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PREM 19/1457

Pt 13

SECRET

MT 205

Confidential filing

Domestic Monetary Policy

Economic Policy

Pt 1: May '79

Pt 13: May '85

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~15.5.85~~							
~~29.5.85~~							
~~30.5.85~~							
~~5.6.85~~							
~~7.6.85~~							
~~11.6.85~~							
~~12.6.85~~							
~~20.6.85~~							
~~25.6.85~~							
28.6.85							
PART ENDS							

PREM 19/1457

PART 13 ends:-

AT to PM + att LBS forecast 28/6/85

PART 14 begins:-

AT to PM 3/7/85

10 DOWNING STREET

Prime Minister ⊕

Another way of looking at overfunding which makes mortgage interest relief the villain of the piece.

AT 28/6

Monetary policy file

LONDON BUSINESS SCHOOL

Sussex Place, Regent's Park, London NW1 4SA Telephone 01-262 5050

CENTRE FOR ECONOMIC FORECASTING

FORECAST RELEASE

LBS Financial Outlook, July 1985

EMBARGO : 00.30 HOURS, MONDAY 1 JULY

The main points of the July issue of the LBS Financial Outlook are :

- Increased tax avoidance through mortgage lending, which has more than doubled to £17bn in four years, is being financed by the government using cash from sales of gilts to tax-exempt pension funds. The summary (attached) traces this finance across the economy and argues that rapid expansion of such double tax avoidance has been possible since 1980 because of overfunding. The effect is to boost credit artificially and to reduce the scope for tax cuts elsewhere.

- Buoyant mortgage demand will contribute to high personal loan demand over the coming year. Corporate borrowing in 1985/86 as a whole will be less affected by changes in capital allowances than last year and in addition we expect medium dated corporate bill issues to reduce bank borrowing by about £1bn per annum. Assisted by this, sterling M3 growth will be within the target range even though bank base rates decline from now on, reaching 8 per cent by the end of next year.

...continued...

- Inflows to pension funds and other institutions will remain at a high level although further expansion will be smaller than in the last two years because of lower growth in investment receipts and due to the ending of special factors, such as anticipation of Budget changes, which have recently boosted inflows.

- Equity yields will remain static as further substantial rises in average earnings prevent any future rise in profits as a share of GDP. This is a major reason why the institutions will invest almost half their cashflow in gilts over the next three years.

- John Ellis, General Manager of Abbey National, calls for easier merger procedures 'to reduce drastically the number of societies'. His Viewpoint on the changing role of Building Societies states that Abbey National would like to see a more liberal approach to regulation than is currently proposed. He argues that it is inappropriate 'to apply controls to societies that are not related to their scale, influence or management expertise.'

- In an analysis of prospects for US financial markets, Marc Hendriks of Baring Brothers predicts that slowing domestic private credit demand will reduce the incentive for US banks to repatriate funds, thus removing one of the major recent sources of finance for the current account deficit. However, lower private borrowing will ease financing of the Federal deficit.

Press calls to Giles Keating :
(day) 01-262-5050 x 380
(home) 01-727-6432

Summary

The UK banking system is participating in probably the largest tax avoidance scheme yet seen in this country. Money enters via one tax window, given by tax-exempt pension funds, and leaves through another, given by mortgage relief. En route there is a boom in bank credit. This process has only been possible on a large scale since 1981, when the government started to provide active assistance by overfunding.

The process can be described using the table opposite. For both 1984/85 and 1985/86 this table sets the familiar money supply identity, in the rectangular box on the left, into a picture of finances across the whole economy.

The first row indicates that the personal sector had an estimated financial surplus of £11.4bn in 1984/85. In addition, the sector borrowed some £6.7bn direct from the banks (row 7) and a further net £1.9bn from Building Societies and hire purchase companies (netting the deposits in row 14 from the loans just beneath). Why does a sector with an £11.4bn surplus need to borrow on this scale? The answer is given by the last row in the 1984/85 table, which shows £17bn for inflows to life asurance and pension funds. Given these inflows, the personal sector can only balance its books by borrowing heavily.

The excess of the inflows over the personal sector surplus is a recent phenomenon. In 1980/81, the surplus was £15bn and the inflows only about £12bn. Since then the surplus has tended to decline as net discretionary saving has fallen to reflect lower inflation. Meanwhile the inflows to the funds have risen sharply in real terms, reflecting rapidly rising investment earnings on the institutions' portfolios and other factors including increased awareness of the tax advantages.

What happens to the £17bn of inflows? The fifth column in the table shows that Other Financial Institutions (which include Building Societies and some leasing companies, as well as life assurance and pension funds) invested some £4.1bn in UK equities (row 2) and £7.0bn in gilts (row 6). Much of the remainder was spent on liquid assets such as bank deposits and on property (included as a negative in the financial balance at the top of the table).

The government did not need to sell £7bn worth of debt to the pension funds and other OFIs in order to finance the PSBR. The debt sales row shows that sales of National Savings and gilts raised £4.3bn from the personal sector. This gave it total debt sales to UK non-banks of £11.5bn (column 1, row 6). The government was also raising £0.5bn of finance by the easiest route of all, printing currency (shown as 'notes and coin' in row 12). Thus in total, UK non-banks took up £11.9bn of government financial assets, when the PSBR was only £10.1bn.

The difference of £1.8bn was used by the Bank of England Issue Department to buy commercial bills. The purpose of this was to achieve the normally incompatible objectives of holding down sterling M3 growth *and* keeping short term interest rates relatively low, at the cost of keeping long rates unnecessarily high. The Issue Department obtained some further finance from transactions with overseas and with the banks (rows 9 and 13), and so bought a total of £2.7bn worth of bills (eighth row).

Overfunding in this form is sometimes regarded as innocuous because it involves transactions in commercial bills, which appear to have little to do with personal borrowing. The table shows that this is an inappropriate description of overfunding. The £2.7bn of commercial bills bought by the Bank of England appear as a negative in the ICC sector column, indicating that companies obtained finance direct from the government. Immediately above, a figure of minus £2.6bn shows that companies were also borrowing from the banks. In the absence of the overfunding and if other things were unchanged, they would have had to borrow just as much in total and their entry in the 'bank loans' row would instead have been £5.3bn. (It is possible that overfunding depressed the cost of borrowing on commercial bills so much that some companies found it profitable to raise bill finance solely in order to re-deposit at the banks. If this occurred it is another very unsatisfactory side-effect of overfunding, but it raises bank loans and bank deposits by equal amounts and has no effect on net bank finance available for transactions with other sectors,

and so does not alter the argument that follows.)

The reduction in company demand for bank finance means that the banks, without having to raise interest rates to attract increased funds from home or abroad, were able to satisfy £2.7bn more of personal loan demand than would otherwise have been possible. (There was a small offset due to transactions between government and banks, which we neglect.) Some of this £2.7bn may reach the personal sector indirectly, in the form of loans from the banks to the Building Societies or other OFIs, which are then loaned to individuals as mortgages or hire purchase. This effect is included within the £5.8bn for bank loans to OFIs, and the loan-back appears towards the bottom of the table as the difference between the £12.2bn taken in deposits by OFIs and the £14.7bn lent out.

We have now traced the funds all the way round. The personal sector makes what can be described as excessive payments to pensions funds, which are loaned to the government in the form of gilts. Both the inflows to the funds and the interest on the gilts are tax-exempt. The government lends excess funds to companies, which reduces the loan demands on banks, who are able to lend the money to persons either directly or via the OFIs. Much of this lending is in the form of mortgages on which interest is tax-deductable.

We do not envisage this process ending. The lower half of the table on page 3 shows our projections for 1985/86. In this, the PSBR is significantly lower than the 1984/85 value which was inflated by the miners' strike. However, the rate of debt sales is £12.3bn, slightly higher than in 1984/85. These sales can be made relatively easily, given that institutional inflows are forecast to rise slightly to £17.5bn.

With the PSBR lower and debt sales higher, the extent of overfunding rises significantly in 1985/86. This is shown partly as £3.7bn of commercial bill purchases by the Bank of England. It also appears in a different place (in row 13) as transactions between government and banks. This row includes direct deposits by the government with the banking sector, which were re-classified last year so as not to contribute to the PSBR itself. Because there is a limit on the quantity of bills that can be held by the Bank of England Issue Department, the government may move to making direct deposits at banks as a way of providing finance for excessive bank lending. It is even possible that this will be on a considerably larger scale than the £0.6bn shown in the table.

The effect of these deposits will be the same as the commercial bill purchases, allowing the personal sector to take advantage of tax breaks by contributing to pension funds and borrowing on mortgages. However, this new method of overfunding will be a less obscure route. Government support for personal bank borrowing will become more obvious and the extraordinary policy of overfunding may at last come under wider scrutiny.

G.B.K.

Summary NAFA and financial flows

£ billion

	Public sector	Banks	Personal sector	ICCs	OFIs	Overseas
			1984/85			
1. Financial Balance	−13.6	2.3	11.4	9.0	−2.6	0.6
2. Equity & deb. transactions	−2.6	−0.7	−1.8	−1.6	4.1	2.4
3. Other contributions to PSBR & NDLs	−0.9	−2.6	−4.0	5.2	4.8	4.2
4. PSBR	10.1					
5. Banks' non-deposit liabilities		−5.6				
6. Debt sales to NBPS	−11.5		4.3	0.2	7.0	
7. Bank loans to NBPS		15.1	−6.7	−2.6	−5.8	
8. BoE Issue Department purchases of ICC bills	2.7			−2.7		
9. Foreign currency, & overseas sterling	−0.3	1.3	0.8	4.7	−0.5	−6.0
10. Sterling M3		11.8				
11. NBPS bank deposits		−11.3	3.2	5.9	2.2	
12. NBPS notes & coin	−0.5		0.4	0.1	0.0	
13. Transactions between banks and public sector	−0.5	0.5				
14. Building Soc deposits & unit trust units			12.7	−0.4	−12.2	
15. Building Soc & OFI mortgages; hire purchase loans			−14.6	−0.0	14.7	
16. Inflows to pension funds and life assurance companies			17.0	—	−17.0	
			1985/86			
1. Financial Balance	−10.3	1.9	11.4	5.6	−1.7	−2.8
2. Equity & deb. transactions	−2.5	−0.2	−1.6	−0.8	4.1	0.8
3. Other contributions to PSBR & NDLs	0.1	−2.3	−1.3	1.0	2.9	3.8
4. PSBR	7.9					
5. Banks' non-deposit liabilities		−4.4				
6. Debt sales to NBPS	−12.3		3.9	0.7	7.7	
7. Bank loans to NBPS		12.3	−7.8	0.0	−4.5	
8. BoE Issue Department purchases of ICC bills	3.7			−3.7		
9. Foreign currency, & overseas sterling	0.7	−0.2	−0.2	4.1	3.2	−7.4
10. Sterling M3		7.7				
11. NBPS bank deposits		−7.2	3.2	3.4	0.6	
12. NBPS notes & coin	−0.5		0.4	0.1	0.0	
13. Transactions between banks and public sector	0.6	−0.6				
14. Building Soc deposits & unit trust units			11.7	0.8	−12.5	
15. Building Soc & OFI mortgages; hire purchase loans			−14.3	0.0	14.3	
16. Inflows to pension funds and life assurance companies			17.5	—	−17.5	

Increase in assets or reduction in liabilities shown positive; reduction in assets or increase in liabilities shown negative.

These tables are condensed versions of the full matrix of financial flows shown between pages 57 and 73. Corresponding full matrices of past data can be found in *Financial Statistics* and *Bank of England Quarterly Bulletin*. For a key to the derivation of *Financial Outlook* matrices from official sources, see Data definitions and sources, pp. 74 to 77.

Because of the National accounts residual error, the net acquisitions of financial assets do not always sum precisely to zero. The sum of unidentified financial transactions, included in the third row, is approximately equal and opposite to the residual error.

SUBJECT
CC Master.

FILE

MG 1Ry
B/c: Mr Redwood

12

10 DOWNING STREET

25 June 1985

From the Private Secretary

Dear Rachel.

MONETARY POLICY

The Prime Minister held a meeting today to discuss monetary policy. Present were the Chancellor, the Economic Secretary, Sir Peter Middleton, Sir Terry Burns, Mr Cassell; the Governor of the Bank of England, the Deputy Governor, Mr McMahon and Mr Goodhart. Mr Redwood was also present.

The Prime Minister said she was worried about a number of aspects of monetary policy. She doubted whether monetary policy had been tight enough during the second half of 1984 and this had contributed to the current increase in inflation. She also doubted whether the current stance of policy was consistent with bringing inflation down to 3 per cent by 1988. There were a number of worrying indicators of inflationary pressure such as the growth of wages in the private sector and the increase in house prices. Those countries where inflation was under control had built up a reputation for sound finance over many years which enabled them to respond flexibly to external developments without creating doubts about their fundamental commitment to low inflation. There was a danger that recent developments in Britain had damaged the reputation which had been built up over the past six years.

The Prime Minister was concerned at the extent of over-funding and the size of the consequential bill mountain. The Government had argued that it was necessary to keep public borrowing down in order to reduce interest rates but this argument was undermined by the deliberate practice of issuing more debt than was needed to meet the Government's borrowing requirement. She wondered also just how effective this technique was, in the longer term, in controlling sterling M3. It was possible that the issue of more long term debt by the Government pushed companies towards seeking short term, bank provided, finance.

She was also concerned that the Bank's willingness to relieve the shortage each day in full at the prevailing interest rate encouraged banks to extend their lending. Bank lending might be curbed if the the banks recognised that only part of the shortage each day would be relieved at

SECRET

the prevailing rate while residual money market assistance would be at a penalty rate.

The Chancellor acknowledged that monetary policy may have have been too lax at the end of 1984 but the Government's conduct of monetary policy had been complicated by the need to ensure the success for the BT flotation and by the unexpected surge in the dollar. He believe that this position had now been corrected and that the current stance of monetary policy would deliver a declining rate of inflation over the next year. 3 per cent inflation by 1988 was still attainable.

The discussion then turned to the reasons for the rapid expansion of bank lending in recent years and the implications for monetary policy. It was noted that the banking system in the UK had been freed of controls, other than of a prudential nature. Within this framework, the UK banks had shown themselves to be powerful competitors with the result that the banking system had taken over the provision of credit which had previously passed through other channels e.g. trade credit, off-shore lending and long term capital market issues. The reasons why companies were both borrowing on a large scale and building up their liquidity were only imperfectly understood. This was not helped by the inadequacy of statistics for the corporate sector. The result of these trends had been a rapid expansion of bank deposits and hence of sterling M3. It was a matter of dispute how far the growth of sterling M3 was a reliable prediction of inflation. It had not proved so in 1980-81; on the other hand, the authorities could not safely ignore such a rapid build up of liquidity. The Prime Minister also wondered whether this expansion in bank lending had been consistent with the maintenance of sound banking.

The Chancellor argued that over-funding should be brought to an end though he recognised that this would, for a time, imply a more rapid growth of sterling M3. He considered that the target for sterling of M3 of 5-9 per cent was too low; the adoption of these figures had reflected the financial pressures facing the Government at the time of the Budget. He did not, however, propose an immediate revision in the target. This should be considered in the context of the MTFS at the next Budget. If over-funding were ended the Bank should also undertake the technical measures required to reduce the size of the bill mountain.

The Governor agreed that over-funding was undesirable in principle but explained that, faced with constraints on their ability to raise short-term interest rates, the authorities had been forced back on the expedient of over-funding as a way of holding back the growth to sterling M3. He expressed concerned about allowing sterling M3 to grow more rapidly.

It was suggested that the current level of interest rates could be maintained for some time, rather than

allowing them to fall as might otherwise have been the case. This would reduce the growth of bank lending and hence the need for over-funding. It was noted that while reducing funding would bring down long-term interest rates it might cause short-term rates to rise. For example, some of the investment funds of the institutions which were currently being invested in gilts might be moved abroad, putting pressure on the exchange rate, leading to higher short-term interest rates.

The discussion then turned to money market operations and the determination of the interest rates. The Governor doubted if the mechanism suggested by the Prime Minister for penal rates for some money market assistance could be operated. For example, it would not be clear which banks would receive assistance at the lower rate and which at the penal rate. Since banks operated by adding a margin to the cost of funds, the effect of a penal rate would simply be to force up bank lending rates. Exactly the same outcome could be achieved more simply under present arrangements. Demand for bank credit would be reduced by higher interest rates rather than through an independent effect on banks' willingness to lend.

Summing up the discussion, the Prime Minister said it was agreed that monetary conditions would have to be kept tight for some time and there was little scope in the immediate future for short-term interest rates to fall. It was desirable to eliminate over-funding and a temporary phase of faster growth in Sterling M3 might be acceptable but before decisions could finally be taken it was necessary to consider more fully what the secondary effects would be on long and short term interest rates, on bank lending, the exchange rate and the monetary aggregates. She asked the Chancellor and the Governor to prepare a paper setting out alternative timescales over which a move to end over-funding could be accomplished and the likely consequences of such a course. She would also welcome a note explaining the background to the rapid growth in bank credit and the implications for the control of inflation. This should also consider whether the increased bank lending had been at the expense of banking standards. She would arrange a meeting in the middle of July to discuss these issues further.

I am copying this letter to John Bartlett (Governor of the Bank of England's Office) and to Sir Alan Walters.

Yours sincerely

Andrew

(Andrew Turnbull)

Mrs. R. Lomax,
HM Treasury

SECRET

5 ||

MR TURNBULL

MONETARY POLICY

1. The Bank's Indicators of Monetary Conditions

In addition to booming bank lending, the Bank cites "high business confidence" and increases in unit labour cost as cause for concern about inflation. Two questions arise for the Bank:

i. is not high business confidence a function of expectations and low and stable inflation - this is the evidence one gets from many interviews?

ii. unit labour costs increased rapidly in 1979/80. This preceded a great credit disinflation from the end of 1980 onwards.

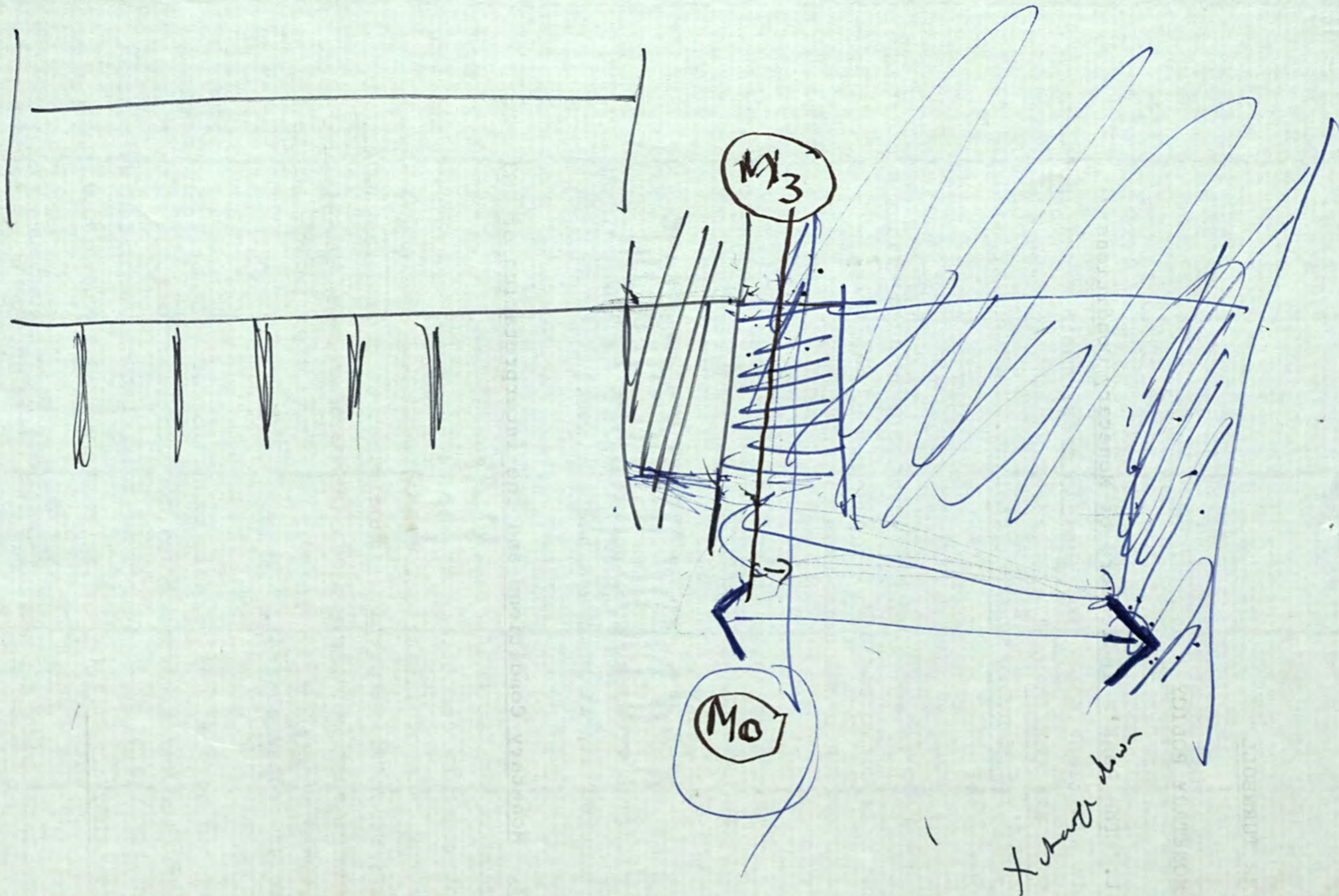
[The Treasury does not deal with either of these points; you may like to ask their views.]

2. Monetary Conditions and the interpretation of £M3

I believe that the Treasury is correct in its interpretation of monetary conditions as relatively tight and consistent with a low rate of inflation. The growth of broad money - more strictly called credit - should not be considered as either undesirable or a "problem", provided we have suitably low growth of narrow money and that those expenditure balances are under proper control.

We can have a considerable expansion of bank credit, as in 1980/81, where hard-pressed corporations borrowed from flush households without affecting disinflation, provided we control spending money. (Where M3 [handwritten: MO] is a good approximation.)

The Bank makes a powerful point that the financial markets attach much importance to £M3 (para 12 - the Treasury does not deal directly with this point). But the Bank should be asked:


M3
Mo

i. why did not the markets attach much importance to £M3 expansion in 1981 with inflation falling?

ii. what part of the importance that the financial markets attach to £M3 is due to the fact that the authorities, and particularly the Bank, themselves attach great importance to £M3? If the authorities eschewed £M3, would not the markets also?

Even if we agree with the Bank's views that bank credit must be restrained, raising interest rates is neither a speedy nor effective way of controlling it. The lags are long (more than a year). The effects are uncertain (they might be perverse as the Financial Times delightedly pointed out in 1980/81).

