

Critics argue that the use of these trading strategies can cause a cascade effect, as follows: stock prices decline for some 'external' reason; participants sell futures so that if the market falls further they have locked in a price; the futures price falls in relation to the price of the stocks in the underlying index; arbitrageurs buy futures and sell stocks; stock prices fall further; more shorting of futures takes place; further arbitrage is undertaken; and so on.

In theory, arbitrage activity—through putting upward pressure on futures prices and downward pressure on stock prices—should limit or modify this pattern. The cascade effect might also in practice be inhibited, at least in the context of the New York market, by the 'short-sales' rules of the NYSE, which prohibit short-selling of stocks if the previous sale price represented a decrease. (For the United Kingdom, by contrast, there are few, if any, constraints on short-selling within an account period.) On the other hand, however, the halt to trading in either the cash market or the derivative products market could cause distortions in both the index and arbitrage activity related to it, thereby interrupting the self-balancing arbitrage mechanisms.

The role of derivative products in the October crash in the United States is far from clear-cut and still under review. The Brady Report, for example, indicated that portfolio insurers and other institutions sold in both the stock market and the futures market and that selling pressure in the futures market was transmitted to the stock markets by the mechanism of index arbitrage. According to Brady, sell programmes by three portfolio insurers on 19 October accounted for just under $2 billion sales in the cash market, and in the futures markets three portfolio insurers accounted for the equivalent of $2.8 billion of stock. The Brady Report concluded that, although index arbitrageurs were not the primary cause of price movements in the stock markets, they could be described as 'the transmission mechanism for the pressures initiated by other institutions'. The report commissioned by the New

York Stock Exchange (the Katzenbach Report) also concluded that the futures markets may have contributed to the speed of the fall in prices on the stock market.

Reports on the crash produced by the US futures exchanges, however, tend to present a rather different picture. The Chicago Mercantile Exchange, for example, argued that index arbitrage transferred to New York only a fraction of the total selling pressure experienced in Chicago and that, without the stock index futures markets, selling pressure on the NYSE would have increased and resulted in further price declines. The Chicago Board of Trade contended, similarly, that futures markets 'far from being a cause of the market decline, performed their hedging and risk-transfer functions admirably'. The Commodity Futures Trading Commission's estimate was that only 9% of shares traded on the NYSE on 19 October represented index arbitrage.

In contrast to the US markets, the use of stock-related derivative products in the United Kingdom is very limited and the volume of stock-index-related business is very small. Such programme trading as does take place in London, which is carried out on behalf of UK institutional investors, seems to be placed mainly on the US markets by US investment houses. In these circumstances, the interaction of the cash and derivative products markets seems to have played a very limited direct role in the crash in London.

Summary

This article has focused on the course rather than the causes or the consequences of the crash. On the evidence to date, the overall judgement must be that the international financial structure survived the shock at least passably well. There were no major insolvencies, although some firms sought additional capital from existing parents or by merger, and most markets, for all but relatively short periods, remained open.

But this assessment is only tentative. A good deal of evidence is still to be weighed and there are certainly aspects of present market arrangements and market behaviour in London which call for further examination. These include the experience of the 'retail' investor, the assessment of risks and capital adequacy for market participants, the role of the Stock Exchange account, the potential interaction between derivative and cash markets, and the feasibility and desirability of rules to limit the speed at which prices move.

RM2.81

SECRET

BF 25/10

FROM: MOIRA WALLACE

DATE: 10 February 1988

PS/ECONOMIC SECRETARY

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Sir P Middleton
Mr Scholar
Mr Culpin
Mrs Lomax
Mr Peretz
Mr Ilett
Miss Sinclair
Mr Courtney
Mr Cropper
Mr Tyrie
Mr Call
PS/IR
Mr Cayley - IR
Mr Johns - IR

THE CONTROL OF BORROWING ORDER AND THE BUDGET

The Chancellor has seen your minute of 9 February, Mr Ilett's submission of 8 February, and Mr Peretz's minute of 8 February. In the circumstances, the Chancellor agrees with the Economic Secretary's view that action will have to be deferred to the 1989 Budget - but he is disappointed that we are not far enough forward to make a move in this year's Budget.

MPW.

MOIRA WALLACE

BANK OF ENGLAND

Wednesday the 10th day of February 1988

ISSUE DEPARTMENT

	£		£
Notes Issued:		Government Debt	11 015 100
In Circulation	13 239 822 046	Other Govt.Securities	2 072 485 723
In Banking Department	10 177 954	Other Securities	11 166 499 177
	13 250 000 000		13 250 000 000

BANKING DEPARTMENT

	£		£
Capital	14 553 000	Govt.Securities	630 661 302
Public Deposits- including Exchequer, National Loans Fund, National Debt Commissioners and Dividend Accounts	86 289 288	Advances and Other Accounts	814 032 049
		Premises, Equipment and Other Securities	2 233 657 600
Special Deposits		Notes	10 177 954
Bankers' Deposits	1 089 472 774	Coin	327 828
Reserves and Other Accounts	2 498 541 671		
	3 688 856 733		3 688 856 733

Dated the 11th day of February 1988

G E A KENTFIELD, Deputy Chief Cashier

BANK OF ENGLAND

An ACCOUNT pursuant to the Acts 7 & 8 Vict. ch. 32, 18 & 19 Geo. 5. ch. 13 and 19 & 20 Eliz. 2 ch. 24, for the week ending on Wednesday, the 10th day of FEBRUARY 1988.

ISSUE DEPARTMENT

	£		£
Notes issued —		*Government Debt*	11 015 100
In Circulation	13239 822 046	*Other Government Securities*	2072 485 723
In Banking Department	10 177 954	*Other Securities*	11166 499 177
		Coin other than Gold Coin	
		Amount of Fiduciary Issue	£13250 000 000
		Gold Coin and Bullion	
	£13250 000 000		£13250 000 000

Dated the 11th *day of* FEBRUARY 1988.

G.E.A. Kentfield. Deputy *Chief Cashier*

BANKING DEPARTMENT

	£		£
Capital	14 553 000	*Government Securities*	630 661 302
Rest		*Other Securities*	3047 689 649
Public Deposits (including Exchequer, National Loans Fund, National Debt Commissioners and Dividend Accounts)	86 289 288	*Notes*	10 177 954
		Coin	327 828
Other Deposits	3588 014 445		
Seven Day and other Bills			
	£3688 856 733		£3688 856 733

Dated the 11th *day of* FEBRUARY 1988.

G.E.A. Kentfield Deputy *Chief Cashier*

(3774)

144/3(C)

CONFIDENTIAL until
17.30 on 11 February 1988
then UNCLASSIFIED

The references to the deteriorating trend in the trade balance, and the reasons given for the recent interest rate rise are very unhelpful.

FROM: PETER CURWEN
DATE: 10 February 1988

1. MR PICKFORD
2. MR R I G ALLEN

cc Chancellor
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mrs Lomax
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Bottrill
Mr Hibberd
Mr Matthews
Miss O'Mara
Mr Bush
Mr Hudson
Mr Cropper
Mr Tyrie
Mr Call
JA/001

BANK OF ENGLAND QUARTERLY BULLETIN - FEBRUARY 1988

The February issue of the Bulletin will be published at 5.30pm on Thursday 11 February. The Bank have pre-released articles entitled - 'The Financial behaviour of industrial and commercial companies' and 'The corporate and bulldog sectors of the sterling bond market'. The Bulletin also contains an article (not pre-released) on 'The equity market crash' which is a companion-piece to the speech the Governor is making on Thursday evening to the City University.

Assessment

2. The Bank have taken on nearly all of the Chancellor's comments of an earlier draft of the Assessment. They have, however, included within their introductory remarks a sentence on the growth of domestic demand, highlighting the falling saving ratio as a factor, and noting that it 'has contributed to a deteriorating trend in the trade balance'. The Chancellor had asked that this sentence be removed. It may well prove to be the focus of much press attention.

3. In the final paragraph the Bank refer to the half point rise in interest rates on 1 February, linking it with the need to maintain the non-accommodating anti-inflationary thrust of policy. However they have been slightly more specific than the Treasury on the

C.
I showed RIGA your line for IDT that this sentence was gobbledygook.

asons behind the rise. In particular the Bank cite as a reason the latest indicators which 'depict a still buoyant economy amply provided with credit', and which give 'little sign so far that the pressures from domestic demand will abate soon'. Again commentators are likely to give this some publicity.

4. The first part of the Assessment is able to take a more reflective view of the falls in world equity markets than was possible at the time of the November Bulletin. The Bank note that in spite of the stock market falls world economic activity is 'holding up quite well'. Only in the US do they expect any significant impact, as the now much discussed 'wealth effects' work through into US consumption. This though is seen as beneficial, helping 'to dampen' import growth into the US while also freeing US domestic resources both for 'production of exports' and for 'investment in additional capacity in the tradeables sector'; all of which should help to reduce the US trade deficit.

5. It is, though, the recent sharp fall in the US dollar which the Bank see as being of greater import for world economic activity. They remark on the consequent 'additional sharpening of competitiveness' for US products and anticipate that changes in trade volumes will begin to outweigh the negative J-curve effect of the dollar fall during 1988, although the nominal US trade deficit is unlikely to show immediate improvement. The Bank warn that any further sharp falls in the dollar would be damaging to the world economy, creating an uncertain climate for investment decisions, and any benefit to US activity would in any case be largely 'dissipated in inflation'. Furthermore to correct world trade imbalances supporting fiscal and structural policies are required in many countries. This is particularly so in Germany where 'fiscal policies are barely stimulative at present when cyclical factors are allowed for'. Japan might also have to act if its economy were to slow significantly. Stimulatory fiscal policies in these countries would become even more urgent if the US authorities acted to stabilise the dollar by use of tighter monetary policies. The US authorities could help to stabilise the dollar by giving 'indications' that they were 'ready to increase interest rates if the dollar were to come under renewed pressure'.