3. **Overfunding and the Bill Mountain**

The overfunding solution in what is thought to be "excessive" bank lending, is essentially quite a short term cosmetic. Overfunding creates a shortage of cash, as payments are made to the Government for the gilts. The Bank supplies the cash on demand at the fixed bill rates. It is like the Government borrowing medium to long at fixed rates and lending long (not short, since the bill mountain gets ever higher) at floating rates of interest. The Bank's defence is that overfunding raises long yields and reduces short term interest rates, so deliquifying assets held by the private sector.

The Bank should be asked to explain first why the yield curve of the United Kingdom is nevertheless flatter or downward sloping compared with the rising yield curves of other countries, for example Switzerland, the United States and Germany, which do not practice overfunding?

Secondly, the Bank should be asked to question why the excessive Government borrowing at the medium to long end does not simply crowd out corporate and other borrowers who are then tempted instead to issue bills for the Government to buy?

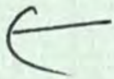
[margin note: from which it follows that removing it won't be harmful either]

It is doubtful if overfunding has any substantial direct effects on the real economy, but the bill mountain has certainly introduced great rigidities in monetary control, generated opportunities for bill arbitrage distortions and, I believe, engenders great uncertainties in the market. Clearly something must be done, and the markets are uncertain both what is to be done and how it will affect them. Such uncertainty is not a good basis for policy.

4. **Monetary Control: Next Steps**

[margin note: I don't believe these ever operated as intended]

The Bank and the Treasury agree that we should get back to the largely successful 1981 arrangements; but the Treasury wants to stop overfunding and the Bank does not. Unless one places extraordinarily high value on short term cosmetics, I do not think the Bank's defence of overfunding stands up to critical examination. From 1982 our policy was to fund only the PSBR, and this is still the right policy (as in Germany, the USA and Switzerland). This, however, will not much reduce the bill mountain. It will be helpful in stopping it growing. Some additional technical measures, which the Bank agrees, are needed (such as the ECGD transfer, direct deposits by the public sector in the banking system).



5. **Monetary Base Control (MBC)**

In 1981 we agreed that the arrangements should envisage a steady improvement in monetary management towards a system similar to the successful ones in Germany, the United States and Switzerland. In these systems the banks find it profitable to hold considerable deposits at the central bank in order to avoid having to borrow at a penal rate. In Britain per contra the Bank supplies all demands for cash at the prevailing bill rate. Thus, the banks find it profitable to hold virtually no non-mandatory balances at the Bank. This absence of bankers' deposits at the Bank seriously inhibits monetary control. In other countries they are the most sensitive of believers of monetary management (foreign central bankers find it difficult to understand how we can run our system without such deposits).

[margin note: unless Bank decides to raise rate]

The Bank is most reluctant to take this step - which it rightly sees as the road to MBC - and has elaborated arguments in para 25 about all the "unknowns", particularly about the "starting point". (And I agree that these are unknowns.) But this should not prevent us taking a first small step to:

why not just raise Bank's dealing rates?

i. under-supplying the expected deficit on the money market by, say, £30m-£35m a day; and

ii. operating an afternoon penalty rate for any additional funds needed.

This would encourage deposits at the Bank, perhaps quite small initially, but they would serve as a basis for further development. The Bank and Treasury should be asked to study this as a next step.

ALAN WALTERS
24 June 1985

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6
10

24 June 1985

PRIME MINISTER

MONETARY POLICY

Inflation Prospects

John Redwood and I agree with Alan Walters and the Treasury that inflation will come down when the mortgage rate increases drop out of the index. The stable exchange rate and high interest rates mean that policy is again prudent after sailing too close to the wind last year. But we are not on target for 3% inflation by 1988. What do the Chancellor and the Governor think we need to do to get there?

Alternatives to Over-funding

If we stop over-funding, then we must:

either: accept that £M_3 will grow faster;

or: raise short-term interest rates to hold down £M_3.

The Chancellor has cautiously embarked on both approaches. There are obvious risks in going too far. If we abandon £M_3, the City might misinterpret it as loosening up for a pre-Election boom, and the exchange rate might fall. Higher short-term rates are unpalatable if the mortgage rate rises.

SECRET

The Money Markets

Money market operations are the economist's equivalent of the Schleswig-Holstein question. Only 3 people understand them: one's dead, one's forgotten, and the third's gone mad.

The money market position measures the net daily flow of cash between the public and private sectors. It is the balance of payments between them. Bankers' balances at the Bank make the final adjustment.

It follows that private sector bank lending doesn't cause money market shortages. One bank's loan is another bank's deposit. If I borrow money to buy a car, the garage then banks it. These are transactions purely within the private sector.

Moreover, over-funding isn't the only cause of shortages. Just rolling over our current stock of bills, as they mature and cash goes to the Bank, means continuous money market shortages, even if we never over-fund again.

Conclusion

- Although policy is now tighter, we are not on track for 3% inflation by 1988. How do the Bank and Treasury see us getting there?

- Don't change the way you formulate policy so suddenly that it gives an impression of instability. Can the Bank and Treasury be reconciled on monetary targets and keeping £M3 for the time being?

- Stopping over-funding won't necessarily stop money market shortages. But would there be agreement to less funding?

David Willetts

DAVID WILLETTS

9

PRIME MINISTER

SEMINAR ON MONETARY POLICY

Papers

1. Monetary Policy - Note by the Treasury

2. Monetary Control - The Bank's views.

3. Issuing Long-dated Conventional Gilt Edged - Note by the Bank.

4. Paper by Professor Brian Griffiths

5. Comment by Sir Alan Walters (to come - papers have been sent to him in Washington).

6. Note by the Policy Unit

Issues

It will be helpful to take the discussion in the following sequence:-

- Assessment of Monetary Conditions
- Choice of Target Aggregate
- Overfunding and the Bill Mountain
- Determination of Interest Rates/Money Market Operations
- Long term debt sales.

(i) Assessment of Monetary Conditions

You will probably find yourself closer to the Bank than the Treasury. Treasury argue that current rate of

inflation is result of lax monetary conditions last year for which corrective action has been taken. Interest rates are now higher and exchange rate much stronger. As often in the past £M3 is a poor indicator of monetary conditions. The stance of policy is tight enough if interest rates are held up to resume downward path of inflation to below 5 per cent next year.

The Bank say inflation has bottomed out at 5 per cent, the economy is very strong, unit labour costs are growing at 5-6 per cent and that current monetary conditions if sustained will produce only a modest reduction in inflation, and certainly nothing like 3 per cent by 1988.

It is doubtful if the discussion will produce a meeting of minds, though there is agreement that interest rates have to stay up for some time and exchange rates cannot be allowed to fall significantly.

(ii) Choice of Aggregate

Treasury argue that £M3 is a poor indicator of inflationary conditions. There is no clear trend to velocity; it does not respond predictably to higher interest rates and it can be kept under even moderate control only by overfunding. The target range could be raised or better still it could be dropped as a target. This would allow overfunding to be dispensed with. Treasury accept that either option must be accompanied by greater commitment to MO and high exchange rate. Treasury do not propose any immediate change but recommend the role of £M3 be looked at in the Budget by which time the inflation outlook should be better. It is not clear however how much progress can be made in reining back on funding (see below) without announcing a change in status of £M3.

The Bank think £M3 is an indicator of build up of liquidity and even if monetary conditions now are satisfactory, the potential dangers of rising liquidity cannot be ignored. The effect on expectations of downgrading £M3 would be serious. Bank recommend two courses - higher short term interest rates plus technical solutions to reduce the bill mountain - see below. Alan Walters and Brian Griffiths both favour downgrading £M3 and increasing emphasis on MO.

(iii) Overfunding and the Bill Mountain

Policy here flows directly from choices made under (ii). Bank and Treasury agree that in principle overfunding and the resulting bill mountain need to be tackled but Bank is more ready to contemplate overfunding as a second best for holding down £M3. They also think the problem of arbitrage is exaggerated. The Treasury course allows overfunding to be dispensed with. Retaining a prominent role for £M3 as Bank suggest is likely to require its continued use unless short term rates go significantly higher. The bill mountain can be reduced by the Bank making deposits with the banks or by buying in export credit paper. Both represent correcting an absurdity by adding another layer of distortion.

(iv) Determination of Interest Rates/Money market Operations

Neither Treasury nor Bank believe that problems of monetary control lie in Bank buying bills too freely. They agree that Bank buys enough bills, and no more, to take out the cash shortage each day. (Para 26 of Treasury paper; para 25 of Bank paper). Neither see any merit in the Walters/Griffiths proposal that money market assitance should be at progressively more penal rates. The effect of this would be just the same as raising the general level of interest rates, which can be achieved under the existing methods of money market operation if

But by day when they lend to increase the shortage because however high it is it will always be met.

the authorities so wish. Neither believe that penalty rates have any independent effect on bank lending because the banks lending rates would simply rise to reflect the higher cost of funds.

(v) Long term debt sales (there may not be time to discuss this at this meeting)

The Bank argue, and the Chancellor to a degree goes along with them, that conditions have changed since original decision to stay out of long term market.

(i) long term yields now around 11 per cent compared with over 14 per cent earlier.

(ii) real rate of return as indicated by indexed gilts is 3½ to 4 per cent rather than the 2½ per cent which was expected. (i) and (ii) combined mean that the expected inflation built into long term gilts yield has come down considerably.

(iii) companies have shown no signs of stepping into the post 2000 void.

(iv) there is considerable congestion in the 1990s.

In the light of this the Bank believe long dated stocks are not unreasonably expensive and that to foreswear them entirely would add to the existing hump in yields in the 1990s.

Conclusions

You will need to seek conclusions on the following points:-

(i) will the maintenance for some time of current monetary conditions restore a satisfactory downward trend of inflation?

(ii) should £M3 be downgraded? And if so when should this be made public.

(iii) if £M3 is retained as a target, can a satisfactory rate of growth be achieved by higher short term interest rates or will some measure of overfunding be required?

(iv) Should efforts be made to fund the bill mountain?

(v) can existing methods of money market operation deliver the interest rates the authorities consider appropriate.

My own views are:-

(i) provided the authorities keep interest rates up and resist temptation to lower them if the exchange rate improves inflation can be brought down.

(ii) we must move away from £M3, but only when inflation figures have started to improve and only if combined with increased commitment to MO.

(iii) (ii) will allow overfunding to be dispensed with and will prevent bill mountain increasing. Some funding of the existing stock of bills could take place but it does not need to be eliminated as the permanent shortages which it produces keep the banks coming to the Bank and allow the latter to dictate interest rates.

(iv) If operated robustly, the present system of money market operation will deliver whatever interest rates the authorities want. Penalty rates are a red herring.

AT

Andrew Turnbull

21 June 1985

001A/296

cc JR

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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

21 June 1985

Andrew Turnbull Esq
10 Downing Street
London SW1

Dear Andrew

MONETARY POLICY

As you know, the Treasury and the Bank are submitting separate papers for next Tuesday's discussion. I attach the Treasury paper. It deals primarily with current monetary conditions in the framework of policy, and the related problems of sterling M3 and overfunding. The technical issues raised by Sir Alan Walters about money market operations and the workings of the 1981 arrangements are discussed in some detail in the separate paper by the Bank, which you already have.

I am copying this to John Bartlett (Governor of the Bank of England's office). I also enclose an extra copy for Sir Alan Walters.

Yours ever
Rachel

RACHEL LOMAX

MONETARY POLICY

I Summary and Conclusion

Different indicators are once again giving conflicting signals about monetary conditions. The buoyancy of the real economy, the rise in RPI inflation and the rapid growth in bank lending and broad money point to a degree of monetary ease. But the strong exchange rate, high real interest rates, and the modest growth in M0 suggest that monetary conditions are suitably tight.

2. We judge that the rise in inflation is temporary. It reflects the weakness of the exchange rate earlier in the year, and the sharp rise in interest rates needed to correct it. Monetary policy has been tightened substantially this year: short term interest rates are still 3 per cent higher than they were in December and the exchange rate is over 10 per cent higher than it was in January. We expect inflation to fall sharply over the next year - possibly to 4 per cent by next summer. Looking further ahead, the aim of policy should be to keep it on a downward trend. This may leave little room for further falls in interest rates. But, like the Bank, we see no immediate need for them to rise.

3. Problems in interpreting the monetary indicators are neither new, nor unique to the UK. We have certainly lived with them since 1980. We, like the US, have a sophisticated financial system which has been subject to significant and, at times, abrupt changes as a result of deregulation and increasing competition. Measures of broad money and liquidity have been particularly affected. Since 1980, the growth

of sterling M3 has persistently exceeded that of money GDP, in sharp contrast to the middle and late 1970s. Narrow measures of money - including M1 - have also been distorted by the development of interest bearing current accounts. M0 - largely notes and coins - has not been immune. But the changes affecting it have occurred at a steadier pace and, in the event, it has proved a useful indicator over a number of years. Given the problems of the monetary aggregates, it is not surprising that the exchange rate has become a useful supplementary guide to policy.

4. The build up of liquidity obviously carries a risk. The risk is that some of it will be spent. We have little idea how much will be used in this way or when. Sterling M3 certainly does not provide a good guide. But some still argue that it is necessary to restrain its growth to ensure against the danger that the authorities will not act quickly enough if it is monetised. However, experience suggests that M0, asset prices (especially house prices) and the exchange rate provide the most reliable warning signs. It is only when these signs have been ignored - as in the early 1970s - that we have got into trouble.

5. The rapid growth of bank lending has been the driving force behind the expansion of liquidity in recent years. The attempt to offset this by selling more debt has driven us into over-funding. But over-funding drains cash from the banking system and the process of relieving cash shortages has led the Bank to buy commercial bills on an increasing scale. The bill mountain was thought to be temporary; but it now stands at £17 billion. If it continues to grow at the present rate, it could double over the MTFS period. It opens up opportunities for arbitrage which may compound the problem of bank credit, and it has been a major reason why the 1981 money market arrangements have never operated as intended.

6. Over-funding and the bill mountain are in danger of bringing our system of monetary control into disrepute and with it our monetary policy. As the Bank paper makes clear, the Treasury have discussed this issue with them on many occasions. The Chancellor said in his Mansion House Speech in 1983 that we should not normally sell more debt than was needed to fund the PSBR. We must now take steps to implement this policy and reduce the bill mountain significantly.

7. Specifically we should:

(i) stop over-funding. Sell enough debt to fund the PSBR and stop there. This is normal international practice in countries which pursue sound financial policies, including Germany, the US and Switzerland;

(ii) ask the Bank to examine urgently other methods for reducing the scale of the bill mountain.

8. This may lead to a faster growth in sterling M3, at least for a time. So it will be all the more important to keep other indicators on track: that will mean maintaining high short-term real interest rates and a strong exchange rate. We do not suggest changing the sterling M3 target yet. But, in the light of experience, we shall need to reconsider the role of sterling M3 and the appropriate target range for it (if any), at Budget time, in the context of the MTFS.

I **Inflation: Short term prospects**

9. The recent inflation increase - as measured by the RPI - from around 5 per cent to 7 per cent largely reflects two factors, both of which we expect to be temporary.

10. The first is the exchange rate fall in the second half of last year which increased import prices and gave companies the opportunity to widen their profit margins. It also meant higher oil prices expressed in terms of sterling; petrol prices are currently 11 per cent higher than a year ago.

11. The second factor has been the effect on mortgage rates of the higher level of interest rates. The timing and extent of the interest rate increase was associated with the exchange rate weakness but a higher level of interest rates was appropriate for domestic reasons as money demand was rising faster than expected; in particular world trade and exports were stronger than has been foreseen.

12. Both of these influences on prices should unwind in coming months. The increase in mortgage rates last July will fall out of the year on year comparison in August; and the 2 point rise early this year will disappear next Spring. Even if mortgage rates do not fall at all from today's levels this would have the effect of reducing inflation by 1½ per cent next summer compared with today's rate.

13. In addition the exchange rate has now recovered last year's fall and import price growth is already moderating. Firms will find it less easy to raise prices and already oil prices in sterling terms are some 10 per cent lower than in January. If the normal relationship of petrol prices to oil prices holds they could be down by nearly as much by next summer.

14. On the basis of the present level of the exchange rate and world oil prices our present expectation is that inflation

will be around 4 per cent a year from now. This is not contradicted by present information on house price increases. Recently there has been some very modest and patchy signs of quickening but average increases remain below 10 per cent on a year earlier, around the same rate of increase as over the last two years. There is nothing to suggest that we face the difficult conditions of the early or late seventies when rapid house price increases anticipated an upturn in the general inflation rate (see Chart 2).

15. Abstracting from these temporary influences we estimate that the underlying rate of inflation has shown only a small increase in recent months. The underlying inflation rate has been on a plateau of around 5 per cent over the past two years and more; for part of the time the recorded rate was helped by special factors, particularly the mortgage rate; and for part of the time the recorded rate has been damaged by those same factors. Although the recorded inflation rate is likely to fall sharply over the next year, the underlying inflation rate will probably only decline slowly. Maintaining the monetary policy implied by this year's MTFS may not leave much room for interest rate reductions but we do not, at present, see any need for a further increase. A significantly tighter monetary stance designed to secure a faster fall in inflation would, in the short term, have adverse effects on output and thus employment.

II Choice of monetary targets and indicators

16. Taking **narrow money** first, in principle the obvious indicator to choose would be a measure of cash and balances held for transactions purposes - perhaps the aggregate of notes, coin and current accounts. But the figures here have been greatly distorted in recent years by the growth and heavy marketing by banks of interest bearing sight deposits. This has lead to funds previously held at longer term being switched into sight deposits; and it also seems to have resulted, not surprisingly, in a growth of interest bearing sight deposits at the expense of non-interest bearing sight deposits.

Growth of transactions money, 12 months to May 1985 (%)

MO	Non-interest bearing M1	Interest bearing M1	Total M1
5.5	4.1	43.8	15.8

17. It was this distortion to the current account figures that led us to choose a narrower measure still, MO (the total of notes, coin and bankers' balances at the Bank of England) as our preferred measure of narrow money. This measure has also been affected by structural and technical change, such as the growing use of credit cards and cash dispensers. But these changes seem to have been taking place at a predictable pace, giving a fairly steady velocity trend for MO over a long period which we have been able to take into account in setting targets for it.

18. Despite these features, many still doubt that an aggregate that consists largely of notes and coin can be an adequate indicator of monetary conditions in a sophisticated financial system. It may be that the Treasury and Bank could have done more to explain with more conviction the merits of MO as an indicator: it is certainly clear that without some more concerted effort of that kind the market is unlikely to switch its focus from £M3 to MO.

19. Turning to the **wider measures of money**, a £M3 overshoot is scarcely a new phenomenon. As the following table shows, £M3 has exceeded its target over most of the period since 1979, only coming within it for the 2 years (1982-84) after a deliberate decision to raise the ranges originally announced for those years. Despite this we have brought inflation down.

£M3 performance against target : % growth at annual rate

	Target range	Outturn	Growth of money GDP (financial years)
Jun 1979 - Oct 1980	7-11	16.2	19.8
Feb 1980 - Apr 1981	7-11	19.4	13.8
Feb 1981 - Apr 1982	6-10	12.8	10.1
Feb 1982 - Apr 1983	8-12	11.2	9.4
Feb 1983 - Apr 1984	7-11	9.8	7.9
Feb 1984 - Apr 1985	6-10	11.9	7.0

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20. The explanation lies in developments over the period that have affected the nature of £M3 and the private sector's demand for liquid assets. As real short-term interest rates have turned from negative to positive, bank deposits have become a more attractive way of holding savings, and this combined with other structural changes has diminished the significance of £M3 and other broader aggregates as monetary indicators. Much of the increase is in institutional funds held on deposit at banks as part of investment portfolios. The result is that the velocity of £M3, which rose sharply between 1974 and 1980, has since 1980 been steadily declining (see Chart 5).

21. The driving force behind £M3 growth has been the buoyant demand for private sector credit, leading to a rapid increase in bank lending. But like the rise in bank deposits that has financed it, this growth of bank lending does not seem in itself to have added to inflationary pressures. In the last three years bank lending has grown at an average rate of 18 per cent, while money GDP has been growing at around 8 per cent.

22. The rapid growth of bank lending is not entirely surprising. We have deliberately encouraged the UK banking system to operate on shore - unlike the United States and Germany. Since 1979, we have abolished compulsory cash ratios, exchange controls, and the supplementary special deposit scheme (the corset). These developments have left our banking system remarkably free of artificial constraints - a situation that has strengthened London's position as a major financial centre.

23. Bank lending has been less of a problem in other countries. But they differ from us in putting the main emphasis on narrower measures of money - M0 in Switzerland, M1 in the United States and central bank money in Germany. With less concern about the growth of liquidity, the role of funding is also different in other countries: the normal rule is to sell enough debt to fund the PSBR but no more.

24. Finally, the **exchange rate** has come to play a larger part in our assessment of monetary conditions. Although on occasion movements in the exchange rate can reflect events that have little direct relevance to domestic monetary conditions, more normally there is an effect on inflationary pressures and expectations. In practice, we have found the exchange rate a useful supplementary guide to policy: often a more useful guide than £M3.

almost always?
When did we last change interest rates solely on evidence of £M3?

III Monetary Control: overfunding and short term interest rates

25. There are essentially two different approaches to controlling £M3. We can either seek to control bank lending directly via short term interest rates, or neutralise the effect on liquidity by over-funding.

26. The effect of over-funding - that is, selling more debt than is needed to finance the PSBR - is to raise long term interest rates. Some investors - probably mainly the institutions - will as a result move out of bank deposits and buy gilts instead. But with a given PSBR the effect of this transaction is to contract the monetary base, and create money market shortages which, if not relieved, would lead to a sharp rise in short term interest rates. Unless such a rise is thought warranted by monetary conditions, the Bank will relieve these shortages by adding to its holding of commercial bills (the bill mountain).

27. Overfunding has a reasonably reliable impact on £M3, at least in the short run. Changing **short term interest rates**, on the other hand, has at best a delayed effect on £M3 and bank lending. Indeed, the short run effect can even be perverse.

28. But if short term interest rates are uncertain and slow acting in their effect on £M3 and bank lending, they can be expected to have a more substantial effect on the real economy - with a rise adding to the financial pressures on large and small companies, both directly and through the exchange rate. Overfunding, on the other hand, probably has much less effect on the real economy - partly because long term interest rates have less effect than short rates. It is also arguable that although there is a short run effect, overfunding does not greatly reduce £M3 in the longer term. That would be the case, for example, if the extra sales of gilts and higher long rates were crowding potential corporate borrowers out of the long term capital market, and forcing them to borrow from the banks instead.