6. On the domestic front the Bank acknowledge the UK's current strong economic performance. On the basis of strong third quarter growth in personal consumption they note 'the fall in the personal saving ratio to levels not seen for nearly a generation'. Although the Bank believe the decline 'may reverse itself soon' and is 'not necessarily a cause for alarm' they point out that the 'associated growth of debt' raises 'prudential considerations for banks and other suppliers of personal sector credit'. And as a final remark they note that this trend in the savings ratio 'raises questions about the appropriate response of monetary and fiscal policy'.

7. The recent fall in the value of the dollar is viewed by the Bank as beneficial for the UK in dampening inflationary pressures but as posing 'some problems for UK activity and the balance of payments'. The Bank cite the overall 10 per cent loss in cost competitiveness since the fourth quarter of 1986 and also remark on the large movements between the dollar and third currencies as being injurious to the UK economy. Such large differential exchange rate movements create substantial shifts in the profitability of different sectors impeding 'long-range planning by industrialists' and depressing activity if the 'losers react by cutting back more quickly than the gainers expand'. On the balance of trade the Bank note that as a result of the recent improvement in supply performance the expected 'further deterioration in the balance' will be smaller than would have been expected just a few years ago. The current account will also be adversely affected on the invisibles side as earnings from UK investments in the US fall in tandem with the dollar. However, as the Bank point out, 'the UK is capable of financing moderate current account deficits for several years' if necessary.

8. The Bank expect any slowing of output growth in 1988 to be less through a slowing of domestic demand and more through a deterioration in the trade balance. While noting the improved supply response of recent years they question the sustainability of current and prospective domestic demand growth at a level 'above that currently being achieved by most other major countries'. Their proposed remedy is faster domestic demand growth in the rest of Europe and slower growth of UK domestic costs. In this respect they point out that the underlying rise of domestic costs is still excessive relative to our competitors and in particular note that 'wage developments are ... not reassuring.'

9. On the monetary side the Bank note the strong growth of broad money which reflects 'the strength of credit demand from the private sector'. This, combined with the interest rate reductions in the closing months of 1987, meant that 'it was important that the exchange rate should remain firm to counter any impression of monetary ease.'

Commentary

10. The Commentary broadly follows the line taken in the Assessment but in more detail. Most of our comments on an earlier draft were taken on board.

Peter. S. Curwen

PETER S CURWEN

12/2
CH/EXCHEQUER
REC. 12 FEB 1988
ACTION Mr Ilett
COPIES TO EST, Sir P Middleton
Sir T Burns, Mr Scholar
Mrs Lomax, Mr H P Evans
Mr Cropper, Mr R I G Allen
Mr Pickford

Speech given by

THE RT HON ROBIN LEIGH-PEMBERTON
GOVERNOR OF THE BANK OF ENGLAND

at The Third Annual Alumni Dinner of
The City University Business School
Evening MBA Programme

on Thursday 11 February 1988

ASSESSING THE STOCK MARKET CRASH

In an article last week on the events of October, the Financial Times remarked on how little official analysis of the crash appeared to have been produced here, and observed that the Americans had pulled ahead of us to the extent of several stout volumes of analysis and prescription. As you will have seen, we have taken some modest steps towards reducing the gap: in today's Quarterly Bulletin the Bank has provided a reasonably concise account of the crash - although it does certainly not pretend to be a "UK Brady Report"; the Stock Exchange have released their own "Quality of Markets" report; and some of you may have heard Sir Nicholas Goodison's excellent speech yesterday to another City University audience. But I was never, to be honest, very concerned about our apparent slowness to leap in with elaborate post-mortems or proposals for structural change in the markets or in their regulation. "Post-mortem", in any event, seems scarcely the appropriate term, given that the world's equity markets appear to have been restored, if not to rude health then at least to a reasonably stable condition.

There are two general points worth making about the American reports. First, many are concerned with the effectiveness of the various regulatory arrangements in the United States, and address questions which have already been decided here and which it would be foolish for us to reopen until we have some experience of the new regulatory system now coming into being. Second, the American studies have been concerned partly with the causes of the crash; and since in looking for causes here we have to start with the US markets, there is not much to be gained from duplication.

It nevertheless seems appropriate for me now to offer some preliminary views on the crash, to suggest some of the areas that may repay further study, and perhaps to suggest some tentative conclusions at least for our markets in the United Kingdom.

<u>A portrait of the crash</u>

Let me begin by recalling briefly the history of the bull market which came to an end so abruptly last autumn. In London, prices began to rise in a sustained way in early 1982, when the FT 30 share index stood at around 550. Over the succeeding five years or so, to the middle of 1987, the index moved up to about 1850, an increase of almost three and a half times. After allowing for inflation, the real increase in prices was still of the order of 170%. This represented one of the strongest and most prolonged bull markets since the Second World War.

At the beginning of last year, when the bull market had already been running for some time, the pace quickened appreciably. By June, the FT 30 share index was about 35% above its level at the beginning of the year. There was then a moderate adjustment but by mid-August prices were again beginning to rise quite briskly. In the months before the crash, earnings yields on UK equities had

fallen to the lowest level since 1973, some three percentage points below the yield on government bonds.

The pattern of price movements in New York and Tokyo was similar to that in London although there were differences in the timing of the periodic peaks and breaks in the continuing bull market. The Dow Jones index rose by a factor of three and a third and the Nikkei-Dow by a factor of three and a half over the five years to mid-1987 - very close, therefore, to the increase in London. London and New York continued broadly in step during the subsequent fall, and having at one stage been 35-40% higher, they finished the year about where they began it. In Tokyo, however, while the increase in prices during the first three quarters had been similar to that in London and New York, the subsequent decline was only half as large; and in dollar terms the Tokyo market was almost unchanged over the fourth quarter.

As to the causes of the decline, it seems fairly clear that an underlying concern about prospects for the world economy, especially focussing on the external imbalances between the major countries, coupled with a more immediate worry about the possibility of a collapse in the dollar and rising interest rates, brought about a break in market psychology in October. But the extent of the decline in prices was out of all proportion to the economic news then emerging, and this does suggest that the fall was indeed a correction, the bursting of a bubble. If it is true, as many would argue, that equity prices had by last October reached levels which were conspicuously out of line with the so-called fundamentals, it is perhaps not very instructive to try to pin responsibility for the crash on particular short-term factors.

But the crash has provoked a great many questions about the way markets operated and the way investors behaved. I will address just three: the adequacy and robustness of trading mechanisms; the interaction of the cash and derivative product markets; and finally, some implications for prudential supervision, including in particular the assessment of capital adequacy and of credit exposure.

Market structure

The trading mechanism in New York depends heavily on the "specialist", who occupies a position in the market which is in some respects similar to that of a traditional London jobber. Each specialist has sole privileges and obligations in relation to a particular and distinct group of shares. These include a commitment to make, as principal, a two-way price on the Exchange floor, and to act to moderate volatile movements. With the approval of the Exchange authorities a specialist can, for

example, delay the opening of trading if the imbalance of orders would indicate a price significantly different from the previous day's close.

In London, the jobbing system has given way to one that emphasises competition between a number of market makers, each of whom is obliged to make, during market hours, continuous two-way prices in the stocks in which he is registered. The system can perhaps be seen as giving priority to continuous liquidity rather than to price stability. Since the Big Bang a further and important difference has emerged, as between London and New York, in the typical corporate structure of the firms involved. Most London market makers are now part of much larger financial groups and as such have relatively flexible access to additional capital; the New York specialists, on the other hand, are mostly independent firms.

These differences were reflected in behaviour during the crash. In New York, trading in many stocks halted altogether on 20 October in the face of huge imbalances in the orders received by the relevant specialists. Some firms suffered pressure on their capital resources, which in turn made banks wary of extending further credit or led them to recall existing loans. In the absence of a ready source of new capital several firms were forced into mergers. In London, on the other hand, any disruption of trading seems to have been manifest mainly in the sense that market makers were said to be sometimes difficult to reach on the telephone - but this does not seem to have prevented record volumes of trading on the days when it was supposed to be happening. Pressure on market makers' capital was reflected in capital injections from their parents during, or shortly after, the crash. But although London's experience in October was perhaps less obviously traumatic than New York's, the abnormality of trading conditions was well illustrated by a substantial widening of spreads. This seems to have affected particularly alpha stocks, for which the "touch" roughly doubled, but was also true for the less liquid beta and gamma stocks.

Derivative and cash markets

Trading in derivative products associated with the equity markets has been identified by some as a major factor contributing both to the speed of the decline in, and the volatility of, cash market prices. The use of such products in this country is very limited and the volume of stock-index related business is small. It seems unlikely, therefore, that these markets played any significant direct role in the crash in London.

In New York, however, a good deal of attention has focussed on so-called "trading strategies" or "program trading", of which two

forms appear to have been particularly important: index arbitrage between stock index futures and cash stock; and non-arbitrage strategies, notably the straightforward purchase and sale of futures instead of cash stock to take advantage of faster and cheaper execution, and "portfolio insurance" which, if implemented in the futures markets, involves selling futures as a hedge against a cash holding.

It has been argued that the extensive use of these trading strategies can give rise to a "cascade" effect: stock prices decline for some "external" reason; investors sell futures to lock in a price; the futures price falls in relation to the price of cash stocks; arbitrageurs buy futures and sell stocks; stock prices fall further; more futures are sold; more arbitrage takes place; and so on. In theory, arbitrage activity - by putting upward pressure on futures prices and downward pressure on cash prices - should limit and eventually halt this cycle. Furthermore, institutional rules in some markets - for example, the "short-sales" rules in New York - are also intended to choke off any incipient cascade effect. On the other hand, halts in trading in either the cash or the futures markets are likely to cause distortions both in stock indices and in arbitrage activity related to them, thereby perhaps interrupting the self-balancing arbitrage mechanism.