29. With the persistent tendency of £M3 to overshoot the targets set for it since 1979, we have regularly been faced with the choice of whether to seek to rein it back by raising short term interest rates, or by overfunding. Each time

we have reviewed the choice as we did in the summer of 1982 and again last year, we have concluded that it was preferable to avoid overfunding; and on each occasion in practice we have subsequently concluded that reliance on short term interest rates alone did not offer a sure enough prospect of reducing £M3 growth, and that gilts sales should therefore be increased. The result has been the steady acquisition by the Bank since 1979 of a massive stock of short term commercial paper - in effect short term loans to the banking system. The total has now reached around £17bn, rising from a negligible figure in 1979.

30. The sheer scale of this bill mountain is now creating a range of technical, presentational and other problems. Not only does it look absurd, but because the stock of bills matures and has to be turned over every 4-6 weeks, it creates regular huge daily shortages in the money markets that the Bank has to relieve by purchasing new bills. The Bank is thus intervening more regularly and at longer maturities than originally envisaged under the operational arrangements instituted in 1981, giving the authorities a higher profile in the setting of short term market rates. The scale of daily shortages makes it easier for the authorities to influence rates. But large scale dealing in the bill market can make it hard to avoid opening up opportunities for "round-tripping" arbitrage transactions between bills and bank deposits. Failure here artificially inflates the £M3 numbers and confuses the interpretation of monetary conditions.

IV Is the growth of broad liquidity a problem?

31. We thus come back to the question of whether we should be seeking to restrain the growth of £M3, and if so what rate of growth is appropriate. The more we are concerned about the growth of sterling M3, the more we are likely to have to contemplate further overfunding, and a further rise in the bill mountain, as the only reliable means of controlling it. If we believe the rapid growth of £M3 is

of less concern, or that its effects can be offset by tightening monetary conditions in other ways - eg by persisting with a policy of high real short term interest rates and a strong exchange rate - then we have the prospect of breaking out of the cycle of ever increasing additions to the bill mountain and beginning to reduce the problems that it has brought in its train.

32. Table 1 and Charts 1 and 2 show the growth of MO, £M3 and some other indicators against the path of inflation since 1970. They show that both £M3 and MO gave warning of the inflation of the early 1970s. Conditions in 1972-74 were very different from today's. The exchange rate was weak, fiscal policy was lax, interest rates had for a long time been kept artificially low and an incomes policy was breaking down. Moreover, the international environment was highly inflationary, reflected most dramatically in the oil price rise in late 1973.

33. Conditions today, both domestic and international, are totally different. There is certainly no sign of asset prices taking off in the way they did in 1972-74 sometime before inflation took off (see Chart 2). Had we been operating then as we do today, the movement in MO, the exchange rate and asset prices would have led us to take action even without a target for £M3.

HM TREASURY
June 1985

TABLES AND CHARTS

Table 1: Monetary aggregates, exchange rate inflation, money GDP and PSBR/GDP ratio, since 1969-70

Chart 1: Monetary growth and inflation since 1970

Chart 2: Assets prices (house and land prices) since 1970

Chart 3: MO and money GDP since 1965

Chart 4: £M3 and money GDP since 1965

Chart 5: Velocity of £M3

MONETARY TARGET AGGREGATES, EXCHANGE RATE, INFLATION AND PSBR/GDP RATIO : 1969-70 to 1984-85

	MO*	£M3*	£ EXCHANGE RATE[1]	INFLATION[2]	MONEY GDP	PSBR/GDP RATIO
1969-70	2.9§	1.7+	127.3	5.0	7.4	-1.2
1970-71	13.0	12.6+	127.1	8.5	10.6	1.5
1971-72	[- 1.0**]	16.9+	128.8	8.0	11.5	1.6
1972-73	14.8	26.5	114.6	7.9	13.8	3.6
1973-74	10.8	22.8	107.2	12.7	11.0	5.8
1974-75	15.7	8.1	105.1	20.3	18.7	8.9
1975-76	9.7	7.3	94.0	22.5	24.1	9.2
1976-77	10.6	6.2	80.9	16.5	16.8	6.4
1977-78	13.9	14.6	84.8	9.5	16.4	3.6
1978-79	14.8	11.2	82.4	9.6	14.6	5.4
1979-80	10.0	12.4	93.0	19.1	19.8	4.8
1980-81	6.5	19.1	101.4	12.7	13.8	5.4
1981-82	2.7ø (3.7)	13.6	91.1	11.1	10.1	3.3
1982-83	5.3	9.8	80.6	4.9	9.4	3.1
1983-84	5.7	9.8	81.7	5.1	7.9	3.2
1984-85	5.3	9.3	72.1	5.5	7.0	3.1

* Mid-March to Mid-March

1 Q1 level

2 RPI: Q1 on previous Q1

\+ Q1 on previous Q1

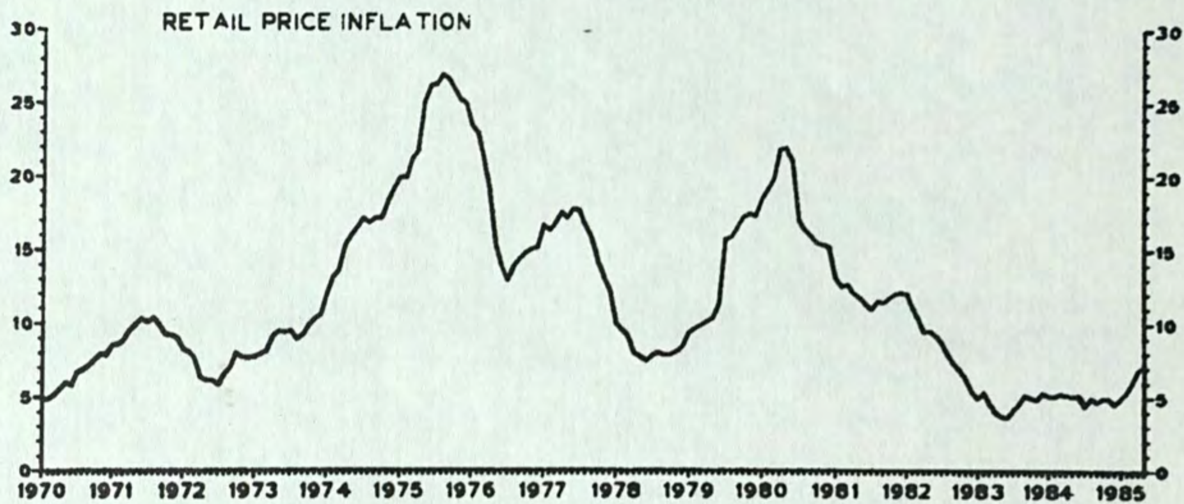
ø This figure is distorted by the change in the definition of MO in September 1981, after which date non-operational balances were excluded from MO. The figure in brackets is the estimated change adjusted for the change in definition.

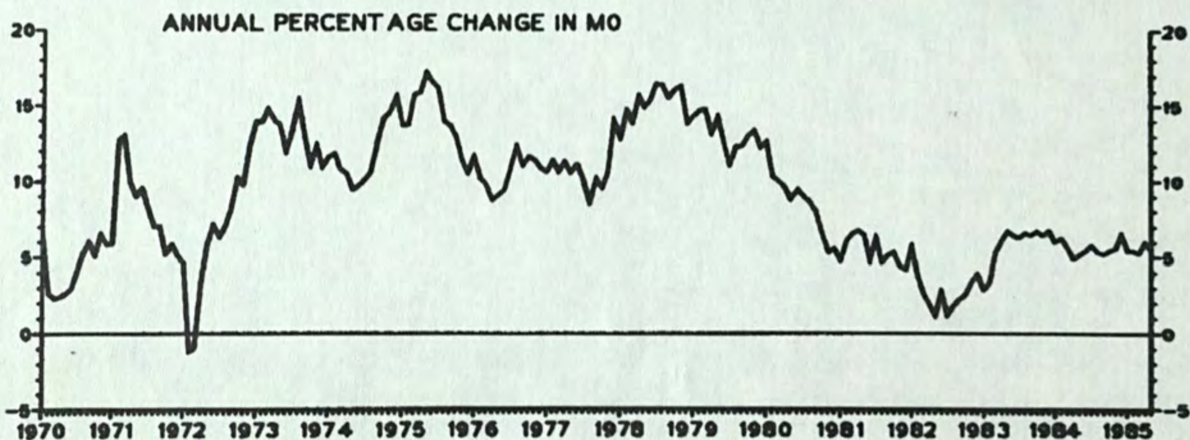
** Prior to September 1971 the clearing banks agreed to hold at least 8% of total assets in the form of till money plus bankers balances. Thereafter under the Competition and Credit Control regime banks held 1½% of their eligible liabilities as non-interest bearing balances at the Bank of England. The net result was a large reduction in till money plus bankers' balances and hence in MO.

§ June on previous June.

Chart 1

MONETARY GROWTH AND INFLATION





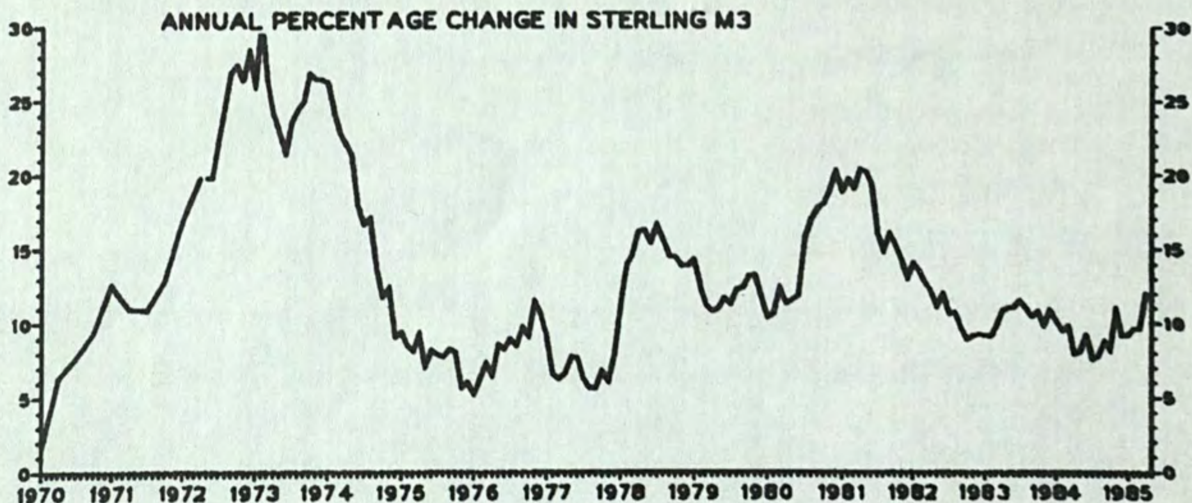


Chart 2

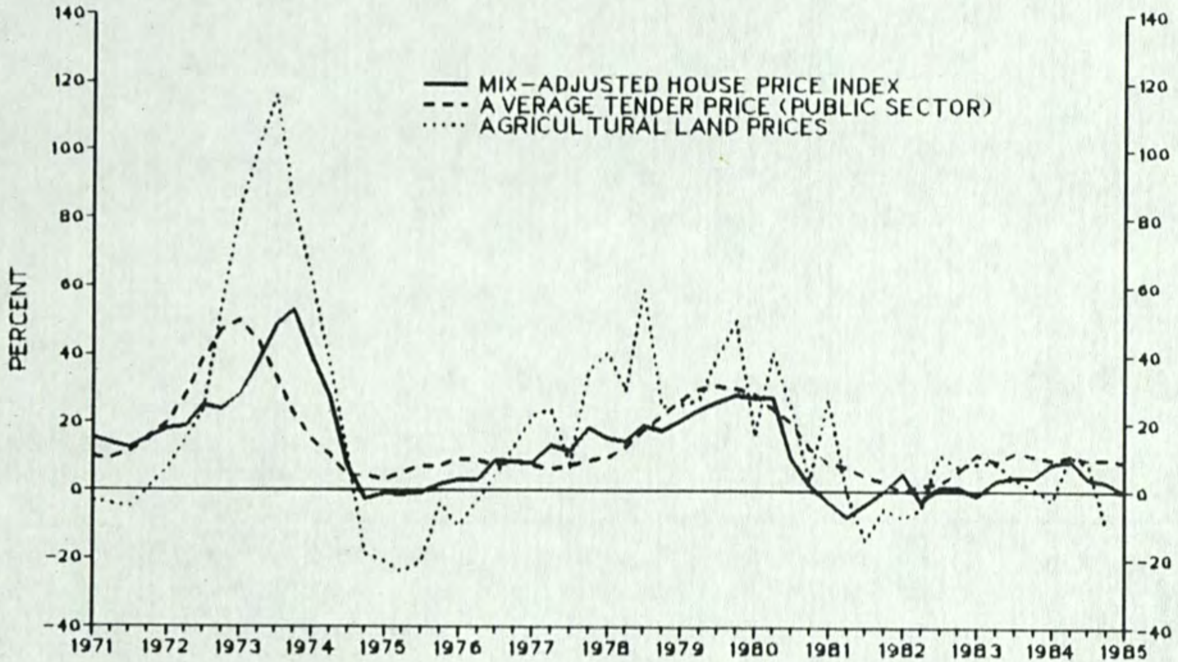


CHART 3

MONETARY GROWTH

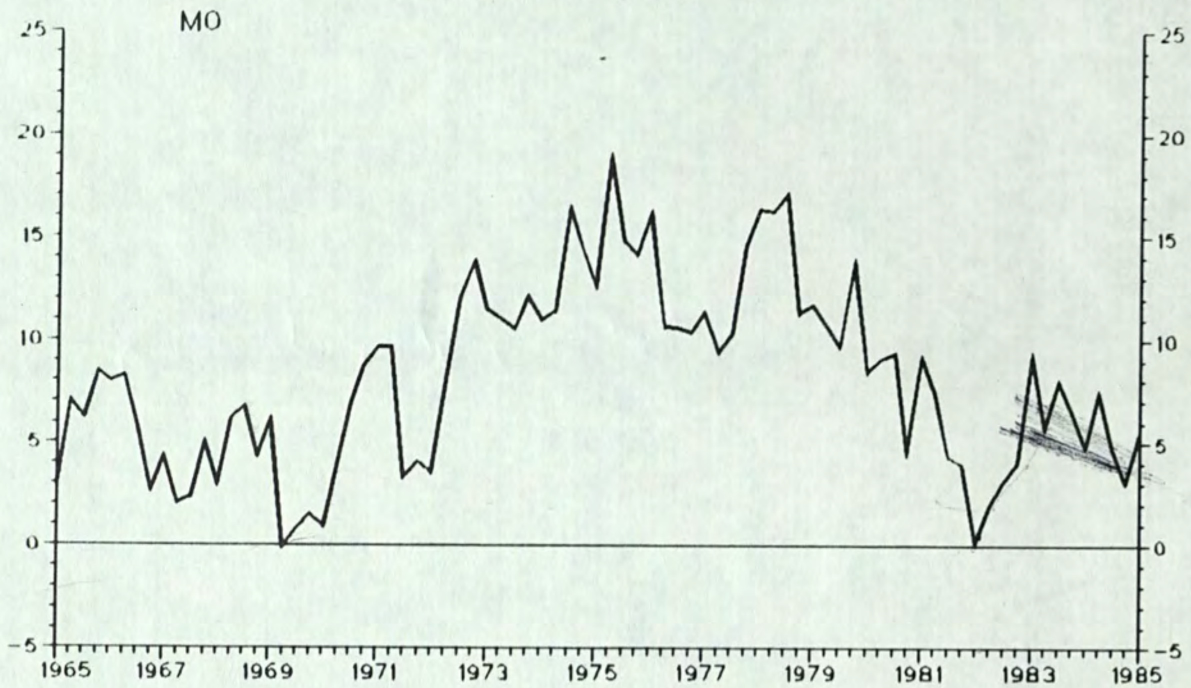
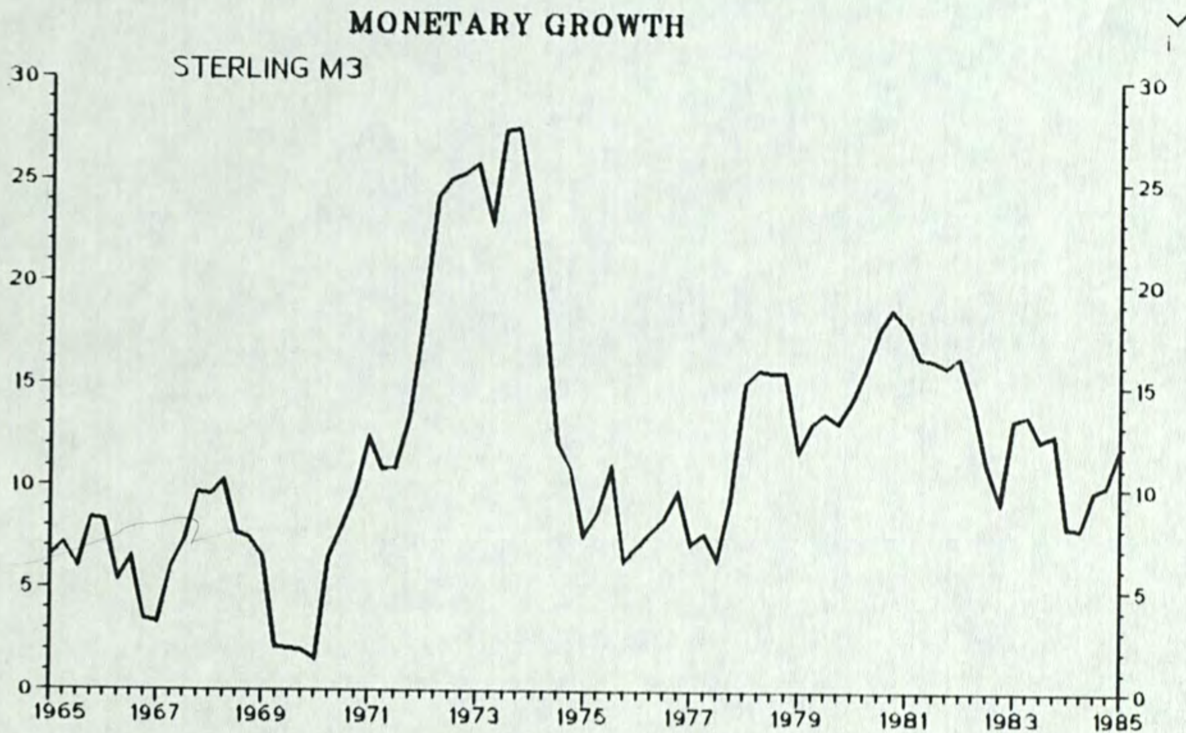


Chart 4

MONETARY GROWTH



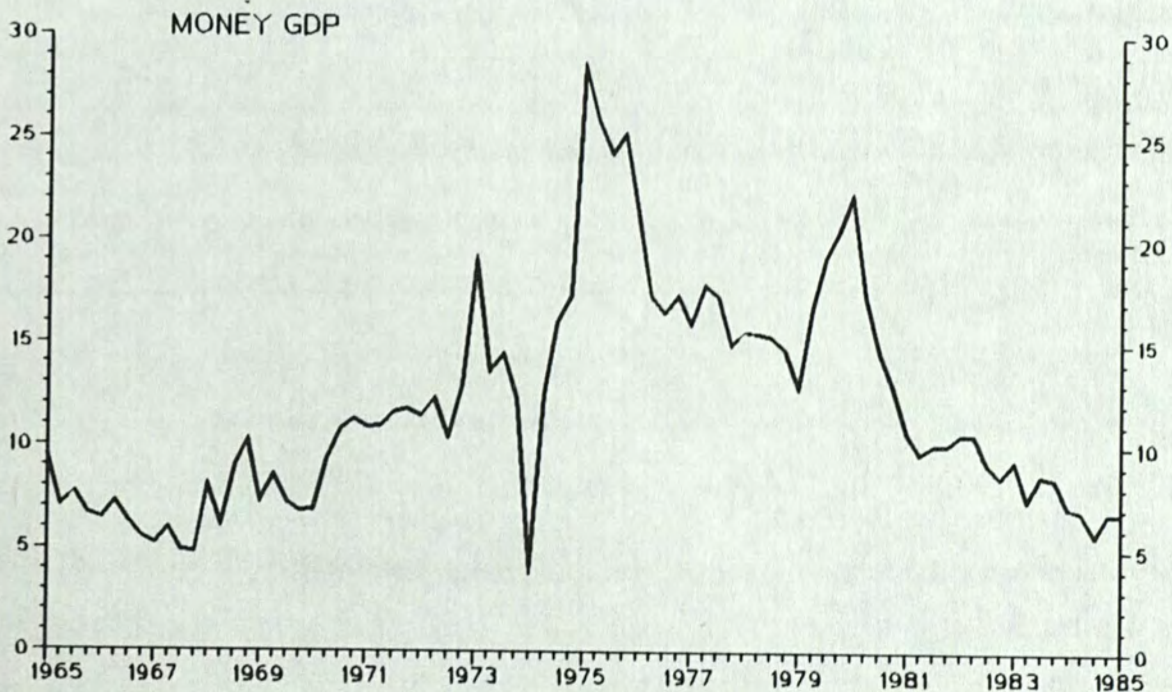
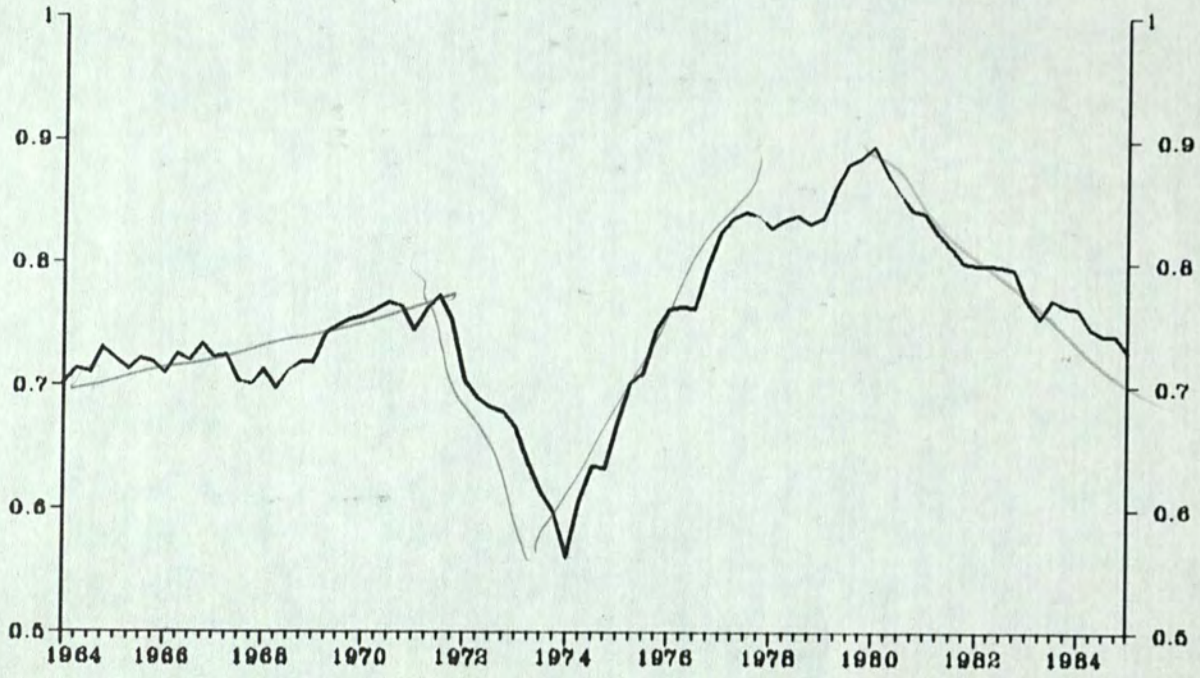


Chart 5



SECRET

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The Governor

Bank of England
London EC2R 8AH
21 June 1985

The Rt Hon Margaret Thatcher MP
Prime Minister
10 Downing Street
London SW1

Dear Prime Minister,

In your Private Secretary's letter of 6 June to Mrs Lomax the Bank was asked to let you know its views on the concerns you have expressed about monetary policy. In response to that request I enclose two notes which have been prepared here, the first commenting on your wider concerns about the present situation and the general framework of policy; and a second note on the more specific question of the sale of long-dated gilts.