The role of derivative products in the US market crash seems far from clear. The Brady Report, for example, says that portfolio insurers and other institutions sold in both the cash market and the futures market, and that selling pressure was transmitted between the two by the mechanism of index arbitrage. The report concludes that, although index arbitrageurs were not the primary cause of price movements in the stock markets, they could be described as "the transmission mechanism for the pressures initiated by other institutions". The report commissioned by the New York Stock Exchange, and the SEC's more recent report, also conclude that the futures markets may have contributed to the speed of the fall in prices. On the other hand, the reports from the US futures exchanges present a rather different picture. The Chicago Mercantile Exchange, for example, argues that index arbitrage transferred to New York only a fraction of the total selling pressure experienced in Chicago and that, without the stock index futures markets, selling pressure on the NYSE would have increased and resulted in further price declines. It is interesting that the London Stock Exchange report, in the light of pricing anomalies between the cash and derivative markets, argues for greater use of index arbitrage in our markets.

These differences of view, or at least of emphasis, suggest to me that we should weigh the evidence of October very carefully before reaching any conclusions on what action, if any, should be

considered in London. It has been suggested that formal arrangements for trading stoppages should be instituted, and there may be something in the argument that if a market is going to be closed it is better done in an orderly and well-understood way, rather than coming about as the result of haphazard and unpredictable failures in the trading system. Equally, however, as the US studies recognise, closing one market may simply exacerbate the pressures on another. It is not at all clear that proposals for market closure, "circuit breakers" or limits on price movements, go any way to addressing the problem, rather than simply delaying or even compounding it.

Supervision

This carries me to the last of the three issues I identified, regulation and supervision. How much capital should be held against a particular "book" is a difficult matter involving many different considerations - some technical, some judgmental. But in most assessments, the price volatility of the securities involved is of key importance. The regulatory regime that we are now putting in place in the UK was conceived and legislated for wholly within the period of a bull market; that background may to some extent have conditioned views about what constituted "reasonable" or "likely" price variations. It is salutary, and perhaps in the long run healthy, that we have been reminded how violently markets can move just as our new arrangements are coming into force. Some may be inclined to dismiss October as a "one-off", which will not be repeated for a very long time. That may be true; but we cannot discount altogether the possibility that some of our domestic markets, perhaps as a by-product of improved liquidity, globalisation and technological change, have become permanently more volatile, and that this will have implications for the capital resources that participants must be required to maintain.

We have also to keep in mind the extent to which the bull market provided support for the earnings of securities houses. The much lower turnover since October, combined with the higher fixed costs that have been associated with the Big Bang reforms, have plainly impaired profitability and thus tended to weaken the general financial position of firms.

The question of capital adequacy did not, of course, arise all of a sudden with the crash: it had been debated widely and at great length before. Equally, another aspect of prudential supervision which the crash served to emphasise - the need to keep firm control of credit exposure - had been a focus of attention for some time.

In this context it is worth noting that one characteristic of the Stock Exchange account arrangements in London is that they can contribute to an accumulation of counterparty exposure. At the time of the crash, which took place in mid-account, such exposures, compounded with those represented by unsettled bargains from previous accounts, gave rise to worries in the market about a number of firms and clients - which fortunately in the event turned out to be misplaced. But in circumstances where the whole system is under strain, the likelihood of contagion is far greater if firms are disproportionately exposed to particular counterparties. Another feature of the present account arrangements worth examining is the extent to which they facilitate the shorting of stock. For both reasons, I believe that it might be helpful to reconsider the role of the account.

There is one further aspect of regulation which I will mention only briefly, as I have spoken about it at length on other occasions. One of the most important challenges facing financial regulators now is to reinforce procedures for domestic and international co-operation. This need is particularly acute in circumstances such as those of the crash, so that all concerned can establish an accurate and timely picture of what is going on. It was reassuring to see how quickly and effectively arrangements were put in place in October to reinforce this collaboration - both among domestic supervisors and between them and their counterparts overseas. We shall be building on those arrangements.

Conclusions

I have focussed this evening on the events in New York and London, and have suggested some features of interest and significance which would repay further study. I have not attempted to draw firm conclusions at this stage, and as I indicated at the outset I am wary of premature judgments in this area. But let me nevertheless venture now some brief observations on the experience of the past few months.

- First, I do not think we are being in any sense complacent in saying that the new dealing systems which came into being in London at the time of the Big Bang acquitted themselves well in October. Of course, not all of those who had piled remorselessly into equities in the previous three quarters could get out, all at once, at the precise moment of their choosing and at the price shown on the screen. But overwhelmingly, trading in London continued during the crash with little interruption despite extremely heavy volumes. This suggests, I believe, that in adopting a competing market-maker system, rather than one of the more formal and less flexible alternatives, the

Stock Exchange chose wisely. And while there were some understandable early hitches in the SEAQ system, its performance during October and November reflects very great credit on the Stock Exchange.

- Second, we should obviously be wary of the assumption that the hedging markets will enable risk to be laid off promptly and cleanly in all circumstances. More generally, I suggest that we should not allow ourselves to be unduly dazzled by the complexity and novelty of the derivative products markets, or to exaggerate their capacity to override fundamentals in the cash market. They may have changed the style and language of trading; and perhaps, too, the speed with which markets respond: but there may, I think, have been a tendency to overstate their impact. I would not wish to dismiss the dangers: but if we have been seeing some form of electronic stampede, we should remember that the "herd instinct" has always been a feature of stock market movements.

- Third, I have yet to be persuaded of the need to introduce artificial breaks in the markets. I can see that they might impose a semblance of orderliness, but this would have to be at the expense of what must be the key feature of any market, which is to provide liquidity.

- Fourth, the events of last year have reinforced very strongly my concern that we should promote much closer and possibly more formal links between supervisors internationally, both in the banking and securities fields. If the markets have become more complex and volatile, and if the risks are less than perfectly understood, then our concern as supervisors must be with the soundness of all the participants in the major centres.

- Finally, I have focussed very much on the market aspects of the crash. But I believe it would be wrong to portray what happened last October purely in technical market terms. Underlying the events in London, New York and Tokyo were, quite clearly, long-standing and deep-rooted concerns about imbalances at the macro-economic level, particularly of course the US fiscal and external deficits. Refining market mechanisms may be a way of addressing some concerns, but reducing these imbalances must I think be a pre-requisite of longer term stability.

I hope that in conducting this post-mortem I have avoided on the one side complacency and on the other undue alarm. In any event, I have certainly not been comprehensive, and there are many other

aspects of the crash that deserve examination. So far, at least, the financial system seems to have weathered the storm passably well; but there are certainly lessons in what happened that we should identify and study - and before an audience of MBAs that cannot be an altogether discouraging conclusion.

006/3291

FROM: **ZOË EVEREST-PHILLIPS**
DATE: **11 February 1988**

MR BEECROFT

cc:
PS/Chancellor
Sir Peter Middleton
Mr Anson
Mrs R Lomax
Mr Perez
Mr Scholar
Miss Noble
Mr L Watts
Mr Griffiths
Miss S Chalk

BANK OF ENGLAND CASH LIMIT 1988-89 (BofE 1)

The Chief Secretary has seen your submission of 8 February and is content with the proposed cash limit for the Bank of England for 1988-89 of £88.7 million.

ZOË EVEREST-PHILLIPS
Assistant Private Secretary

002/010

CONFIDENTIAL

FROM: N J KROLL
DATE: 21 July 1988

1. MR SCHOLAR
2. CHANCELLOR

cc Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Anson
Sir T Burns
Sir G Littler
Sir A Wilson
Mr Byatt
Mr Lankester
Mr Monck
Mr Phillips
Mr Culpin
Mr H Evans
Mrs Lomax
Mr Mountfield
Mr Odling-Smee
Mr Gieve
Miss Noble
Mr Walsh

Mr Painter)
Mr McGivern)Inland
Mr Skinner)Revenue
Mr Spence)

So far so good. The tax crunch with the banks is about to happen.

MCS 25/7

BANK SOVEREIGN DEBT PROVISIONS

We have recently taken stock with the Bank of England and Inland Revenue on the first year's operation of the Bank's "matrix" for assessing UK banks' provisions against sovereign debt. This minute, which is for information only, reports on the outcome of our discussions both on the value of the matrix as a framework for realistic provisioning levels and on the Inland Revenue's experience to date in applying the matrix for tax purposes.

Bank of England matrix - one year on

2. Since the matrix was introduced a year ago, the major UK banks have strengthened their provisions very substantially; the average level is now some 25-30 per cent of problem country exposure, compared with under 10 per cent a year ago. But despite this major advance an international comparison (details in the table at Annex A) suggests that, although UK banks' provisioning levels are now ahead of Japanese, Italian and some US money centre banks, they have not yet come up to the levels being set by many

competitors. Moreover secondary market discounts on par value of problem country debt are for nearly all countries higher than provisioning levels derived from the matrix (illustrative figures at Annex B). This prompts the question whether matrix-based provisioning levels adequately reflect the risks inherent in problem country debt.

3. The Bank consider that the matrix is working well and providing a helpful basis for assessing the adequacy of country debt provisioning. It has been acknowledged internationally as a valuable supervisory tool. The matrix is not intended as a precise instrument, but as a means of providing a consistent, analytical framework for banks' decisions on provisioning levels. The Bank see no evidence that matrix-based provisions are unrealistic and need radical review; in any event they set great store by continuity at this stage.

4. The Bank acknowledge that UK banks' provisioning levels are below the levels set by banks in some other G10 countries. In part this reflects extraneous factors such as competitive considerations. Nevertheless the fear that the major UK banks might be isolated and disadvantaged by being left behind all their competitors has substantially reduced, and a number of other countries' banks - notably Japanese banks - look much more vulnerable.

5. Nor do discrepancies with the secondary market cause the Bank concern, since secondary market prices and matrix provisioning levels measure different things: the market price reflects the NPV of all expected cash flows from the debt; but the provisioning level is essentially concerned with the undiscounted value of expected recoveries and outstanding debt principal held to maturity. The matrix is intended to provide a reasonably objective measure, and as such is inevitably backward looking; comparisons with more forward-looking secondary market prices are bound to vary. The Bank do not consider that the limited (5 per cent) weighting currently given to secondary market prices in the matrix scoring system needs to be increased; if it were to be substantially changed, the Revenue would have to review its use of the matrix for tax purposes.