You will see that we share some of your concerns about policy. Our fundamental difficulty is over the strength of private sector demand for bank credit. We do not feel we can ignore this without serious risk to the counter-inflationary strategy. But equally it does not readily respond to higher interest rates, so that if we relied upon that means to choke it off, we could risk damage - in the short term at least - to the economy. There are different technical approaches, but this is the heart of our problem which remains essentially unchanged whatever techniques we adopt.

I look forward to discussing the notes with you and the Chancellor on Tuesday.

Yours ever,

Robin

SECRET

MONETARY CONTROL - THE BANK OF ENGLAND'S VIEWS

MONETARY CONDITIONS

1 The Bank shares the view that the current upturn in inflation, as measured by the RPI is, in part, the consequence of sterling's weakness in the exchange markets around the turn of the year in the context of a very strong dollar, and of the interest rate response to that situation. We expect to see some moderation in the RPI after the summer. But, setting this blip in inflation aside, we are more fundamentally concerned at the underlying upwards pressure on inflation coming from unit labour costs, the rate of growth of which in manufacturing has risen from below 1% in late 1983 to over 5% now, much faster than our major competitors overseas. We fear the persistence of this trend as wage settlements, and earnings, have now begun to edge upwards again while the exceptional gains in productivity of 1983/84 have not been maintained. It seems that the recovery in profitability may have weakened management's position in pay negotiations; and the labour force - which has achieved a persistent increase in real earnings in recent years for those remaining in work - is likely to respond to the upturn in the RPI with higher wage demands.

2 Although we may be helped in the period ahead by weak world commodity prices, the underlying rise in unit labour costs may make it difficult to get back to, and stay on, the recent plateau of around 5% in the underlying rate of inflation. And we are certainly not confident that we are on course for a further gradual decline from that rate in the period up to 1988.

3 It is in this context - and in the context of strong business confidence, which, though it too may weaken later in the year, has shown very little sign of doing so thus far despite the recovery in the exchange rate and persistence of high nominal interest rates - that we seek to assess monetary conditions.

4 Of the monetary indicators, MO has grown steadily over the past year comfortably within its target range. Other narrow measures of

money have been heavily distorted by competitive pressure and innovation within the financial system (particularly by the widespread introduction of interest bearing current accounts) and are, by general consent, telling us very little at present.

5 Broad money, on the other hand, has been growing relatively fast over the past year, including £M3, which was around the top of its target range for most of the last target period, going well above it, to an annualised rate of 12% compared with the 6-10% target range at the very end of the period. In part this was erratic - reflecting inter alia a surge in bank lending to the private sector as investment spending (notably via leasing) was brought forward to take advantage of the higher initial tax allowances available up to the end of the last financial year. But allowing for this the underlying rate of £M3 growth has increased in recent months and is for the time being substantially above the current 5-9% target rate.

6 There are grounds for thinking that this may, in some degree, reflect an upwards shift in the demand for £M3 (rather than the excessive creation of money) which would not have immediate implications for inflation. Broad money too has been affected by financial innovation; and, perhaps more importantly, the persistence of high positive real interest rates on deposits generally has made them relatively more attractive than in the past as a home for genuine long-term savings rather than just a vehicle for transactions balances. If all the other available evidence suggested that monetary policy was visibly tight in relation to the ultimate objective for nominal income and inflation, these factors could provide justification for taking the rapid growth of broad money at less than its face value.

7 But that, in the Bank's view, is not the situation we are presently in. As noted earlier business confidence is exceptionally strong for the time being, and unit labour costs are giving a worrying signal about the future rate of inflation. In this situation therefore the Bank does not consider that the excessive growth of £M3 can be ignored and would be very cautious about any easing of policy until either £M3 growth moderates or the other available evidence points to a slackening of the pace of nominal income growth and underlying inflationary pressures.

MONETARY ARRANGEMENTS

8 The Bank agrees that the 1981 monetary arrangements are not working as originally envisaged in a number of respects. We did not contemplate then the degree of overfunding that has been undertaken to keep £M3 within its target range; nor therefore did we foresee the consequent systemic cash shortages within the banking system or the bill mountain that has resulted from relieving those shortages. These questions are discussed further below. It should be noted, however, that, despite these departures from the original intention, the 1981 arrangements have not been unsuccessful hitherto in delivering the Government's objectives for nominal income and inflation.

Overfunding

9 The core of the problem of monetary control for many years has been a persistent tendency for bank lending to the private sector to grow at a faster rate than is consistent with an acceptable rate of broad money growth. It is this excessive growth of bank credit that has driven us into overfunding to contain the effect on £M3; and overfunding in turn has resulted in the bill mountain, which is a symptom of the difficulties of monetary management rather than a cause, though it brings complications of its own.

10 In this situation of excessive bank lending in relation to the £M3 target we have had effectively four - not necessarily mutually exclusive - policy options -

(i) to develop other, non-bank, channels of finance for the private sector;

(ii) to raise short-term interest rates to a point where bank lending to the private sector was reduced;

(iii) to compensate for excessive bank lending to the private sector by overfunding the public sector outside the banking system; or

(iv) to allow faster growth of £M3.

11 We have repeatedly reviewed these options with HMT. As a result a number of actions have been taken under option (i) to encourage more private sector recourse to the capital market - most recently the

introduction of a regime for corporate sector 1-5 year bonds. Further action could be taken in this field, eg a tax on consumer credit and reduction in the tax incentive to borrow on mortgages to dampen what appears to be a structural rise in the personal sector debt ratio; and the introduction of a regime for corporate sector one-name commercial paper on which the Bank will shortly be writing to HMT. But apart from a surge in equity issues in the first half of this year these measures have had limited success and cannot be relied upon to produce any quick or adequate solution.

12 Of the remaining options (iv) - allowing faster growth of £M3 - has, hitherto, been ruled out because it was seen to carry inflationary risks. As explained in the first section in this note the Bank continues to attach importance to containing broad money growth for this reason. So too, despite the recent debate, do the financial markets.

13 As noted in paragraph 6 above, there are grounds on which some relaxation of the £M3 constraint would be justified if we had clearer evidence that policy was tight in relation to its ultimate objectives, notwithstanding relatively rapid growth of £M3. But we need to be cautious about moving in that direction because the build up of liquidity it would represent could equally become a source of inflationary pressure. It would not be enough, in the Bank's view, to rely upon containing that pressure only when evidence of it had emerged. That would carry the danger of acting too little, too late.

14 These risks would be greatly increased if the £M3 constraint were to be abandoned altogether. This would be seen as giving up all attempt to control the monetary consequences of the expansion of bank credit (or, by extension, of the PSBR), which has been at the heart of the problem of monetary control, and would be regarded as a major relaxation of policy. And, although we might undertake to continue to take account of broad money growth, the fact that we did so on a purely discretionary basis would, in the Bank's view, in substance represent a significant weakening of monetary discipline.

15 If, therefore, constraint on broad money growth is to continue to play a role in the monetary policy framework, as the Bank thinks it must, the policy choice of means of influencing it comes down essentially to options (ii) and (iii) above, ie either short-term

interest rates or overfunding (which, with some oversimplification, can be regarded as higher long-term interest rates).

16 Hitherto, at any particular moment, overfunding has seemed more immediate and certain in its effect. Short-term interest rates appear to affect the private sector's demand for bank credit only with a long and uncertain time lag, and they may at the same time increase the demand for broad money. Moreover overfunding has, analytically, seemed justified in that it is the total demand for bank credit from the public and private sectors combined which has monetary effect rather than the demand from these sectors (the boundary between which is in any case somewhat arbitrarily determined) individually. It has the effect, by changing prospective yield relativities, of persuading asset holders to shift from more liquid to less liquid assets so reducing the inflationary risks of the initial creation of credit.

17 This is not to say that overfunding is without its problems. In itself it has now reached the point where it may be damaging confidence in the policy as a whole by being seen as a softer option than more effective containment of bank lending to the private sector, which is the source of the dilemma. Overfunding also has consequences for the money markets leading to the bill mountain. In essence this is a presentational problem - we agree with Sir Alan Walters when he says it looks absurd. And the need constantly to rollover the outstanding market assistance is a technical inconvenience as discussed in the following section. But if we are to avoid overfunding we would have to accept either faster £M3 growth or a general level of short-term interest rates which is systematically higher than would otherwise be necessary, or some combination of the two.

The bill mountain

18 The original intention of the 1981 arrangements was that there should be no systemic cash shortage within the banking system, enabling the Bank to smooth out day-to-day fluctuations in the system's cash requirements by dealing in either direction in short-term bills (normally up to 14-day maturities). This would leave longer-term money market rates free to fluctuate providing a greater degree of market determination of rates, including base rates which were expected to vary more frequently, outside official influence beyond that exerted by the Bank's intervention at the very short end of the market.

19 The cumulative effect of overfunding has had the unavoidable consequence of adding to the bill mountain. (It is not the sole cause of the bill mountain as the parallel paper by HMT explains.) The bill mountain, in turn, has made it impossible for the Bank to confine its operations to the very short end of the market. The daily shortages, resulting from the rolling over of maturing assistance, rapidly became so large that we had to offer to buy bills in all maturities out to three months in order to allow the banking system to meet its liabilities. And the rates at which we deal have, as a consequence of this continuous involvement in all maturity bands to three months, become ossified, normally changing only when there is a change in the general level of short-term rates, including base rates.

20 Despite this unintended development, the arrangements as they operate even now do permit greater market influence over the term structure and general level of short-term interest rates, including base rates, than was previously the case - albeit not to the degree envisaged in 1981. This is because although our bill dealing rates have become effectively frozen from day to day, interbank rates are free to vary around them - and do so quite substantially - and it is interbank rates that largely determine base rates. The stickiness of our dealing rates may serve to reduce the variation of interbank rates; if we moved our longer bill dealing rates more closely in line with interbank rates both would become more volatile. It would even now, without further change in present arrangements, be possible for us to do this, if Ministers were prepared to accept the greater volatility of short-term rates generally, including base rates, that would result.

21 Alternatively we could move back closer to the original 1981 intention by reducing the size of the bill mountain by putting a part of our market assistance on a longer term basis. Two proposals have been put to HMT to achieve this -

(i) the purchase from the banks of their outstanding ECGD-guaranteed export credit paper; or

(ii) the placing of long-term cash deposits with the major banks.

Both proposals, which are still under discussion and which are not without drawbacks, are designed to reduce the continuous rolling-over of market assistance which is a factor in the rigidity of our bill

dealing rates. Here too the purpose would of course be to restore something more like the degree of market determination of interest rates envisaged in the 1981 arrangements.

22 Such steps as those described in the two preceding paragraphs would reduce a technical inconvenience in the way in which we presently operate by reducing the scope for bill arbitrage which arises from the fluctuation of interbank rates around our bill dealing rates. Some market commentators have suggested that this occurs on a massive (and growing) scale and explains much of the recent growth in both bank lending to the private sector and in £M3. In the Bank's view this is wishful thinking. It is certainly true that such opportunities for arbitrage, or round-tripping, open up from time to time. But we have monitored the situation closely day by day and investigated every alleged instance of arbitrage of which we have become aware; we are confident that the scale of such activity is greatly exaggerated and based on, at best, hearsay evidence. But the fact that it can, and does, occur, even if on a relatively small scale, is troublesome, because the stories to which it gives rise also damage confidence in policy as a whole. (It is for this reason, rather than because we believe it to be a real problem, that we have recently made it clear to eligible banks that we do not provide them with eligibility to facilitate purely artifical transactions of this sort.)

23 From this point of view going back to greater market determination of the term structure and general level of interest rates would be helpful. It would, if allowed to operate in this way, also help to reinforce the protection against purely administrative determination of interest rates, with its risks of too little too late, which was an important part of the 1981 objective. At the same time it would leave us more exposed to wrong market signals and perverse movements in interest rates, as in July last year, though these tend, as then, to reverse themselves relatively quickly.

24 Freer market determination of interest rates could be a means of ensuring a more "automatic" rise in rates in response to an excessive build up of broad money. But it would not, in and of itself, resolve the question of whether, or how far, we should continue to overfund as an alternative to higher short-term interest rates as the

means of constraining the growth in broad money. That is a distinct, and prior, question. If it were decided, for any given £M3 target, to do more or less overfunding, our need to provide money market assistance would be correspondingly altered, but the more important effect would be on the level of short-term interest rates that would need to be produced, by one means or another, to produce an appropriate rate of growth of bank lending to the private sector.

25 It is sometimes suggested that we should approach the problem from the other end, ie that we should begin by declining to provide all the money market assistance which the banks require to square their books, or do so only at progressively rising interest rates. In principle one could do this to achieve the same ultimate effect as in paragraph 24 above. The general level of interest rates would rise, ultimately reducing the growth of bank lending, which for any given £M3 target, would then reduce the need for overfunding, and, in consequence, the need for money market assistance. This approach would be a form of monetary base control. If one could assume that there was a reasonably stable relationship between the quantity of base money which we supplied and either broad money as the intermediate objective or nominal income as the ultimate objective and that this could be identified and relied upon to continue, the approach would have the attraction of allowing the process of short-term interest rate formation to be more automatic, reducing the need for the exercise of official discretion. Even at the conceptual level there is considerable doubt whether such a relationship could be identified. At the practical level there is the problem that we would have no idea, possibly for some years, about the starting point: the change in our operating procedures, and associated interest rate volatility, would cause the demand for bankers' operational balances with ourselves, and so the necessary stock of base money, to increase, but we would have no means of telling whether it was this factor or an underlying expansion of bank lending that was creating the need for money market assistance, nor therefore of deciding upon the amount of assistance we could appropriately provide.

26 It has been argued that controlling the "supply" of our money market assistance would exert an additional discipline on the lending decisions of banks - independently of the effect of the rise in the general level of interest rates it would produce - by exposing them to

potential losses. This argument would appear to depend upon a view that it would be possible to inflict penal interest rates for our money market assistance upon those individual banks which were expanding their lending most rapidly. Because banks can borrow from each other in the interbank market, however, and will do so until interbank borrowing becomes as expensive as borrowing from ourselves, this is not the case. Equally, since all banks are now in the position where their assets are overwhelmingly interest rate variable, they are protected from serious loss as a result of an increase in the general level of interest rates. We conclude, therefore, that rationing the supply of our money market assistance has its effect by raising the general level of interest rates and so affecting the demand for bank credit in just the same way as an interest rate rise brought about by other means. The problem of bank lending from which we started cannot therefore be made to disappear by a change in our operating techniques, it simply surfaces in a different form; and, unless its monetary effects are neutralised by overfunding, it can only be resolved by higher interest rates which can be brought about in more direct ways - with a greater or lesser element of market determination - if that is what Ministers are prepared to see.

THE POLICY OPTIONS

27 It is possible that bank lending to the private sector will moderate over the course of the year particularly if the present level of interest rates is sustained. In that case the present policy dilemma would become somewhat easier with the need to choose between overfunding, higher short-term interest rates or relaxing the £M3 constraint reduced. If that does not happen, the Bank would be cautious about easing the £M3 constraint, and would strongly advise against removing it altogether. This would be interpreted as meaning that we were paying less attention to the monetary consequences of the excessive growth of bank credit to the private sector and might be seen as the prelude to relaxation of the PSBR target too. It would, in the Bank's view, carry substantial risks for the underlying rate of inflation. Some tolerance of £M3 growing above the top of its present range may be justifiable - to take account of the apparent upwards shift in demand for £M3; but this would only be the case if there were clear evidence - which might include slower growth of MO or a strengthening of the exchange rate - of inflationary pressure diminishing into the next wage round.

28 Even with some relaxation of the £M3 constraint we are likely to continue to face the difficult choice between overfunding or a higher general level than otherwise of short-term interest rates. In that case it would seem unwise to exclude the possibility of overfunding altogether. But we would be content to seek generally to fund less heavily provided that the corollary were accepted of short-term interest rates being held higher than otherwise.

29 In any event the Bank would wish to continue exploring ways of reducing the private sector's demand for bank credit, including the possibility of a commercial paper market mentioned in paragraph 11.

30 And the Bank would wish to take action on the lines of paragraph 21 to reduce the size of the bill mountain and the associated need constantly to roll over its maturing money market assistance. This in turn could serve to increase the present degree of market determination of interest rates to something closer to what was envisaged in the 1981 arrangements.

ISSUING LONG-DATED CONVENTIONAL GILT-EDGED

1 In 1980 and 1981 we began a policy of reducing the dependence of the funding programme on sales of long-dated conventional gilt-edged. There were two main reasons for this.

2 First, it was expected that long-term gilt yields, which averaged 14 3/4% (for 20-year stocks) during 1981, would fall as the rate of inflation fell, so that the Government would be able to fund itself more cheaply either by issuing shorter-term debt and refinancing when that matured, or by issuing index-linked debt. In the event, long-term gilt yields fell sharply during 1982, and got down to just about 10% in the autumn of that year. Since then, however, they have remained in the range 10 - 11 3/4%, as chart 1 shows.

3 Second, it was hoped that if the Government kept out of the long-term debt market, companies would thereby be induced to issue their own long-term debt, so that their demand for credit from the banks would be reduced. Although there was a spate of corporate issues of fixed-interest debt in autumn 1982 when gilt yields came down to 10%, and there has been a number of further issues since then, the flow of such issues has been by no means sufficient to have a perceptible effect on corporate demand for bank loans.

4 It was, of course, recognised that this policy would lead to a bunching of gilt-edged maturities in the second half of the 1980s. This has now become a major concern. On the most optimistic assumption about outstanding short-convertible stocks being converted by the holders into long-dated stocks, we face maturities over the four financial years 1986/87 - 1989/90 averaging £8.2 billion a year or £680 million a month. The concern is that those funds could turn into money: if gross sales fall short of £680 million a month, there will be net redemptions of gilts, adding to rather than subtracting from monetary growth.[1]

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(1) On the least optimistic, but by no means unrealistic, assumption that none of the outstanding short-convertible stocks are converted, maturities over the next four financial years would average £8.8 billion a year (£730 million a month).

Although the funds will naturally accrue to holders of gilts there can be no guarantee that they will in fact be reinvested in gilts. This short-term maturity schedule is about twice as heavy as it was in 1981 (see chart 2); in addition a substantial burden of maturities in the second half of the 1990s has already built up.

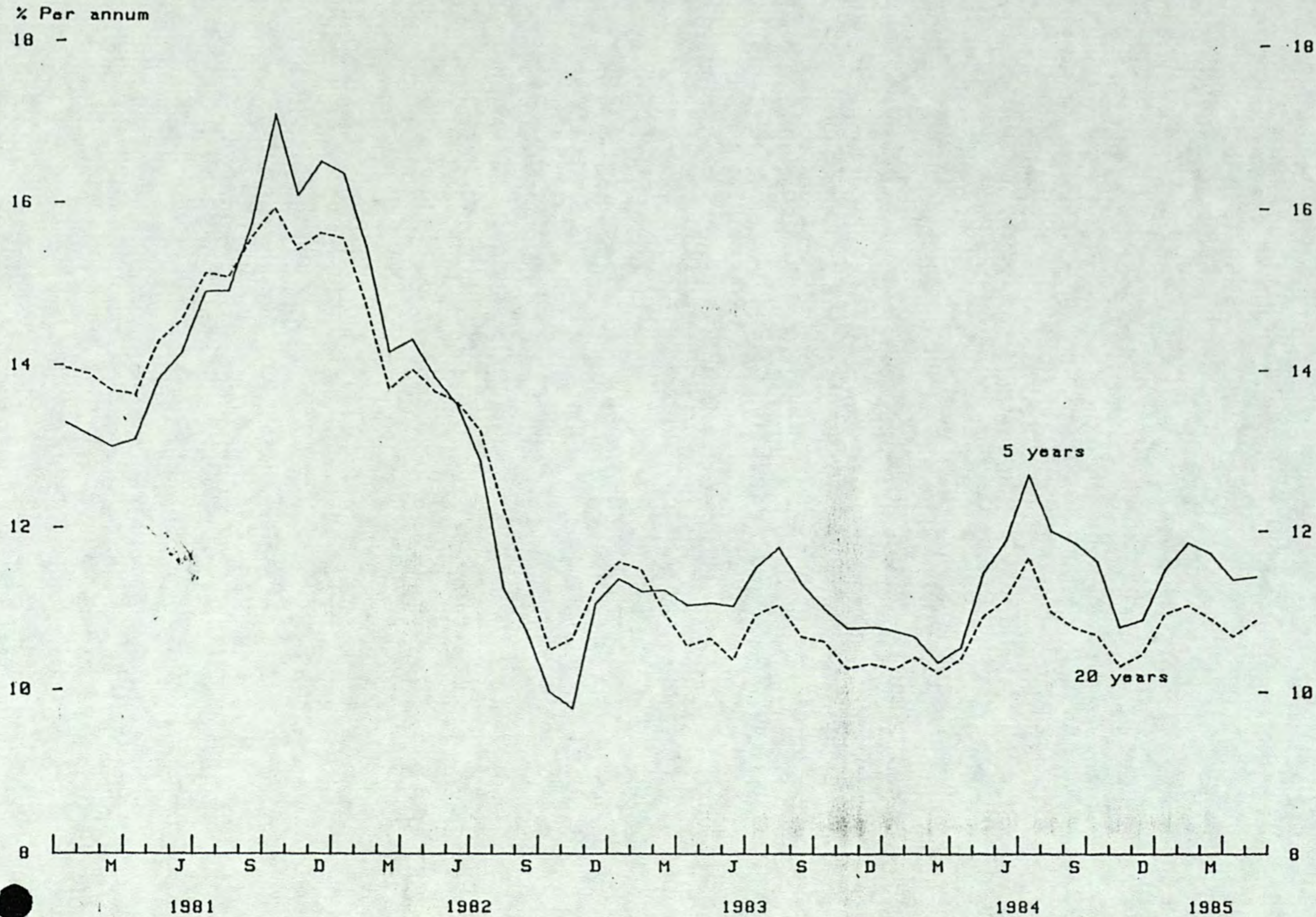
5 Partly for these reasons, we have recently been anxious to reduce our dependence on short-dated stocks. In addition we have been influenced by the fact that the building societies' demand for short-dated stocks has lessened. This reflects not only the slackening in their inflows of funds but also the fact that they have deliberately aimed for lower liquid asset ratios, partly because the change in their tax treatment in February last year has made gilts less attractive to them. The main other sources of demand for short-dated and, increasingly, for medium-dated, stock are in the monetary and overseas sectors, but sales to those sectors are not as helpful to broad money control as sales to the non-bank private sector, adding to the bill mountain without directly reducing £M3.