6. The Bank accordingly conclude that a review of matrix-based provisioning levels is not needed at this stage. But they acknowledge that the matrix is not immutable, and if in due course - say after 2 to 3 years' operation - the overall balance appears to be wrong, for example in comparison with international provisioning levels or changing repayment prospects for individual country debt, they will consider making changes. This approach has been endorsed by the Board of Banking Supervision, who reviewed the operation of the matrix in March and are due to consider the matter further later this year.

7. For the immediate future, the indications are that banks and supervisors internationally foresee further provisions being made during 1988, although not to the same scale as in 1987. Many smaller banks are now working to eliminate their net country exposure and remove themselves from the market place. Some larger banks may follow the trend for a number of reasons, not least competitors' actions. But pressures for competitive provisioning may be reduced in the face of a discernible toughening of attitudes of some tax authorities; and we understand that a number of overseas regulators are thinking harder before requesting higher provision levels.

Inland Revenue application of the matrix

8. We also reviewed the Inland Revenue's experience in applying the matrix to assess tax relief for provisioning. The current round of negotiations on banks' 1987 accounts is not yet complete - indeed the most difficult phase probably lies ahead. As agreed when the matrix was introduced last summer, the Revenue's approach involved two adaptations for tax purposes. First, the Revenue read across from the factor score to a fixed point in the matrix provisioning range (rather than allowing banks to choose their own point in the range) in order to ensure the necessary consistency of tax treatment between banks. Second, the Revenue then apply a discount to this figure; this reflects the differences in the Bank's and Revenue's judgements as between supervisor/prudential considerations and considerations relevant for tax deductibility. It was made clear to the banks in the Revenue's guidance last August (which you approved) that matrix-based provisioning figures would not necessarily be fully accepted for tax purposes.

9. It is already clear that for some banks there are significant gaps between actual provisioning levels and amounts which the Revenue can agree for purposes of tax relief. The following general trends are beginning to appear:

(a) there is considerable variation in banks' country-specific provisioning levels. Provisioning levels are on the whole much higher than the Revenue consider acceptable for tax purposes even before application of the discount factor;

(b) banks fall into two main categories. For those which are tax-exhausted, there is little incentive to make an issue of levels of tax relief. But banks with large tax capacities have set provisions at the top of the matrix range, and it is clear that they intend to take a firm line in discussions with the Revenue. Some have told the Bank that they may appeal to the Commissioners;

(c) more generally, although the principles of the Revenue's application of the matrix are recognised at the professional level within banks, there may well be less understanding at Chief Executive and Board levels.

10. There is no question at this stage of negotiations breaking down. But banks can be expected to lobby the Revenue for a relaxation of their approach. The BBA have now asked for a meeting with Mr Painter, which is likely to take place around end-August. Individual banks may lobby the Governor and Ministers. The Bank's line if approached is that application of the matrix by the Revenue is proceeding in line with the/Revenue's originally declared intentions. The Revenue see no reason for changing their approach: nothing has happened to call it into question since it was agreed and cleared with Ministers last summer.

New approaches to the debt problem

11. The matrix aims to provide an objective framework for assessing adequate provisioning levels. But the Bank have applied

it flexibly in individual cases - for example, in the Mexican debt buy-back scheme. The Bank's approach on one-off menu-based initiatives depends on the circumstances of each case; the essential point is the degree of certainty attached to any new claim substituted for existing debt.

12. You asked earlier this year about the War on Want proposal to withhold tax relief from UK banks which have provisioned against LDC debt unless they provide an equivalent amount of debt relief to LDCs. Mr Walsh will be responding with a separate paper on the tax treatment of debt write-off and associated issues.

Summary

13. This minute is for background information; no action is called for. Among points to note are -

(a) the Bank consider that the matrix is providing a useful basis for assessing the adequacy of country debt provisions. Although there are discrepancies with some international provisioning levels and with prices in the secondary market, the Bank do not consider that a review of matrix-based provisioning levels is needed at this stage; the Board of Banking Supervision have endorsed this conclusion. Consistent with this, you will no doubt wish publicly to continue to welcome provisioning by UK banks, although we suggest that you do not comment on the levels at which provisions should be set;

(b) Inland Revenue's negotiations to date on banks' 1987 accounts suggest that there may be significant gaps between provisioning levels and amounts which the Revenue can agree for purposes of tax relief. Banks can be expected to lobby for a relaxation of the Revenue's stance, and might take the matter up with the Bank and possibly Ministers in due course;

(c) the Bank will continue to apply the matrix flexibly in individual menu-based initiatives on an ad hoc basis;

(d) Mr Walsh will be submitting a separate paper on the tax treatment of debt write-off and associated issues.