6 Ever since 1981 we have been aiming to maximise our sales of indexed gilts (IGs), particularly at longer maturities. IGs in total have accounted for about one quarter of our net gilt sales since the beginning of 1981, so that 8% of outstanding gilts are now in indexed form. But our keenness to sell IGs has inevitably been obvious to investors, who have realised that as soon as IG prices begin to rise we are likely to issue further stock, thereby pushing prices down again. Partly for this reason the real yield on the 1996 IG has risen from just over 2% at the time it was issued in 1981 to just over 4% now, despite the ending of the restriction on ownership of the stock.

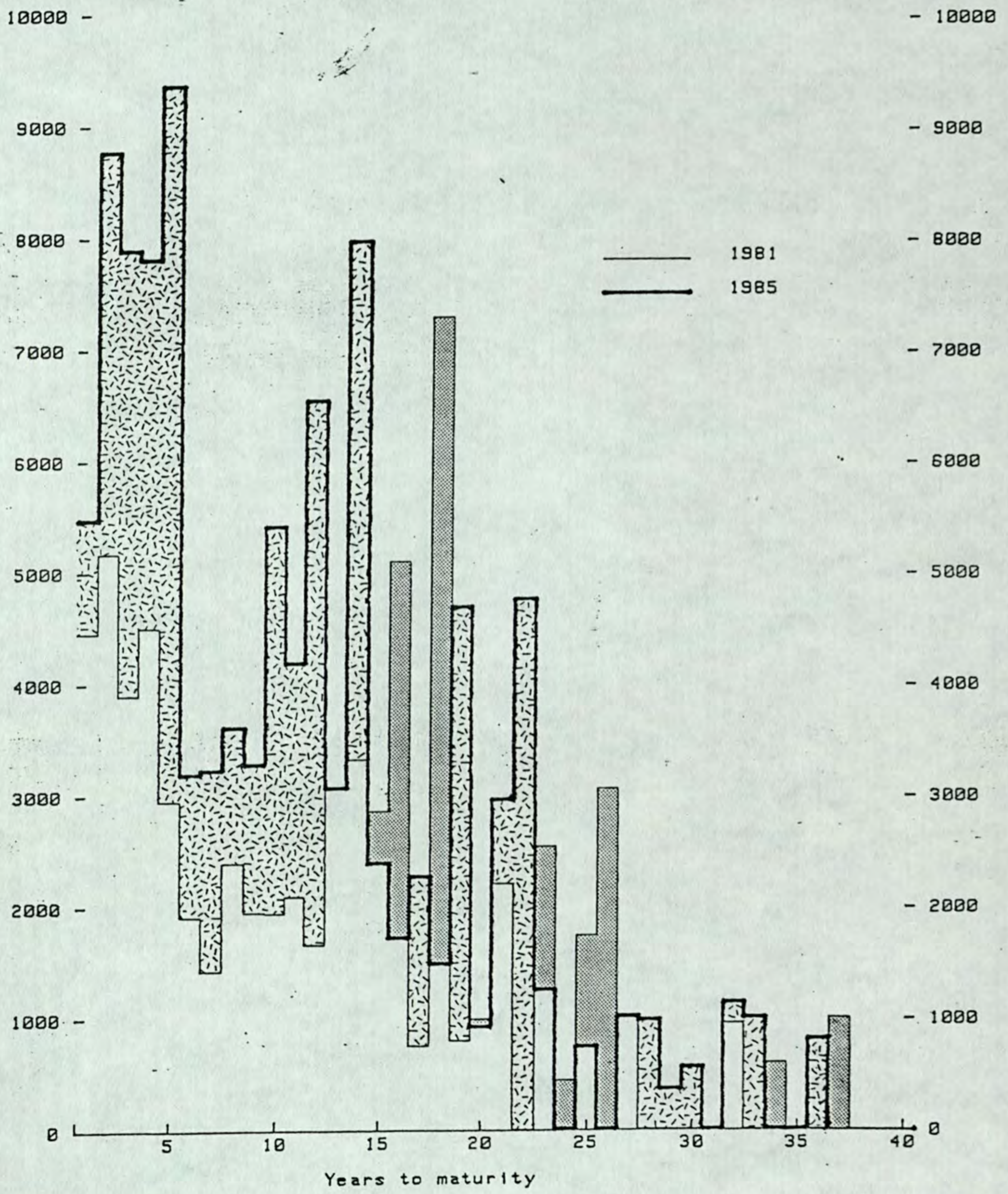
7 Given the build up of maturities (and the fact that companies now tell us that they would be more interested in capital market borrowing in the short-medium area), given the change since 1980/81 in the yield pattern, given the continuing need to fund very heavily outside the banking and overseas sectors, and given the limited market appetite for IGs, we have been obliged - particularly at times when the momentum of the funding programme has threatened to slow - to offer stock with longer maturity. We limit the amounts of longer maturities which we

issue as far as we reasonably can, particularly at times of market weakness and higher yields. But, if we are to achieve the funding volumes which Ministers have recently required, we will need to be able to continue to issue next century stocks fairly regularly, occasionally going beyond 20 years.

Gilt-Edged Yields[1] CHART 1



(1) Monthly averages of gross redemption yields on 5-year and 20-year British Government Securities



Maturities of dated stocks
outstanding at 31 March 1981 & 1985
£millions
10000
9000
8000
7000
6000
5000
4000
3000
2000
1000
0
1981
1985
5
10
15
20
25
30
35
40
Years to maturity

PRIME MINISTER

JOHNSON MATTHEY

The Chancellor's statement went off rather quietly, helped by the absence of Dr. Owen and Dennis Skinner who was at Brecon and Radnor. The Chancellor managed the difficult balancing act between accepting that the Bank had been at fault in its supervision and in the extent to which it had kept Government informed, without undermining too much the credibility of the Bank or the Governor.

A number of issues were raised:

(i) Why was JMB rescued rather than, say, Corton Wood or Stone Platt? The answer was that the proprietors of JMB were not rescued but lost £170 million and special factors relating to the banking system and the bullion market dictated that no depositors should lose.

(ii) Why had the Chancellor not corrected his statement of 17 December which made no mention of the fact that the Bank had made a £100 million deposit with JMB? The answer was that the Leader of the House had acknowledged two days later that a deposit had been made without the Chancellor's knowledge.

(iii) Why was the Price Waterhouse report not published? The answer was that this was commissioned by the Bank to help it in its investigation; it contained commercially confidential information and publication would have weakened the Bank's position in the forthcoming legal action.

(iv) Would public money be lost?
The Chancellor gave an assurance that no public money would be lost. To deliver this the Bank will

/need

need to sell JMB for at least £168 million in order to recover the £100 million of capital and the £68 million provided under the indemnity agreement.

It is unlikely that this will be the end of this issue - the Opposition have demanded a Debate - but unless they can rake up some new angle it seems likely to remain an issue for specialists rather than becoming one of main-stream politics.

pp. ANDREW TURNBULL

20 June 1985

File

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SECRET

CHANCELLOR

FROM : D PERETZ

DATE : 20 JUNE 1985

cc Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Lavelle
Mr Lankester
Mr Sedgwick
Mr H Davies

PAPER ON MONETARY POLICY

I attach a revised draft paper on monetary policy for the Prime Minister's meeting next week.

2. The structure follows that you outlined at your meeting on 17 June. We have also taken account of points made at the meeting with the Bank yesterday. You will see that the first three paragraphs incorporate a summary and guide to the rest of the paper. The Annexes are bulky, particularly Annex II. But we think it important to deal there with the points that Sir A Walters and others have raised.

3. Sir P Middleton is away today, and Mr Cassell engaged giving evidence to the TCSC. But they have seen an earlier draft, and this version includes their comments, and those of others.

4. The paper will need to go to No. 10 tomorrow, once it has been amended to take in your own comments. I attach a draft private secretary covering letter for the purpose. I understand Mr Turnbull will be arranging to get a copy to Sir Alan Walters in Washington.

5. As we promised at yesterday's meeting, I have also sent copies of this draft to the Bank.

DLP

D PERETZ

SECRET

SECRET

DRAFT LETTER

From : Mrs Lomax

To : A Turnbull Esq
10 Downing Street

MONETARY POLICY

As you know, it has been decided that the Treasury and Bank will submit separate papers for next Tuesday's discussion. I attach the Treasury paper. The Bank will be letting you have theirs separately.

I am copying this letter and the paper to John Bartlett (Governor of the Bank of England's office). You kindly undertook to arrange for the paper to be sent to Sir Alan Walters over the weekend, and I enclose an extra copy for the purpose.

SECRET

MONETARY CONTROL

I Introduction and Summary

There has been recent criticism and misunderstanding about the operation of monetary policy, and we are facing difficulties, both in the interpretation of conditions and the methods of control. The current divergence between broad money and other indicators has drawn attention to other longer standing problems about the operation of policy. These relate to the choice of targets and indicators, and, at a more technical level, the techniques of control, particularly the way the Bank operates in the money markets and the process of "overfunding" with the resulting growth of the bill mountain. It is right to take stock.

2. The most immediate question is whether monetary conditions are suitably tight to bring us back to a declining path for inflation. The various indicators do not all point in the same direction. Real short-term interest rates are at a historically high level; the monetary base (MO) is growing at a satisfactory rate, well within its target range; the £ is firm, and has risen against all currencies since earlier in the year. On the other hand bank lending and the wider measures of money and liquidity are growing very fast, with £M3 well above the top of its range. Our assessment (paragraphs 4-12 below) is that the recent rise in inflation reflects conditions that had become too loose last year and the short run impact of the higher interest rates needed to correct them. We believe that current conditions are tight enough to bring inflation back to a downward trend. There may not be much room for interest rate reductions but neither do we see any need for an increase.

3. The rest of the paper deals with longer standing problems, many of which have been reviewed on several occasions in the past. The fundamental issue, which underlies the others, is the choice of monetary targets and indicators.

(i) Interpreting monetary conditions in a sophisticated financial system like ours is not easy. MO has had a steady velocity trend and proved a useful indicator in recent years. The exchange rate has also proved a useful supplementary guide to policy. But £M3 has persistently exceeded its targets and grown faster than money GDP and inflation. Along with other measures of broad liquidity, it has been greatly affected by structural changes - which are certain to continue in future - and a rise in the demand for liquid assets as a form of savings (paragraphs 13-23).

(ii) "Overfunding" has seemed a more reliable way to seek to contain £M3 than raising short term interest rates. The process involves the Government borrowing more than it needs to cover its deficit, with the Bank offsetting the resulting cash shortages by short term lending to the market, mainly in the form of acquisition of commercial bills. But it has led to a £17bn bill mountain. This looks absurd; represents a large structural distortion in financial markets; and complicates official day to day market operations. And £M3 has still exceeded its target range (paragraphs 24-29).

(iii) There is some dispute over the extent to which growth of broad liquidity constitutes an inflationary danger. The danger of a liquidity overhang is that it might be converted into spending power at some future date. Some argue that it is right to try to restrain liquidity growth as an insurance against the risk of not being able to act quickly enough when the time came. But on the other hand, there are indicators - the exchange rate, MO, asset prices - likely to give early warning

of any inflationary pressures from this source, signalling the need for a rise in interest rates to contain them (paragraphs 30-33).

(iv) The arrangements for the Bank's operations in the money markets have turned out to be less flexible than originally envisaged when the present system was set up in 1981, partly because of the growth of the bill mountain. But interest rates whether influenced directly or indirectly are a key mechanism of monetary control. It was mistaken to believe in 1981 - if it was - that rates could be "left to the market". The practical question is whether we have adequate techniques for influencing interest rates, and whether these are sufficiently reliable to react quickly to a sudden move to spend liquid balances and the inflationary threat that would imply. We are satisfied that they are, and that we can and would react quickly in response to adverse movements in the monetary base, the exchange rate and asset prices. (It is not true to suggest the Bank are prepared to supply liquidity to the market without limit) (paragraphs 34-36).

(v) The final section of the paper sets out the main policy options on the central issue: the choice of targets and indicators and the role of £M3 (paragraph 40).

II What are the short term prospects for inflation?

4. The recent inflation increase - as measured by the RPI - from around 5 per cent to 7 per cent largely reflects two factors, both of which we expect to be temporary.

5. The first is the exchange rate fall in the second half of last year which increased import prices and gave companies the opportunity to widen their profit margins. It also meant higher oil prices expressed in terms of sterling; petrol prices are currently 11 per cent higher than a year ago.

6. The second factor has been the effect on mortgage rates of the higher level of interest rates. The timing and extent of the interest rate increase was associated with the exchange rate weakness but a higher level of interest rates was appropriate for domestic reasons as money demand was rising faster than expected; in particular world trade and exports were stronger than anticipated.

7. Both of these influences on prices should unwind in coming months. The increase in mortgage rates last July will fall out of the year on year comparison in August; and the 2 point rise early this year will disappear next Spring. Even if mortgage rates do not fall from today's levels this would have the effect of reducing inflation by 1½ per cent next summer compared with today's rate.

8. In addition the exchange rate has now recovered last year's fall and import price growth is already moderating. Firms will find it more difficult to raise prices and already oil prices in sterling terms are some 10 per cent lower than in January. If the normal relationship of petrol prices to oil prices holds they could be down by nearly as much by next summer.

9. On the basis of the present level of the exchange rate and world oil prices our present expectation is that inflation

would be below 5 per cent by next summer. This is not contradicted by present information on house price increases. Recently there has been some very modest signs of quickening but average increases are below 10 per cent on a year earlier, and rising at around the same rate as over the last two years. There is nothing to suggest that we face the difficult conditions of the early or late seventies when rapid house price increases anticipated an upturn in the general inflation rate (see Annex III, Chart 2).

III **Are conditions tight enough to keep inflation declining in the longer term?**

10. Abstracting from these temporary influences we estimate that the underlying rate of inflation has shown only a small increase in recent months. Unit labour costs in manufacturing industry have been rising by less than 5 per cent a year after making allowance for the effect of the Budget which reduced the average rates of National Insurance Contributions. Although this is faster than competitor countries it does not point to higher inflation arising from labour costs. And the lower inflation rate in the autumn should reduce the pressure for larger wage increases, though the settlement rate in the next pay round could well be a little higher than the 5½-6 per cent of the last year or so.

11. In general terms it can be argued that the underlying inflation rate has been on/a plateau of around 5 per cent over the past two years; for part of the time the recorded rate was helped by special factors, particularly the mortgage rate; and for part of the time the recorded rate has been damaged by those same factors. Although the actual inflation rate may fall below 5 per cent in 1986-87 the underlying inflation rate is only likely to decline slowly. Maintaining the monetary policy implied by this year's MTFS may not leave much room for interest rate reductions but we do not, at present, see any need for a further increase.

12. It is right to be cautious about the speed with which we bring down inflation. A policy stance designed to produce a sharp fall would put pressure on companies and would have adverse effects on output and unemployment. The implication is that we should stick to our strategy and not over-react to the high levels of inflation we are experiencing this summer; levels whose origins lie in monetary conditions that have already been corrected and the influence of the mortgage rate on the RPI.

IV Choice of monetary targets and indicators

13. In a sophisticated and fast changing financial system like ours, it is not easy to decide what monetary indicators to look at and how to interpret them. The difficulties are most obvious when, as at present, the different indicators are giving conflicting signals.

14. Taking **narrow money** first, in principle the obvious indicator to choose would be a measure of cash and balances held for transactions purposes - perhaps the aggregate of notes, coin and current accounts. But the figures here have been greatly distorted in recent years by the growth and heavy marketing by banks of interest bearing sight deposits. This has lead to funds previously held at longer term, so as to attract interest, being switched into sight deposits; and it also seems to have resulted in a growth of interest bearing sight deposits at the expense of non-interest bearing sight deposits.

Growth of transactions money, 12 months to May 1985 (%)

MO	Non-interest bearing M1	Interest bearing M1	Total M1
5.5	4.1	43.8	15.8

15. It was this distortion to the current account figures that lead us to choose a narrower measure still, MO (the total of notes, coin and bankers' balances at the Bank of England) as our preferred measure of narrow money. This measure has also been affected by structural and technical change, such as the growing use of credit cards and cash dispensers. But these changes seem to have been taking place at a steady pace, giving a fairly steady velocity trend for MO over a long period which we have been able to take into account in setting targets for it.

16. Despite these features, many still doubt that an aggregate that consists largely of notes and coin can be an adequate indicator of monetary conditions in a sophisticated financial system. It may be that the Treasury and Bank could have done more to explain with more conviction the merits of MO as an indicator: it is certainly clear that without some more concerted effort of that kind the market is unlikely to switch its focus from £M3 to MO.

17. Turning to the **wider measures of money**, an £M3 overshoot is scarcely a new phenomenon. As the following table shows, £M3 has exceeded its target over most of the period since 1979, only coming within it for the 2 years (1982-84) after a deliberate decision to raise the ranges originally announced for those years. Despite this we have brought inflation down.

£M3 performance against target : % growth at annual rate

	Target range	Outturn	Growth of money GDP (financial years)
Jun 1979 - Oct 1980	7-11	16.2	19.8
Feb 1980 - Apr 1981	7-11	19.4	13.8
Feb 1981 - Apr 1982	6-10	12.8	10.1
Feb 1982 - Apr 1983	8-12	11.2	9.4
Feb 1983 - Apr 1984	7-11	9.8	7.9
Feb 1984 - Apr 1985	6-10	11.9	7.0

18. The explanation lies in developments over the period that have affected the nature of £M3 and the private sector's demand for liquid assets. Bank deposits have become a more attractive way of holding savings, and this combined with other structural changes has diminished the significance of £M3 and other broader aggregates as monetary indicators. Much of the increase is in institutional funds held on deposit at banks as part of investment portfolios. The result is that the velocity of £M3, which rose sharply between 1974 and 1980, has since 1980 been steadily declining (see Annex III Chart 5).

19. One traditional attraction of the £M3 aggregate is the familiar statistical link with the PSBR. But it is clear that in recent years growth of £M3 has not been caused by excessive growth of the PSBR. Our performance here in relation to other countries has been good (see Annex III table 2).

20. It has been the buoyant demand for private sector credit - leading to a very rapid increase in bank lending - that has been the driving force behind £M3 growth. But like the rise in bank deposits that has financed it, this growth of bank lending does not seem in itself to have added to inflationary pressures. In the last three years bank lending has grown at an average rate of 18 per cent, while money GDP has been growing at around 8 per cent.

21. It is important here to recognise both the similarities and differences between monetary control in the UK and in other countries. Annex 1 describes the operation of monetary policy in the US, Germany and Switzerland. In all three countries the authorities place emphasis on the control of a narrow aggregate (in Switzerland, MO; in the US, M1; and in Germany, Central Bank Money - CBM). In the US and Germany there is also a concern with broader aggregates. But in those countries policy operates through a system of mandatory ratios between banks' reserves - that is their cash and deposits at the central bank - and their other liabilities.

On the one hand this gives a more certain relationship between bank reserves/narrow measures of money and broader measures, with which they are also concerned. On the other hand, because the reserve requirements in effect constitute a tax on bank intermediation, the system tends to lead to credit being channelled in other ways than through domestic bank lending. In other words, it causes disintermediation: including disintermediation through the uncontrolled offshore markets.

22. We have deliberately set our face against mandatory reserve requirements for banks in the UK that would drive sterling business offshore. Such disintermediation would, we have argued, distort the money figures to little real purpose. But we should, perhaps, not be surprised if against this background the result of the liberalisation since the abolition of exchange controls and the corset in 1979/80 has been a greater degree of intermediation via banks - and a faster growth of bank lending and a faster growth of the broader aggregates in relation to narrow money and the monetary base - than in countries like the US and Germany.

23. Finally, the **exchange rate** has come to play a larger part in our assessment of monetary conditions. Although on occasion movements in the exchange rate can reflect events that have little direct relevance to domestic monetary conditions, more normally there is an effect on inflationary pressures. In practice, we have found the exchange rate a useful supplementary guide to policy: often a more useful guide than £M3.

V Control of £M3 and bank lending: overfunding v. short term interest rates

24. Annex II contains an account of the techniques we have used to seek to control monetary growth, and some of the operational problems we have had. If we want to rein back £M3 growth, in the short term there is a choice between using funding policy and raising short term interest rates.

25. Using **funding**, that is selling extra gilts, will in effect raise long term interest rates. Some investors - probably mainly the institutions - will as a result move out of bank deposits and buy gilts instead. But with a given PSBR the effect of this transaction is to contract the monetary base, and it can create money market shortages which, if not relieved, would lead to a sharp rise in short term interest rates as well. Unless such a rise is thought warranted by monetary conditions, the Bank will relieve these shortages by adding/to its holding of commercial bills (the bill mountain). This combination of "overfunding" and money market assistance does not reduce the total of credit extended: what it does is, in effect, to neutralise some of the impact of the rise in private sector borrowing from the banks by financing part of it with less liquid forms of savings - invested in gilts and recycled via the Bank's purchase of commercial bills. We know from experience that overfunding does have a reasonably reliable and early impact on £M3, at least in the short run.

26. Changing **short term interest rates**, on the other hand, will have at best a delayed effect on £M3 and bank lending. Despite the political importance of the mortgage rate, we have on occasion - as at present - been through periods of very high short term interest rates. But on each occasion there has been little discernible effect on £M3. There is an impact on non interest-bearing forms of money including M0. But on £M3 the short run effect could, even, be perverse.

27. But if short term interest rates are uncertain and slow acting in their effect on £M3 and bank lending, they can be expected to have a more substantial effect on the real economy - with a rise adding to the financial pressures on large and small companies, both directly and through the exchange rate. Overfunding, on the other hand, probably has much less effect on the real economy - partly because long term interest rates have less effect than short rates. It does, at least in the short term, reduce total liquidity in the economy. But equally it can be argued that the effect on £M3 is mainly cosmetic - like the corset, affecting the

target aggregate, but not inflationary pressures. Another possibility is that, although there is a short run effect, in the longer term overfunding does not even reduce £M3. That would be the case, for example, if the extra sales of gilts and higher long rates were crowding potential private sector borrowers out of the long term capital market, and forcing them to borrow from the banks instead.

28. With the persistent tendency of £M3 to overshoot the targets set for it since 1979, we have regularly been faced with the choice of whether to seek to rein it back by raising short term interest rates, or by overfunding. Each time we have reviewed the choice in abstract, as we did in the summer of 1982 and last year, we have concluded that it was preferable to control £M3 without overfunding; and on each occasion in practice we have subsequently concluded that reliance on interest rates alone did not offer a sure enough prospect of reducing £M3 growth, and that gilts sales should therefore be increased. The result has been the steady acquisition by the Bank since 1979 of a massive stock of short term paper - in effect short term loans to the banking system. The total has now reached around £17bn, rising from a negligible figure in 1979.

29. The sheer scale of this bill mountain is now creating a range of technical, presentational and other problems. These are discussed more fully in Annex II, but briefly:-

(i) It looks absurd. This in itself does not help the credibility of policy. The Bank of England's holding of commercial bills is now equivalent to about 15% of £M3, and the proportion has been steadily rising by 3-4% a year.

(ii) Because the stock of bills matures and has to be turned over every 4-6 weeks, it creates regular huge daily shortages in the money markets that the Bank has to relieve by purchasing new bills. The Bank is thus

intervening more regularly and at longer maturities than originally envisaged under the operational arrangements instituted in 1981 giving the authorities a higher profile in the setting of short term market rates. This is not necessarily a drawback. It was a fallacy to envisage, if it was in 1981, that interest rates could in some way "be left to the market". To achieve monetary control the authorities have to be able to act on interest rates. The only question is whether to achieve that influence on rates by following an automatic quantitative rule for dealing in the money market (as with monetary base control), or through a more discretionary policy.

(iii) The scale of daily shortages makes it easier for the authorities to influence rates. But large scale dealing in the bill market can make it hard to avoid opening up opportunities for "round-tripping" arbitrage transactions between bills and bank deposits. Failure here artificially inflates the £M3 numbers and confuses the interpretation of monetary conditions.

IV Is the growth of broad liquidity a problem?

30. We thus come back to the question of whether we should be seeking to restrain rapid growth of £M3, and whether growth of £M3 and other measures of broad liquidity should be of concern. If it is, then - as in the past - we are likely to have to contemplate further overfunding, and a further rise in the bill mountain, as the only reliable means of doing so. If we believe the rapid growth of £M3 is of less concern, or that its effects can be offset by tightening monetary conditions in other respects - eg. by raising short term interest rates - then we have the prospect of breaking out of the cycle of ever increasing additions to the bill mountain and beginning to reduce the problems that it has brought in its train.

31. Some argue that a rise in broad liquidity, as measured by £M3, constitutes an actual problem: that it will inevitably lead to faster inflation. Others that it is only a potential problem: a liquidity overhang that could in some circumstances be converted into spending power and hence lead to inflation. Support for both propositions is seen in the history of the early 1970's when, it is argued, it was the growth of £M3 that gave the best warning of coming inflation.

32. Table 1 and Charts 1 and 2 in Annex III show the growth of MO, £M3 and some other indicators against the path of inflation since 1970. They show that both £M3 and MO gave warning of the inflation of the early 1970s. Conditions in 1972-74 were very different from today's. The exchange rate was weak, fiscal policy was lax, interest rates had for a long time been kept artificially low and an incomes policy was breaking down. Moreover, the international environment was highly inflationary, reflected most dramatically in the oil price rise in late 1973. The conditions today, both domestic and international, are totally different. There is certainly no sign - see Annex III Chart 2 - of asset prices taking off in the way they did in 1972-74 sometime before inflation took off. Had we been operating then as we do today, then the movement in MO, the exchange rate and asset prices would have led us to take action even without a target for £M3.

33. Nevertheless concern on this front - on either thesis - might point to the need to act now to restrain the growth of broad liquidity. On the liquidity overhang theory, this would represent a necessary insurance against not being able to react fast enough if and when the time came. By historical standards the present liquidity overhang is not particularly high. But this is the case for continuing to seek to restrain the growth of £M3, and not changing the target set for it.

34. The alternative approach is to make sure we have adequate defences to ensure that broad liquidity is not converted into spending power. In this respect it is argued that the

way the Bank operates in the money market provides no assurance that liquid balances could not be converted into spending power (in the simplest case, encashed). This derives from the suggestion that the Bank is always prepared to buy any quantity of bills - to lend any amount to the market - at the going interest rate. There is a second, related, proposition that this certainty of always being able to borrow from the Bank may have increased banks' willingness to lend, and so have added to £M3 growth.

35. These suggestions are discussed further in Annex II. The short point is that it is simply not true that the Bank will buy any quantity of bills. They calculate the amount they need to buy each day to take out the expected market shortage, and to prevent an unwarranted contraction in the monetary base or rise in interest rates. If (as on occasion happens) they are offered more bills than required they limit their purchase to the calculated amount.

36. As to an automatic tripwire, this should in practice be provided by a combination of the exchange rate and MO; and as in the 1970s we would also most likely be alerted by a rise in asset prices. The exchange rate would quickly react to any conversion of £M3 balances into spending power. In practice MO did rise before the inflationary surges in the early and late 1970s. Both these movements should be sufficient to bring the necessary rises in interest rates in their train.

VII **Conclusion and Policy Options**

37. The key question is thus about our attitude to the growth of broad money and of £M3 in particular. If we were only concerned at the risk that liquidity could be converted into spending power in the future, then we can probably rely on MO and the exchange rate to give us warning signals in time to act to prevent it. If we believe, as we do, that the current rapid growth of £M3 carries little direct threat to future inflation, then we should logically be considering whether to raise or abandon the target for £M3 growth. To

do so would open the way to put an end to overfunding and the various problems associated with the seemingly inexorable rise in the Bank's bill mountain. There is also a subsidiary question about possible changes in the arrangements for the Bank's day to day money market operations.

38. To deal with the latter first, the Bank's operations are both more extensive and less flexible than envisaged in 1981. But it was always mistaken to believe - if it ever was - that short term interest rates could be left to the market. The authorities' influence on them can be discretionary, or work through seeking to change the monetary base: but either way interest rates are a key mechanism of monetary control. Nevertheless, it may be that the official hand on short term rates has become too rigid, and that techniques should be changed so as to permit greater day to day movement in short term rates.

39. On the central question, the future of the £M3 target, whatever our own conclusion there is of course also the market's reaction to consider. A change which undermined the credibility of policy would raise inflationary expectations and interest rates. In this respect the timing of any change would clearly be important: it would be best to wait until inflation was clearly back on a downward path.

40. The main options are:-

(i) No change. Despite our doubts, we could retain the present target for £M3. We could combine this, if desired, with changes in operating procedure of the kind discussed above and in Annex II. It has to be recognised that this would require continued overfunding and a continued rise in the level of the bill mountain. Despite that, no doubt there would be some overshooting of the £M3 target, leading us in turn to continue publicly questioning the significance of £M3 growth if we felt that in practice it was not endangering downward pressure on inflation.

(ii) Drop the £M3 target. We could combine this explicitly with an end to overfunding. History suggests this is necessary if we are ever to secure a reversal in the growth of the bill mountain. It might be preferable to present this as a suspension of the target, rather than a final break: some of the growth following an end to overfunding might be temporary. Given doubts about the value of £M3 as an indicator, it would arguably be a useful clarification of policy. It would imply greater reliance on MO and the exchange rate, but we would want to make it clear that even without a target we would continue to take account of changes in the growth of broad money in interpreting monetary conditions, in much the same way as we already take account of movements in the exchange rate. This has many attractions, and in some ways is not as far as it looks from how we already operate policy, with persistent £M3 overshooting. But it would be seen as a major break: £M3 has featured as a target aggregate since 1976. An end to the growth of the bill mountain would settle market doubts that have arisen on that score. But the change could not carry credibility without a concerted campaign by the Treasury and Bank to explain the reasons for it, the merits of MO as an indicator, and the way that policy would be operated henceforth.

(iii) Raise the £M3 target range. This option is something of a halfway house between (i) and (ii). This might be combined with other changes: for example a widening of the band, or a decision to reset the target more frequently, as recognition of some uncertainty about where it should be. It would be unwise to renounce overfunding altogether. But it might be possible to announce that it would be gradually phased out, with the aim of first slowing and then stopping the growth of the bill mountain. Other countries have at times changed their targets to what were considered more realistic levels, as we did in 1982. As to credibility, there would be a risk of getting the worst of all worlds:

but it might run less risk than option (ii) of being seen as a loosening of policy.

(iv) Switch to an exchange rate regime. If none of these options seemed attractive we could consider again a more complete break with monetary targets. The practical option, which was reviewed in February, is full membership of the EMS. In effect this would be an admission that steering by the domestic indicators had become too difficult, and that we would do better to try to tie policy to that in a low inflation country like Germany. But where exchange rate pressures come from external shocks, like oil price moves or movements in the dollar, it is often preferable to take some of the strain on the exchange rate rather than allowing it all to be transmitted into the conduct of domestic policy. We concluded in February that membership could not in practice be contemplated at a time when pressures on sterling seemed likely, or with the present level of our currency reserves.

H M TREASURY
JUNE 1985

ANNEX 1: MONETARY TARGETS AND CONTROL ARRANGEMENTS IN US, GERMANY AND SWITZERLAND

Summary

1. The United States, Germany and Switzerland have set monetary targets for some years. All three countries place emphasis on narrow measures of money, although the United States also has targets for wider measures and in Germany the Bundesbank monitors M3. The US operates through the level of bank reserves while in Germany the main instruments are short interest rates, repurchase arrangements and alterations to banks minimum reserve requirements. In Switzerland the control problem is exacerbated by the central importance of flows across the exchanges, requiring the authorities to use foreign exchange swaps as well as short term interest rates to control domestic liquidity. Since none of the countries pay all that much attention to broad money they have generally not resorted to overfunding. All three countries have achieved low inflation rates although monetary outturns in Switzerland have often been significantly below target (mainly because of external flows). Excessive interest rate volatility was a problem in the US in the period 1979-81; since then volatility, has been less, in part reflecting changes in control procedures. An examination of the volatility in overnight rates over the last three months suggests that variability (as measured by the standard deviation) in the US, German and Swiss rates is fairly similar, and somewhat below that in the UK (if allowance is made for exceptional movements in the Swiss rate at the end of the month - see para 15).

United States: (a) Targets

2. The US targets the growth of M1, M2, M3 and domestic non-financial debt between the fourth quarter of years. M1 is effectively cash plus current accounts at banks and building societies; M2 is M1 plus retail savings accounts; M3 is effectively cash plus all deposits at banks and building societies; and domestic non financial debt is outstanding credit market debt of the government, local authorities and the private non-financial sector. Of these aggregates M1 is available weekly and the rest monthly. M1 is considered to be the most important aggregate as it has the most stable relationship with nominal GDP.

MONETARY TARGETS AND OUTTURNS

Table 1(a): United States: 1979-84

		Target	Outturn*
1979/80	M1A	3½ - 6	5
	M1B	4 - 6½	7.3
1980/81	M1B	3½ - 6	2.3
1981/82	M1	2½ - 5½	8.8
1982/83	M1	4 - 8	10.4
1983/84	M1	4 - 8	5.2

* % Q4 on Q4

Table 1(b): Germany: 1975-84

	Target for Central Bank Money (CBM)*	CBM growth	Nominal GNP growth
1975	8[1]	10[1]	4.4
1976	8[2]	9[2]	9.1
1977	8[2]	9[2]	6.5
1978	8[2]	11[2]	7.8
1979	6-9	6	8.2
1980	5-8	5	6.5
1981	4-7	4	3.9
1982	4-7	6	3.6
1983	4-7	7	4.6
1984	4-6	5	4.6

* Fourth quarter on fourth quarter

1 December 1975 on December 1974

2 Year on year

Source: Deutsche Bundesbank

Table 1(c): Switzerland: 1980-84

		Target	% calendar year Outturn
1980	Central bank money	4	-7.0
1981	CBM	4	-0.5
1982	CBM	3	2.6
1983	CBM	3	3.6
1984	CBM	3	

(b) Control Procedures

3. The Federal Reserve Board and the Federal Open Market Committee (FOMC) in Washington sets out the short and medium term targets for monetary policy. More-or-less every month the FOMC meets to decide short term policy. The result is a directive to the New York Fed, which is in charge of day to day operations in the money market. Until 1979 the open market desk mainly acted on interest rates to control money supply but since then it has operated on bank reserves in order to achieve monetary targets. The main aggregate M1 is thought to have a reliable relationship with bank reserves and so the New York Fed, adds or drains reserves through repurchase aggreements etc to control M1. From 1979 to 1982 the FOMC set a target for non-borrowed reserves but by 1982 it was realised that targetting this alone allowed a 'leakage' through discount window borrowing, which meant that the Feds' control over M1 was not as tight as it might have been. Thus from 1982 the target for non-borrowed reserves has been altered more often to offset changes in discount window borrowing. This means that now total reserves are targetted. Another perceived fault in the 1979-82 procedure was the system of lagged reserved accounting. The latter meant that banks reserve requirements were known before an accounting period began. Therefore the Fed had to supply a certain level of reserves or allow interest rates to be highly volatile as banks scrambled to meet their reserve requirements needs, once again weakening Fed control over M1. In early 1984 a system of contemporaneous reserve accounting was introduced to allow the Fed to control reserve growth and hence M1 more tightly. This system covers a two week period with the banks required reserves at the Fed calculated from the level of the banks current accounts.

(c) Target and Outturns

4. The comparison between targets and outturns for M1 is set out in table 1(a). It can be seen that in 1982 and 1983 the M1 target was overshot, due mainly to the introduction of new interest bearing current accounts. The Fed decided in mid-1982 that for various reasons the targets were too tight and that money could grow above target without harmful consequences on inflation. On the other hand they have overshot their M3 target for each of the last few years by margins ranging from ½% to 3%. In other years the Fed have a reasonable record on M1. Since October 1979 the annual rate of price inflation has fallen from 12¼ to 4%. Meanwhile, the real economy has grown by almost 3% per annum over the period.

5. In the early part of the period interest rates were highly volatile, as was money supply. Indeed prime rates moved from 12.9% in September 1979 to 19.8% in April 1980 then down to 11.1% in August 1980 back to 20.2% in January 1981. The average level of 3 month rates in 1979-81 was almost 8% higher than in 1971-79. Since 1981 and the introduction of a modified form of reserve targetting, volatity has been less pronounced. Although slightly greater than 1971-79 it is nevertheless considerably less than in 1979-81. Indeed since the beginning of 1982 the prime rate has fallen from 17% to 10% at present, with the rate in 1983 and 1984 varying only between 10½ and 13%. Nevertheless nominal rates have remained high. Three month rates even in 1984 were close on 4% higher than in the 1970's despite a 3% lower inflation rate.

6. As the Fed operates on the reserve requirements of the banks and concentrates mainly on a narrow aggregate, it does not use overfunding as an instrument of monetary policy. To ensure that government finance has as little impact as possible on the liquidity of the system the authorities deposit excess income from government operations in accounts at commercial banks, drawing them down only when they are needed.

Germany: (a) Targets

7. In August 1973 the Bundesbank changed its policy from influencing bank reserves to controlling the growth of 'central bank money' (CBM) defined as currency plus required minimum reserves on banks domestic liabilities at the reserve ratios prevailing in January 1974. CBM is a weighted average of the assets comprising M3[1] but it has the advantage of being available before data on M1, M2 and M3. Targets for CBM have been set annually since December 1974 on the basis of the growth of potential production plus the rate of "unavoidable" price rises. The hope is that this procedure avoids the need to adjust the targets as a result of transitory effects on prices or output. Since 1978 the Bundesbank have expressed the target in terms of a range for the Q4 on Q4 growth rate. The stated objective is to aim for the lower or upper half of the range depending upon the outturn of other non-monetary indicators during the target period, such as the exchange rate. Although only CBM is targetted the Bundesbank also monitors M3 and presents its counterparts. Indeed there is thought to be a reasonably strong link between CBM and M3 because the former includes reserve requirements based on the latters deposits.

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(1) CBM comprises all currency in circulation (less banks till money since March 1978) plus 16.6% of residents' sight deposits plus 12.4% of residents' time deposits plus 8.1% of residents' savings deposits held within German banks. These percentages are the required minimum reserves on those deposits as at January 1974.

(b) **Control procedures**

8. It is useful to distinguish between the methods used for control over the medium term and those used to manage day to day operations. In the former category the main instruments are changes in banks' reserve requirements - which are far more frequent than in the US or the UK - and changes in the amount of, and the rates at which, bills are discounted. The Bundesbank sets rediscount quotas which are varied according to its view of market conditions. The reserve requirements are governed by the Anweisung der Deutschen Bundesbank uber Mindestreserven (AMR). The AMR specifies what reserve ratios are to be applied to the monthly average of reserve liabilities from the 16th of one month to the 15th of the next. For simplicity, the Bundesbank allows banks to calculate their liabilities from those outstanding on the 23rd of the previous month and the 7th and 15th of the current month. (It can order a bank to calculate the full monthly average if it suspects it of "window-dressing" the figures.) This procedure means that by the 15th of the month a bank should know what its reserve requirement is, and can therefore alter its reserves over the rest of the month to satisfy the requirement. Undoubtedly the setting of reserve ratios has encouraged the growth of the offshore EuroDeutschemark market.

9. The Lombard facility is a loan by the Bundesbank secured on eligible collateral granted at the official Lombard rate, which is usually 1% to 1½% above the official discount rate. From February 1981 to May 1982 this system was replaced by the Special Lombard facility which effectively allowed the Bundesbank to decide whether or not to lend and at what rate, thus allowing the authorities to have penal rates for banks short on reserves without raising general interest rates. However, the introduction of the scheme pushed overnight rates up to around 20% to 30%.

10. Day to day control is operated through repurchase agreements, foreign exchange swaps and the Lombard [and Special Lombard] facility. The use of repurchase agreements appears to be on the increase. They are usually for bonds (not bills) for periods of between 25 and 45 days. (The vast bulk of government borrowing is through medium term paper which is not very marketable on a day to day basis as transferability is restricted. Open market operations are therefore carried out using Treasury bills or Treasury discount bonds (ie. zeros) issued by the government to the Bundesbank on request.)

11. Recently the Bundesbank has tried to reduce changes in the politically sensitive Lombard rates and has made increasing use of securities repurchase agreements (repos). To increase the impact of changes in the amount and rates of such agreements, the Bundesbank has gradually increased the size of its holdings of these securities from around DM12bn at the end of 1979 to about DM47bn by the end of 1983. The German 'bill mountain' is therefore mainly a result of a change in the Bundesbank's tactics. Decisions concerning whether or not to roll over the repos are taken in the light of pressure on the DM and the rate of monetary growth. For example, in January and February of this year the Bundesbank kept liquidity tight in the face of pressure on the DM.

12. This combination of altering interest rates and reserve requirements has allowed the Bundesbank to control CBM quite successfully (see Table 1(b)). The overshoot in the period 1975-78 was largely due to exchange market intervention to dampen the appreciation of the DM. The reversal of these exchange rate pressures in the light of the second oil crisis made monetary control easier. This is brought out in table 2 which compares the volatility in interest rates in the period up to 1979Q4, when the German effective rate was generally appreciating, with the period since then when the rate has fallen back a little. During the latter period the Bundesbank has managed to keep monetary growth broadly within the target ranges and interest rate volatility has been reduced. Inflation, which was creeping up to around 8% in Autumn 1973, just prior to the introduction of monetary targets, has been kept firmly under control averaging well under 5% from 1974 to 1985.

Table 2: German inflation, monetary growth, interest rates and exchange rates: 1970-85

	Pre-monetary targets 1970Q1-1973Q3	Monetary targets & appreciating DM 1973Q4-1979Q4	Monetary targets & depreciating DM 1980Q1-1985Q2
Inflation	5.4	4.8	4.3
CBM growth	10.4	8.1	5.3
Effective exchange rate at start and end of period	77.7 - 100.2	97.0 - 132.0	131.7 - 121.5
3 month interest rate	8.2	6.0	8.2
Volatility* of interest rates	0.3	0.5	0.3

* As measured by the coefficient of variation

13. Since less attention is attached to broad monetary growth, there has been no temptation to overfund and debt sales have generally matched government deficits quite closely.

Switzerland: (a) Targets

14. From the introduction of targets in 1975 until 1978 the Swiss concentrated on M1, which effectively is cash plus current accounts at banks and post offices. However in view of the instability of the demand for M1 the Swiss switched in 1979 to central bank money, or monetary base, as the target variable. The target for the monetary base is set annually to last a calendar year and relates to the average of the 12-month percentage changes for each month of the year. This is an extremely slow moving indicator and is clearly of little use in guiding day to day or even month to month policies. In the last few years a 3% target has been set, which is thought to be compatible with 2% real growth and 0-1% increase in prices. Besides the monetary base there have been periods particularly in the late 70's and early 1980 when the central bank has found it necessary to intervene in the exchange markets to resist large short term swings in the exchange rate, and hence relegate the monetary target to a secondary role.

(b) Control Procedures

15. The primary method of monetary control is through foreign exchange swaps with the most active period being at the end of each month when the banks have to meet the liqudity ratios set by the Central Bank. The need for liquidity, which causes a large jump in overnight rates, is relieved by the central bank through foreign exchange swaps which unwind during the following month. Although foreign exchange swaps are the most important instrument the Swiss also set discount and Lombard rates, and occasionally use bond repurchase agreements. However, except at end month, overnight rates are very stable and the central bank operations are very light.