NJKroll

N J KROLL

ANNEX A

ESTIMATED PROVISIONS AGAINST PROBLEM INTERNATIONAL DEBT AT END-DECEMBER 1987

(all information relates to provisions made by a sample of major international banks in each member country)

	1987 provisions	Cumulative provisions	Major provisions	Attitude of authorities
	What additional country risk provisions have been set in 1987?	What is the cumulative outstanding level of provisions (specific, general or "basket") against international lending at end-1987 as a percentage of all unguaranteed exposure to the fifteen problem countries specified in the capital exercise?	Against which borrowing countries have specific (and/or "basket") provisions been made in 1987, or were mentioned as a source of special concern?	Were there any new supervisory guidelines or fiscal policy changes in 1987?
Belgium	Average global increase of about 13 5 per cent of exposure	Average cover of about 31 5 per cent, (range 20-50 per cent.), generated out of after-tax earnings (1986. 11-22 per cent.)	No change	The Banking Commission is likely to impose a minimum cover for the observance of capital adequacy requirements
Canada	Increase of 200 per cent of level of provisions at year-end 1986	39 3 per cent (31st October 1987) (1986: 12 2 per cent)	National basket enlarged to 34 countries (Ivory Coast, Panama and South Africa added, Turkey removed)	Banks have responded to an O S F I guideline for a 30-40 per cent provision against total exposure to the basket. The tax authorities have accepted tax deductibility up to the level specified
France	New increase but at lower rate than 1986, when they were very high But exchange rate movements still favourable	About 40-45 per cent. (1986. 35 per cent)	Brazil, Cuba, Mexico, Peru and South Africa	The Banking Commission has asked banks to step up provisioning levels, at least to average levels. The tax authorities have formally recognised country risk provisions for tax purposes on specified conditions.
Germany	Some increase likely	Probably 40-45 per cent or more (1986: about 35 per cent)	All major debtor countries	Unchanged approach, but fiscal authorities threatening to be less accommodating
Italy	Probably none	(4 5 per cent.) (1986 4 5 per cent)	Romania, Poland, Yugoslavia, heavily indebted OPEC and other "Baker" countries	Tax relief may soon be granted, so banks are waiting.
Japan	Increase of 5 per cent of exposure	About 10 per cent. (end-March 1988) (end-March 1987 about 5 per cent)	All major debtor countries	The provisioning ceiling was doubled to 10 per cent as of end-March 1988 No change in tax threshold
Luxembourg	Further significant increase	41-45 per cent (1986. 35 per cent)	Nearly all fifteen countries included in the capital exercise	Unchanged approach
Netherlands	Increase of 8 5 per cent of exposure to fifteen countries included in capital exercise	35 per cent. (1986 26 per cent)	Two new countries have been added to the list and for twelve countries provisions have been increased.	A 50 per cent provisioning level has been announced as an objective to be reached within two years
Sweden		(1986 61 per cent)	Brazil, Mexico, Peru and Poland	Unchanged approach
Switzerland	Continued increase	About 60 per cent (1986. 40 per cent)	Same basket approach vis-à-vis all LDCs	Provisions must be increased to 35 per cent of all claims on 30-40 LDCs by end-1988 and a further increase will be introduced with effect from end-1989 Tax authorities becoming less accommodating
United Kingdom	Significant increase in total charge Most of the increase was taken at the half-year Exceptional provisions charge resulted in several of the major banks recording pre-tax losses at year-end	Around 30 per cent of total problem country exposures, including trade and other short-term lines (1986 around 10 per cent)	Some change in distribution of specific provisions in line with matrix scores	In August, the Bank introduced a debt provisioning matrix which provides an objective framework to help individual institutions arrive at an adequate level of provisions for prudential purposes Application of the matrix coincided with a general rise in provisions at the half year
United States	All banks increased provisions materially for country risk in the second quarter Some, but not all, banks increased reserves further in the fourth quarter	Between 25 and 60 per cent of exposure to countries that have rescheduled debt over the last five years Usually, provisions are made against medium and long-term exposure, excluding trade or interbank loans Some small banks have written off exposures entirely.	Specific reserves against transfer risk are required for eight countries and range from 15 to 90 per cent Most banks have elected to charge-off this exposure rather than set aside specific reserves	Encouragement for banks to make appropriate provisions according to risk and maturity characteristics

Note: The figures quoted in the press for individual banks or banking systems are often not comparable because of the use of different "baskets" of debtor countries or the exclusion of certain types of claim (e g trade credits) from the exposure base In order to ensure a measure of consistency in the figures presented in this table, a common definition of exposure has been used - total unguaranteed claims on the fifteen major debtor countries Nevertheless, the figures are tentative and should be treated with caution In addition, the figures quoted for some countries represent an average level of the provisions held by a number of banks The range either side of this average may be quite wide

Annex

ANNEX B

Bank of England Matrix (as %), Provisioning Levels and Secondary Market Discounts

May/June 1988

COUNTRY	BoE SCORE %	BoE PROVISIONING GROUP %	CURRENT* SECONDARY MARKET DISCOUNT %
Argentina	65	26-40	74
Brazil	58	26-40	47
Egypt	75	41-60	NA
Mexico	35	16-25	48
Nigeria	75	41-60	71
Yugoslavia	46	26-40	54
Zaire	76	41-60	79

* Salomon's