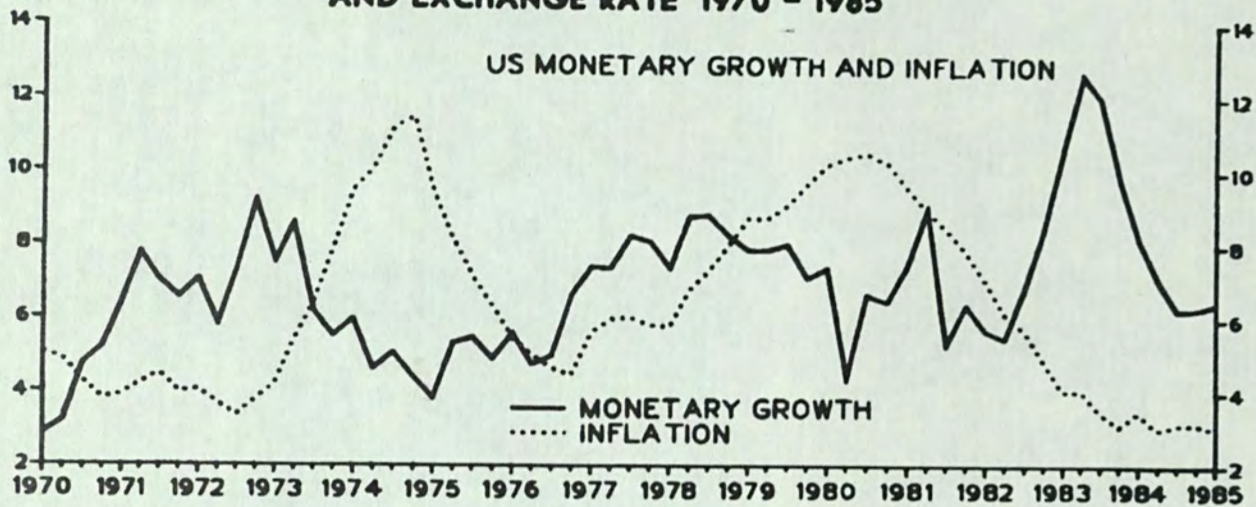
(c) Target and Outturns

16. The comparison of targets and outturns is set out in table 1(c). In 1980 and 1981 there was a large undershoot of the central bank money target

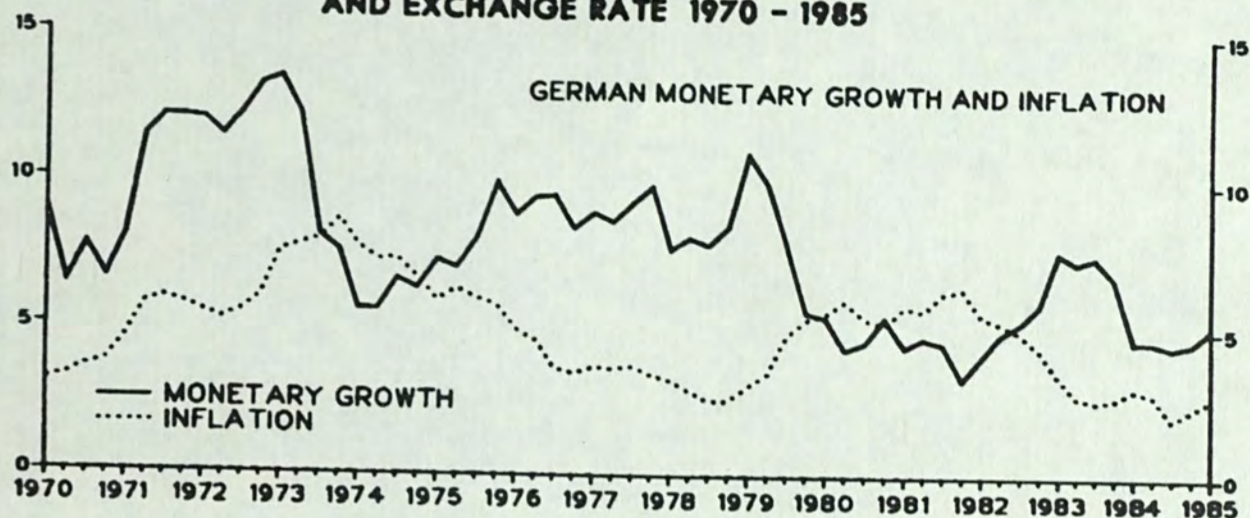
as the authorities absorbed large quantities of liquidity created in 1978-79. Since then the Swiss have been close to their target. Although the growth of the monetary base is stable the growth of the wider aggregates can be volatile, as individuals switch between different types of accounts. The effect of the sharp slowdown in monetary growth in 1980 and 1981 led to a recession in 1982, which co-incided with a peak inflation rate of around 7½%. Since then there has been a slow recovery while inflation moderated to 3% by end 1984. Like most other countries interest rates rose to a peak in 1981 before declining in 1982, since when they have been little changed. Nevertheless three month interest rates in Switzerland only briefly touched double figures in 1981 and soon fell sharply, back to around 3% by end 1982.

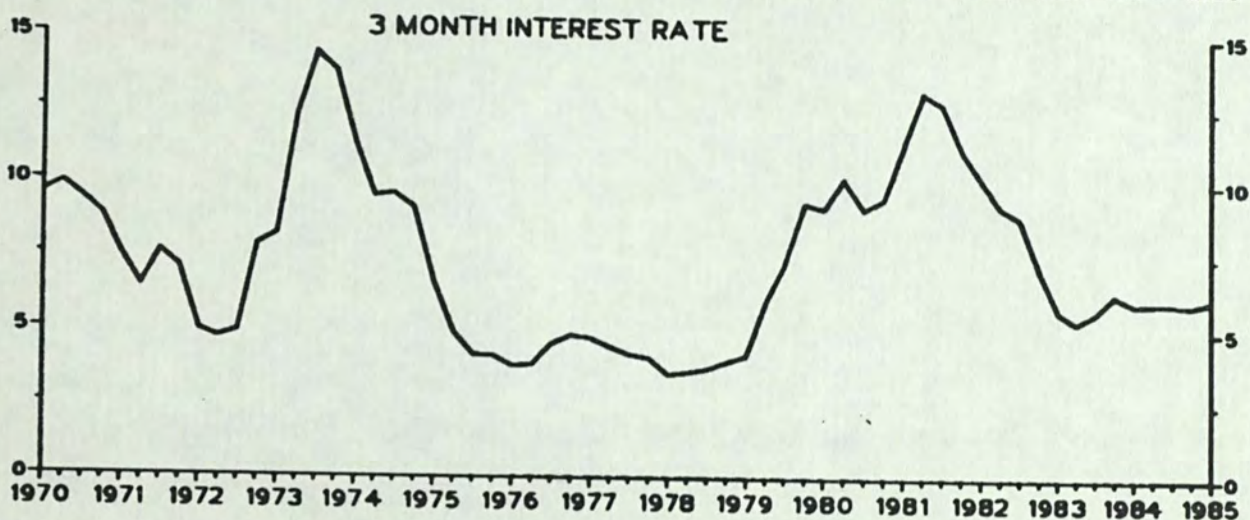
17. In Switzerland government finance is not normally a major influence on changes in the liquidity of the banking system.

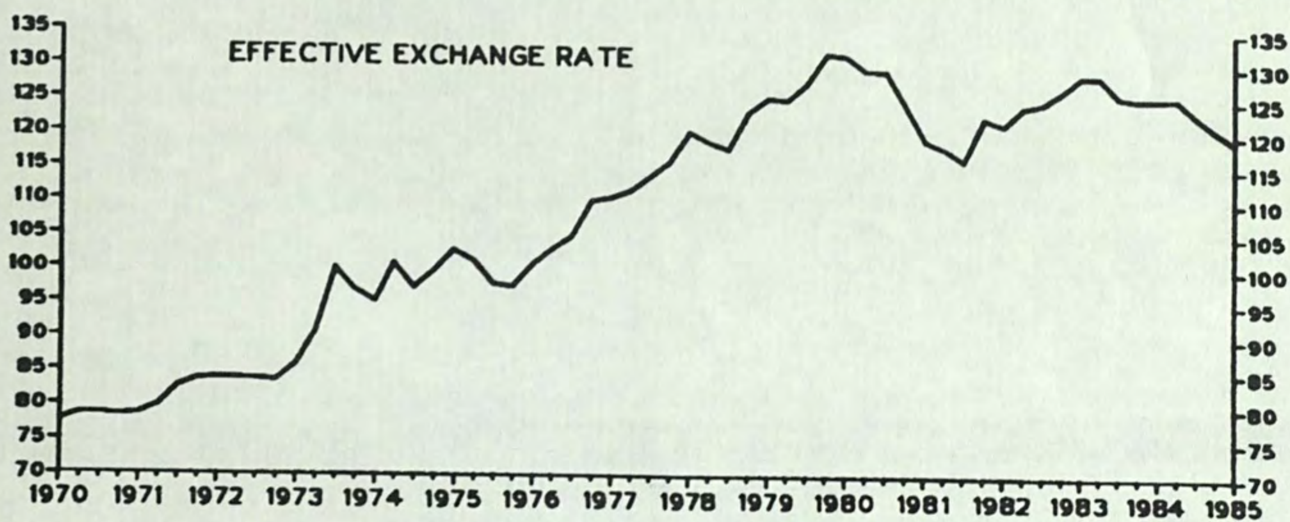
US MONETARY GROWTH, INFLATION, INTEREST RATES AND EXCHANGE RATE 1970 – 1985



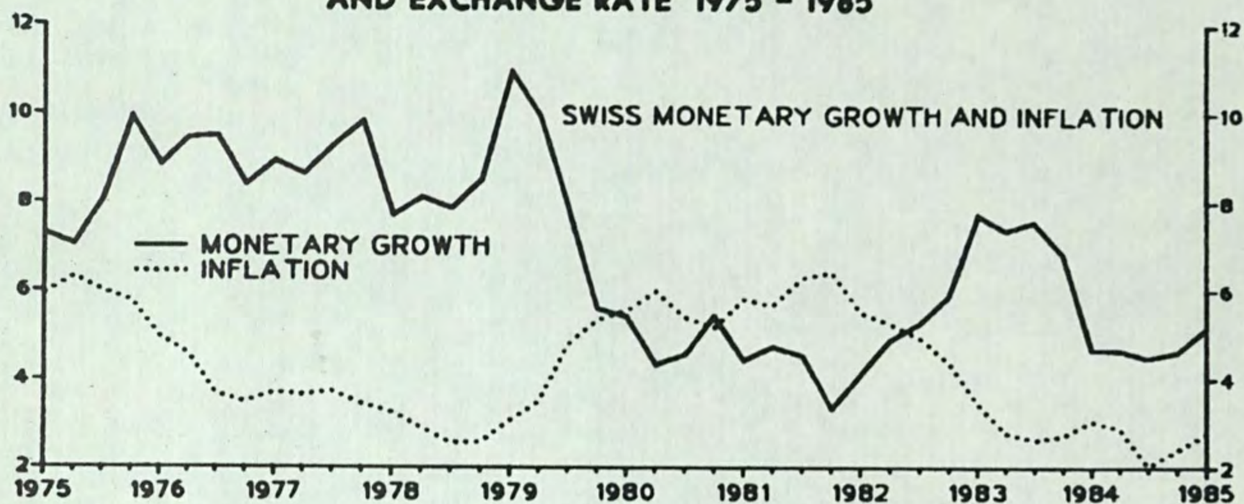
GERMAN MONETARY GROWTH, INFLATION, INTEREST RATES AND EXCHANGE RATE 1970 - 1985







SWISS MONETARY GROWTH, INFLATION, INTEREST RATES AND EXCHANGE RATE 1975 - 1985



ANNEX II - TECHNIQUES OF MONETARY CONTROL

1. We have relied on three main instruments for controlling monetary growth: fiscal policy, funding and short-term interest rates. The first two are particularly relevant for controlling broad money. A tighter fiscal policy (ie lower PSBR) or extra funding will, other things remaining equal, reduce the growth of £M3. Over the medium to long term, higher short term interest rates are also likely to have a contractionary impact through their effect on the demand for credit. But in the short-term their effect is very uncertain: higher short rates may result in an increase in interest-bearing bank deposits and hence lead to an increase in £M3. There is no such ambiguity in regard to narrow money. Thus, higher short rates reduce the demand for MO. While the market has often expected an increase in short rates to counter excessive growth in broad money, we have tended to regard short rates as the more relevant for controlling narrow money.

2. Fiscal policy cannot normally be changed in the short-term, and in any case is beyond the scope of this paper. Suffice it to say that, unless fiscal policy is reasonably tight, too much of the burden for controlling monetary growth has to fall on funding and interest rates. Successive MTFS's have recognised this, though - because of PSBR over-runs - actual experience has not matched up to our intentions.

Funding

3. Over the six years 1979/80-1984/85, the PSBR totalled £61 billion and debt sales to NBPS totalled £65 billion. Because of redemptions and sales to the monetary and external sectors, gross sales of debt were of course very much higher - at £96 billion.

4. In one sense, this has been a major achievement. The Bank have sold large amounts of gilts. Improved selling techniques, notably the use of tranchettes, and the introduction of IG's (and their derestriction in 1982) have made a major

contribution. National savings, having been allowed to languish in the 1970's, have also played a major role.

5. One question is whether, for a given level of funding, we are minimising our **funding costs**. Clearly, we have to pay whatever the market requires for any particular instrument. On the whole, we are likely to do better if we offer the market a range of instruments. The issue of convertibles, low coupons and IG's have helped in this way, as have the introduction of new National Savings instruments. Further options are kept fairly continuously under review.

6. An important aspect from a cost point of view is the choice of maturities. Over the three years 1979/80 to 1981/82, about one-third of the new conventional high coupon stocks issued were of maturity up to 10 years. In the last 3 years these shares have been reversed, with just under a third of new issues having a maturity greater than 10 years. (This is partly the result of issuing convertible stocks which at prevailing prices are unlikely to be converted into longs.)

7. So we have succeeded, to some extent, our policy of keeping out of the long end of the conventional market. The argument for concentrating on shorts is mainly one of cost. Paying double-digit interest rates into the next century is expensive; for assuming over the medium term interest rates fall, it is cheaper to issue short and medium debt and then refinance it. We have also wanted to leave the long-end of the market to the corporate sector.

8. But these factors have had to be balanced by other considerations:

(i) we face exceptionally heavy redemptions in the late 1980's and 1990's. In theory, the redemption monies can be reinvested in gilts; in practice, they often are not - at least in the short term. It has seemed sensible, therefore, to try to avoid too great a bunching of maturities by stretching out the redemption profile to some extent.

(ii) at times when the gilts programme has been running into difficulty or when we have wanted a big increase in sales, it has been helpful to issue some longs - though normally this has been as part of a tranchette package.

(iii) partly because of our heavy sales in the shorter maturities, the yield curve has more recently exhibited a pronounced downward slope towards the longer end; consequently, the cost argument is now less compelling.

(iv) it is more effective for the control of £M3 to sell gilts to the non-bank private sector rather than to banks or foreigners, who are more interested in the shorter end.

(v) we have come to doubt whether the corporate sector will ever issue long stock on any significant scale again. It now seems that, if the corporate bond market is to revive, it is more likely to do so in the short and medium maturities.

9. Another important question concerns **overfunding** (which is usually defined as the extent to which debt sales to the non-bank private sector exceed the PSBR). On this definition, in three of the past six years we have underfunded. But taking the 6 years together we have overfunded by £3.6 billion, and in each of the past two years overfunding has amounted to £2.5 billion. There is an alternative definition. That is the extent to which the Government finances the PSBR other than by borrowing from the monetary sector - ie. overseas borrowing is also counted as funding. On this definition overfunding over the last 6 years has totalled almost £11bn and has been around £4bn in each of the last 2 years. The chart attached shows that overfunding also has a much longer history.

10. Overfunding has not been part of the Strategy. On the contrary, the Chancellor said in his 1983 Mansion House speech that over the medium term there should be no systematic tendency to over or underfund. On each occasion when we

have looked at it (as for example we did in some depth in the summer of 1982, and again last summer) we have concluded that it would be preferable to keep £M3 on track by other means; and that ideally, over a period, we should be looking to fully fund the PSBR, and no more. But when faced in practice with the choice between overfunding, putting up short-term interest rates or allowing £M3 to grow even faster, we have often chosen the first. In the past six months, we have veered to a policy of keeping short-term interest rates high, but this has not yet done much to curb bank lending.

11. Since the abolition of the corset in 1980, bank lending has grown very rapidly indeed - roughly twice as fast as our targets for £M3. This expansion shows little sign of abating. It is partly explained by the liberalisation and increased competition which followed the removal of the corset. Despite high real interest rates, borrowers have been happy to take on extra debt.

12. The growth of lending to the corporate sector has been particularly puzzling. The company sector's financial position has greatly improved and there has been a strong revival of equity issues in the past few years (and particularly in the past few months). But neither have prevented a continuing fast rise in bank borrowing. We have taken steps to improve the prospects for corporate bonds - for example, the deep discount tax regime announced in 1984 and the new arrangements to allow shorter maturity bonds announced in this year's budget. But although there have been a few bond issues, this has not yet been on a scale to take the pressure off bank borrowing.

13. We have looked at other ways of restraining bank lending. One option - considered in the run-up to the last two budgets - was a modest consumer credit duty, but it would have been ineffective to bring in such a duty without applying it to mortgages as well. Now that we no longer have exchange controls, the reimposition of something like the corset would simply drive business offshore.

14. In the absence of other restraints on bank lending, we have felt obliged to overfund. But several criticisms have been voiced against this policy. These include:

(i) Much of the money lent by the banks - eg that to financial institutions - is not going to be spent on goods and services, but held as a financial asset. It makes little difference to the economy whether a pension fund holds an extra bank deposit or buys some more gilts.

(ii) Funding is no answer to excessive growth of bank lending to the private sector, because credit has an independent influence on the economy. Instead, we should constrain credit.

(iii) Aggressive funding is self-defeating. It raises long rates relative to short rates, further crowding private sector borrowers out of the long term capital market and stimulating the growth of bank borrowing - and thus does not reduce £M3.

(iv) Overfunding adds to the bill mountain, is costly and complicates monetary management in ways that could inflate £M3.

15. There may be some truth in all of these. But as regards (i), some part of any extra funding, particularly if it is provided by the personal sector, is likely to be at the expense of spending; and institutions, instead of holding extra bank deposits rather than gilts, may purchase property or foreign assets - both of which could have adverse inflationary consequences. And as regards (ii), it is hard to argue that reducing private sector liquidity has no effect on spending. Both of these arguments in effect question the relevance of £M3 as a target aggregate.

16. There is perhaps more force in argument (iii). By tilting the yield curve in favour of short rates, overfunding may have had some effect in adding to bank lending - rather than "sterilising" a given amount of it. But again

the argument can easily be overstated, and the attraction of overfunding is that, unless this effect were one for one, it will have enabled us to restrain £M3 at lower short term rates than would otherwise have been needed.

17. As regards (iv), it is certainly the case that overfunding has contributed to the need for money market assistance (MMA) and hence to the bill mountain. But it has only been one factor. Thus, between 1979/80 and 1984/85, whereas overfunding totalled £3½ billion, MMA increased by £16 billion. In 1984/85 MMA rose by £6 billion, against overfunding of £2½ billion. Other main factors have been borrowing by the local authorities and nationalised industries from the banks, increases in notes and coins with the public, and debt sales to the banks. All of these drain liquidity from the system, and the resulting shortages have had to be relieved in order to prevent short-term rates from rising to much higher levels. It is sometimes argued that a "neutral" funding policy would in fact be directed at avoiding any increase in MMA. Over recent years this would have involved consistent underfunding.

18. Although overfunding has not been its only cause, the growing bill mountain raises several issues:

(i) since the public sector is lending short and borrowing long, it may turn out to be costly in terms of debt interest.

(ii) the daily shortages in the money markets are now very large simply on account of bills maturing. This has made the Bank a large purchaser of bills almost every day. At times this has tended to put downward pressure on bill rates, opening up opportunities for "round-tripping". Some "round-tripping" has at times almost certainly been a factor in the growth of bank lending;

(iii) the size of the daily shortages, as explained further below, has interfered with the operation of the 1981 arrangements for daily monetary management.

19. Measures being considered for reducing the bill mountain include further encouraging nationalised industries and local authorities to borrow more from central government and less from the banks; and providing part of MMA in other forms, eg through the purchase of export paper from the banks or by making deposits with them. This switch would reduce the quantity of bills held by the Bank and hence also the size of daily shortages.

Short-term interest rates

20. The essence of the money market arrangements introduced in 1981 was that market forces should be given greater scope in determining the level and structure of short-term rates. This was to be achieved by the Bank confining their money market operations as far as possible to buying and selling bills of 0-14 day maturity (bands 1 and 2). The Bank would set the rate at this very short end and it would move within an unpublished 2 per cent band; all other rates would be left to find their own level. There was to be a continued but limited role for discount window lending at published penalty rates. The options, which include the temporary reinstatement of MLR and the so-called 2.30 arrangement, were to be used rarely if and when the authorities wanted to have a decisive effect on rates - resisting or encouraging a rate change as the case might be.

21. In practice, the 1981 arrangements have not been fully implemented for two reasons:

(i) technical - Because of the growing bill mountain the Bank have been buyers of bills almost every day and on a big scale. To take out the large shortages, they have not been able to confine their dealing to the shortest bands; and their dealing rates over the whole range up to three months have been clear to all. This has made changes in dealing rates far less frequent than originally envisaged. Any change in rates has come to be seen as

a signal of a change in the authorities' attitude (and partly for that reason has come to require Ministerial agreement).

(ii) <u>policy</u> - We have been reluctant to accept fully the degree of interest rate flexibility and market influence over base rates which had been envisaged.

22. Nonetheless, the objectives of 1981 <u>have</u> to some extent been achieved.

(i) The official hand in short-term interest rate changes has over the period as a whole been less obvious than it was previously. Market forces have played a bigger role, even though less than envisaged.

(ii) Consequently, interest rate changes have generally had a somewhat lower political profile than previously.

(iii) There has probably been less "bias to delay".

(iv) Interest rates, including base rates, have become more flexible.

23. But even had conditions been as originally envisaged it is doubtful if the arrangements could ever have operated in the way intended. There seems to have been a design fault in the arrangements. As noted earlier, the intention was to confine official operations in the bill market to bands 1 and 2, with these very short term rates acting as a "dragging anchor" on longer term money market rates. But what typically happens when the market is signalling a rise in rates is that the term structure steepens, with longer rates rising, and very short rates (out to 1 month) actually falling. So upward pressure on rates is not always felt at the maturities where the Bank was originally intending to operate. In these circumstances, dealing at unchanged rates would add to, rather than counteract, the upward pressures on longer term rates. So even if we could confine the Bank's dealings to bands 1 and 2, that would probably not be sensible.

24. Any operations by the Bank in the bill market designed to influence the crucial interbank rate are likely to open up differentials between the bill and interbank rates. Take the case when we are trying to push rates down. As long as the differential is not excessive, this leads to a shift from bank finance to bill finance, which takes the pressure off the interbank rate. But if the differential gets too large, there is an incentive to issue bills and redeposit in the interbank market. It is important to avoid this latter "round-tripping", but it should not be assumed that this is always easy when we are trying to influence rates. Even when we are not positively trying to push rates down, the sheer scale of the Bank's daily bill purchases may open up a sizeable differential. In practice there have been many occasions when we believe such round tripping will have been profitable.

25. It is sometimes argued that, because the structure of its rates changes so infrequently, the Bank inhibits moves in the structure of short term market rates; and that this process can lead to arbitrage transactions that inflate £M3. But it is mistaken to suppose that the Bank can, or does, administer the term structure of short-term market rates. Even within the bill market, where the Bank operates directly and on large scale, the structure of rates can often differ very considerably from the structure of rates at which the Bank is prepared to deal. The same is true of the structure in the more imporrant interbank market. The structure of rates at which the Bank is prepared to deal is changed infrequently, and gets out of line with the market structure, for the reason described at the end of paragraph 21(i): any change, even in the structure of dealing rates, has come to have a high profile and to be taken by a "signal" of the authorities' wishes. This rigidity on occasion limits the Bank's ability to deal in bills of some maturities. But it does not "fix" the structure of market rates.

26. It has been suggested by some that we should get back to the pure intentions of 1981. Certainly, it is desirable

to reduce one of the technical impediments - namely, the size of the bill mountain. But on two grounds at least a return to pure 1981 seems questionable:

(i) Short-term interest rates are commonly stated to be one of our main instruments of policy; yet the extent to which we have the technical means of influencing interest rates is not all that great even now. To return to pure 1981 would reduce our influence on interest rates. Certainly operating at longer maturities has given us a much better handle on the 1-3 month rates that have the largest influence in base rate decisions.

(ii) The 1981 papers assumed that the market was likely to produce interest rates that were consistent with the Government's broader objectives. Without denying that market pressures do have some informational content, there was little justification in logic for this assumption. The market can and does at times produce the "wrong" level of interest rates.

27. Nevertheless, there are arguments for permitting short rates to vary more from day to day, as was the original intention in 1981. Two particular points have been made:-

(a) If there were less certainty about the level of short term rates borrowers might be less attracted by bank borrowing, and more by longer term forms of finance. And banks might be less willing to extend loans if they were less sure of their ability to finance them - or at least to do so at an acceptable cost - by bidding for market funds (or by selling commercial bills to the market and ultimately to the Bank).

(b) An arrangement of this kind would provide reassurance that the authorities would not permit the recent growth of broad money aggregates at some point in the future to be converted into cash and spent.

28. Whether any additional reassurance of the kind suggested under (b) is needed is arguable. We already target MO. It is not true to suggest that the Bank are prepared to supply unlimited liquidity to the market at a fixed price. They limit their daily purchases of commercial bills to the quantity calculated as required to prevent an unwarranted contraction in the monetary base or rise in short term rates. If there were signs of the rise in the wider aggregates being converted into an undue increase in MO - or into other forms of narrow money which we also watch - then we would take offsetting action, allowing interest rates to rise. In any event liquidity can be turned into spending without that necessarily requiring a rise in MO or Ml. If the concern were about the apparent lack of an <u>automatic</u> mechanism, then arguably the exchange rate is likely to provide one. For any sudden encashment or spending of £M3 balances would almost certainly be reflected also in sharp movements across the exchanges, and a sharp fall in the £ - which would tend of itself quickly to bring about a rise in short term interest rates.

29. There are certainly some arguments for allowing greater variability in - and thereby injecting greater uncertainty about - short term interest rates. But some of the argument in (a) seems overstated. Since banks lend at variable rates they are (unless the maturities of their assets and liabilities are unmatched) protected against a general rise in market rates. In addition to the points in (a), there is also the argument that more uncertainty and variability in overnight rates could make short term currency speculation a more risky operation, and increase the range of weapons available to the authorities to discourage such speculation. Against that, greater variability in short rates would almost certainly mean more frequent movements in base rates. And we would have to accept less influence over their size and timing.

30. The extreme form of arrangement likely to involve greater interest rate flexibility would be a move to some form of monetary base control (mbc), with the Bank following a wholly quantitative operational rule. We have always seen such a move as likely to give rise to considerable transitional

problems. Banks would certainly require greater operational cash balances than they do now, so - unless the aim were to tighten policy - the change would require some increase in the monetary base. But there is no way of telling in advance how large that increase would be. Nor is there any reason to think there would be fixed relationship between that base and the broader measures of money. We have seen simple forms of mbc as likely to lead to sharp fluctuations at lease in very short (overnight) interest rates, which would bring institutional changes in their train. Although some of these, such as an end to the overdraft system, might be positively welcome, there would be difficult transitional problems, significantly distorting the monetary indicators. We have always seen such transitional difficulties as ruling out a rapid move to mbc.

31. That leaves the question, if it were desired to make a move in that direction, are there any possibilities short of fully fledged mbc? Could the Bank, for example, simply on occasion operate so as to require the market to borrow from it at penal rates? This would involve operating initially during a day so as to relieve less than the predicted money market shortage (under-assisting), thereby forcing up short term rates and forcing the market to borrow from the Bank at the end of the day.

32. It is perhaps important to emphasise that this would not, or should not, involve <u>regularly</u> under-assisting, by only meeting part of the daily shortage and lending some tranche of daily assistance at a penal rate. That would only be appropriate when - perhaps because MO had been growing fast, or sterling had fallen sharply - we felt that short term rates should rise and that market conditions should be tightened. It is indeed possible that on occasions we would want to <u>over</u>-assist, and seek to push rates down or prevent a rise - though our experience is that trying to prevent a strong upward market move in rates by such tactics is likely to be counter-productive.

33. Like a move to fully fledged mbc, but to a lesser degree, we could face transitional problems with such a change of

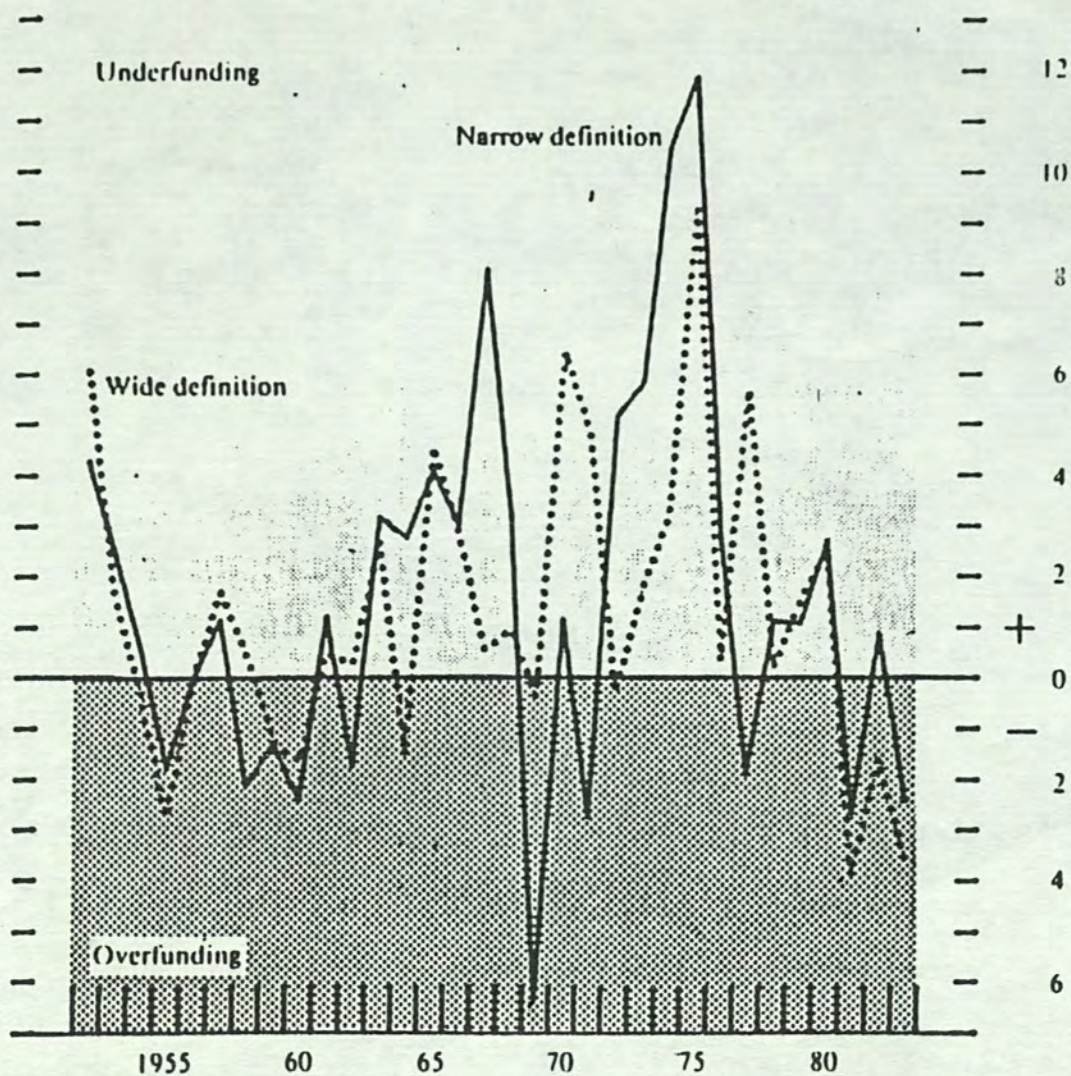
tactics. Banks might wish to increase their reserves of cash somewhat, changing the significance of MO. More generally, more frequent base rate moves might be unsettling to industry. But arguably these effects should not be too sharp if we were to make what at first might be only fairly minor changes in the Bank's operating techniques.

34. While it is not difficult to envisage money market operating techniques being changed in this way, it is perhaps harder to see what operating rule the Bank would follow. With a fully fledged mbc system it is simply a question of operating so as to keep the growth of the monetary base on a predetermined track. Even then there is a question - as is clear from the description of other countries' arrangements in Annex I - of how far to operate on a day-to-day basis, or how far (for example like the Swiss) to try to keep the base on track over a longer period, permitting short-term variations. The latter would not necessarily lead to any great increase in short-term fluctuations in interest rates. In Switzerland the normal variability of very short term interest rates appears little different from in the UK. Had we operated such a rule over the last year, in relation to MO, it is indeed not clear that the Bank would or should have operated in any different way than in fact they did: on this criterion the amount of assistance given to the market has proved about right.

35. The conclusion is that we could, if we wished, bring about more variation in short-term interest rates than hitherto. It would be possible for the Bank to over or under assist the market day by day and lend at penal rates, on occasion, at the end of the day. Before introducing such a change in the Bank's operations it would be desirable to reduce the size of the daily market shortages by measures of the kind described in paragraph 19. There could be some benefits, but against those we might have to accept greater variability in base rates, and less control over their extent and timing than we have exercised recently. No doubt an operational rule for deciding when to under (and when to over) assist could be devised. But

if the focus were on the trend growth of MO it is not clear that an operational rule related to that would in fact have caused any greater movement in short-term rates than we have actually seen over the last year or so.

Chart
Funding of the PSBR



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ANNEX III

TABLES AND CHARTS

Table 1: Monetary aggregates, exchange rate inflation, money GDP and PSBR/GDP ratio, since 1969-70

Table 2: Fiscal deficits in 7 major countries, 1979-1985

Chart 1: Monetary growth and inflation since 1970

Chart 2: Assets prices (house and land prices) since 1970

Chart 3: MO and money GDP since 1965

Chart 4: £M3 and money GDP since 1965

Chart 5: Velocity of £M3

Table 1

MONETARY TARGET AGGREGATES, EXCHANGE RATE, INFLATION AND PSBR/GDP RATIO : 1969-70 to 1984-85

	MO*	£M3*	£ EXCHANGE RATE[1]	INFLATION[2]	MONEY GDP	PSBR/GDP RATIO
1969-70	2.9§	1.7+	127.3	5.0	7.4	-1.2
1970-71	13.0	12.6+	127.3	8.5	10.6	1.5
1971-72	[- 1.0**]	16.9+	127.1	8.0	11.5	1.6
1972-73	14.8	26.5	128.8	7.9	13.8	3.6
1973-74	10.8	22.8	114.6	12.7	11.0	5.8
1974-75	15.7	8.1	107.2	20.3	18.7	8.9
1975-76	9.7	7.3	105.1	22.5	24.1	9.2
1976-77	10.6	6.2	94.0	16.5	16.8	6.4
1977-78	13.9	14.6	80.9	9.5	16.4	3.6
1978-79	14.8	11.2	84.8	9.6	14.6	5.4
1979-80	10.0	12.4	82.4	19.1	19.8	4.8
1980-81	6.5	19.1	93.0	12.7	13.8	5.4
1981-82	2.7ø (3.7)	13.6	101.4	11.1	10.1	3.3
1982-83	5.3	9.8	91.1	4.9	9.4	3.1
1983-84	5.7	9.8	80.6	5.1	7.9	3.2
1984-85	5.3	9.3	81.7	5.5	7.0	3.1

* Mid-March to Mid-March

1 Q1 level

2 RPI: Q1 on previous Q1

\+ Q1 on previous Q1

ø This figure is distorted by the change in the definition of MO in September 1981, after which date non-operational balances were excluded from MO. The figure in brackets is the estimated change adjusted for the change in definition.

** Prior to September 1971 the clearing banks agreed to hold at least 8% of total assets in the form of till money plus bankers balances. Thereafter under the Competition and Credit Control regime banks held 1½% of their eligible liabilities as non-interest bearing balances at the Bank of England. The net result was a large reduction in till money plus bankers' balances and hence in MO.

§ June on previous June.

CW

TABLE 2

CENTRAL GOVERNMENT
FISCAL DEFICIT AS PERCENT OF GDP

	1979	1980	1981	1982	1983	1984	1985
Canada	1.8	2.7	1.6	5.0	6.2	5.8	5.0
US	(0.6)	1.2	0.9	3.8	4.1	3.4	4.4
Japan	4.8	4.2	3.6	3.4	3.3	2.4	1.7
France	0.7	(0.3)	1.8	2.6	3.3	3.3	3.3
Germany	2.8	3.1	3.9	3.4	2.7	2.3	1.7
Italy	9.5	8.0	11.9	12.7	11.8	13.5	12.2
UK	3.3	3.7	3.1	2.4	3.5	3.4	2.8

IMF figures ( ) = Surplus

Chart 1

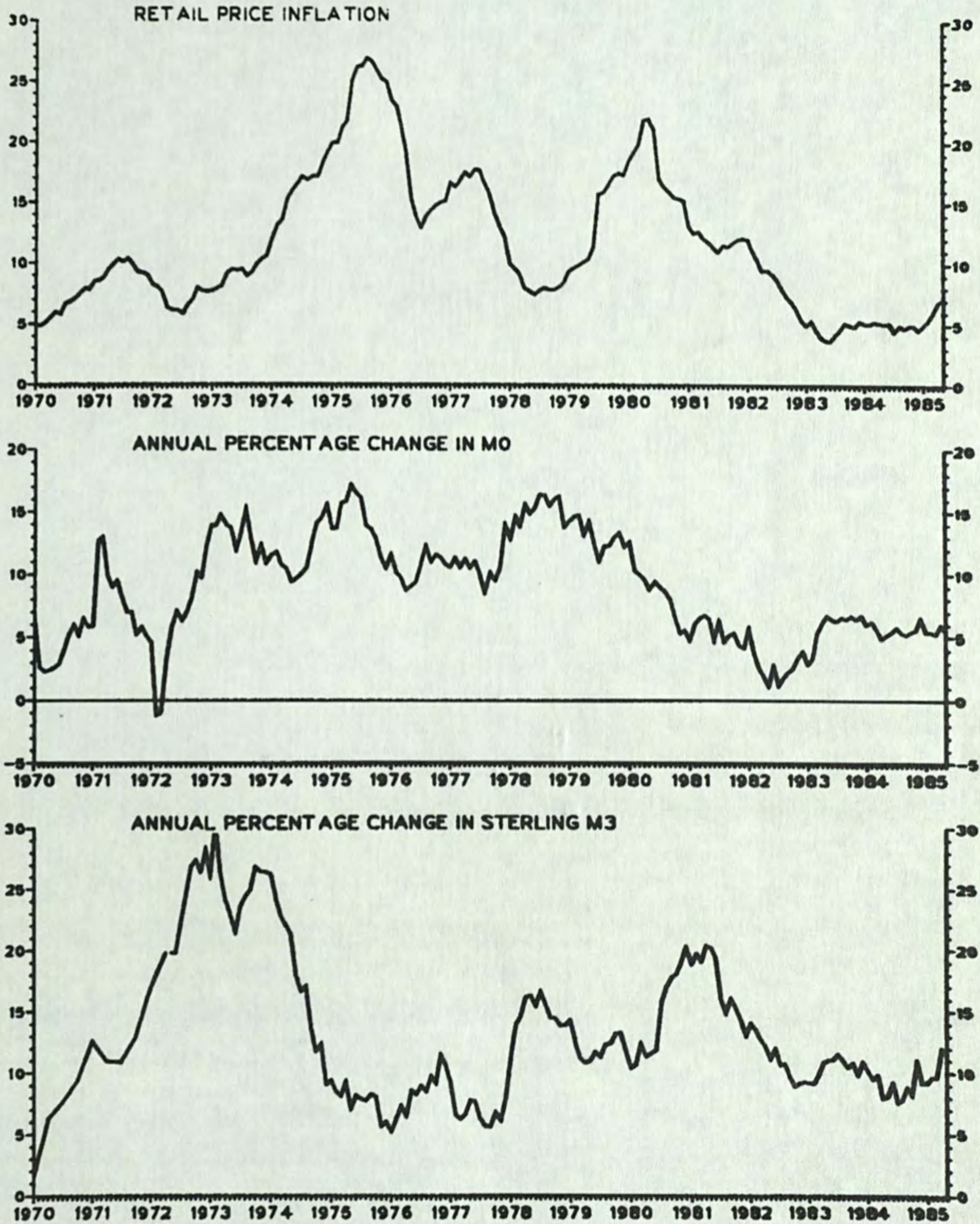


Chart 2

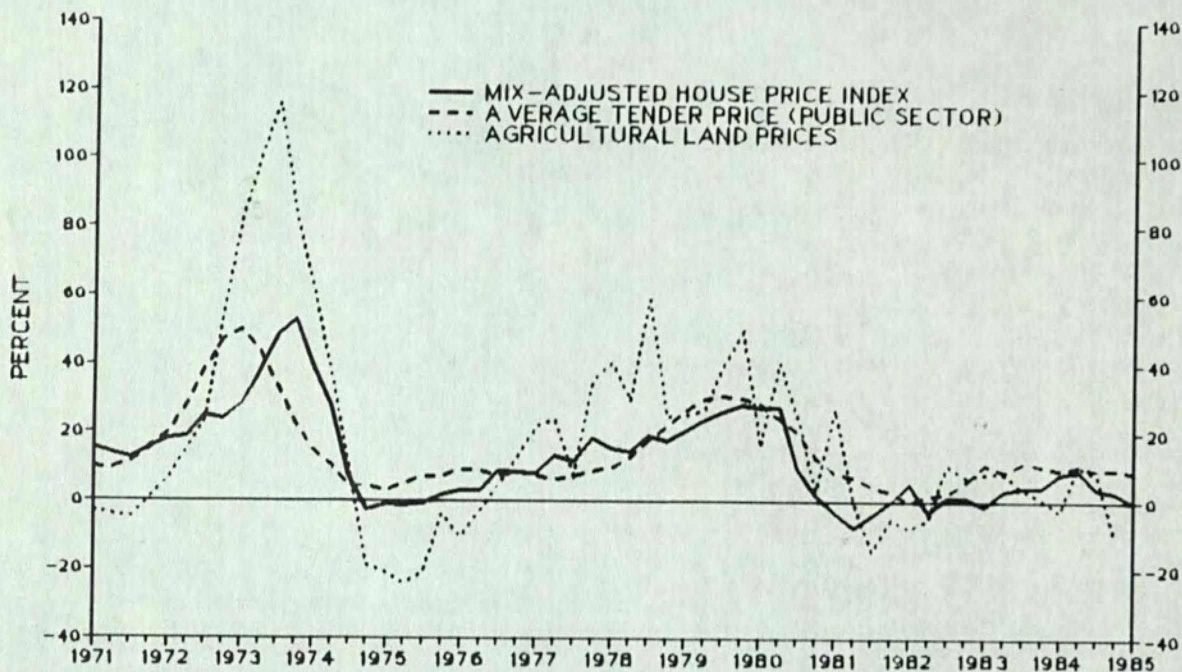
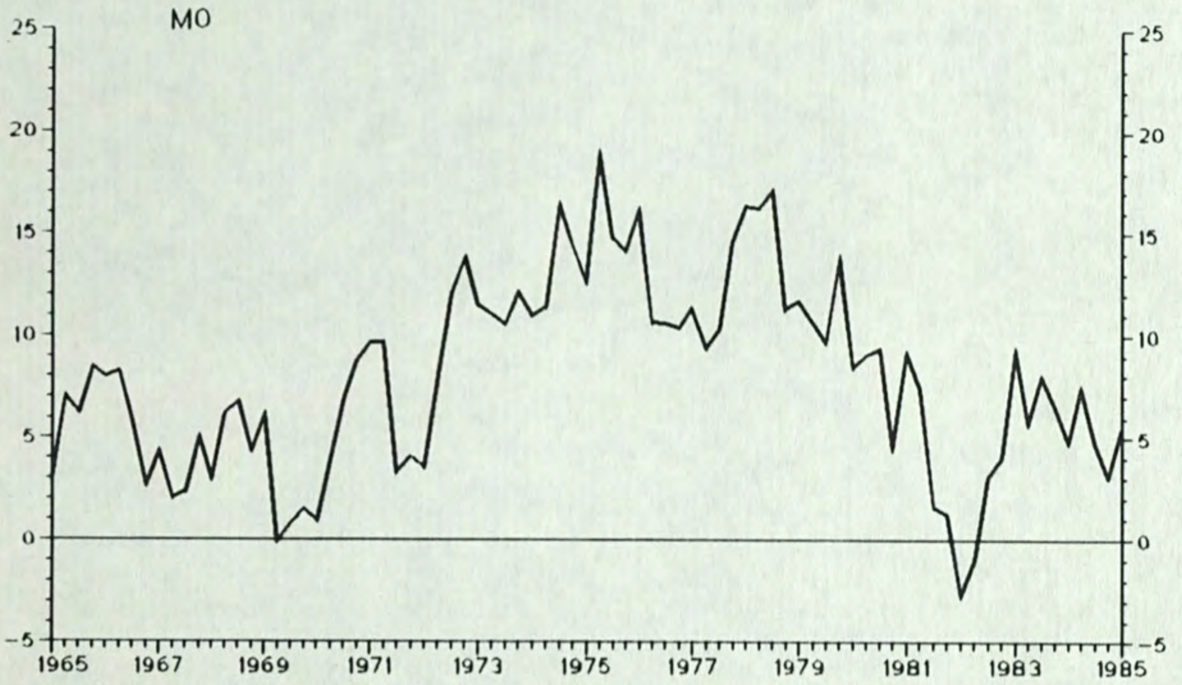


Chart 3



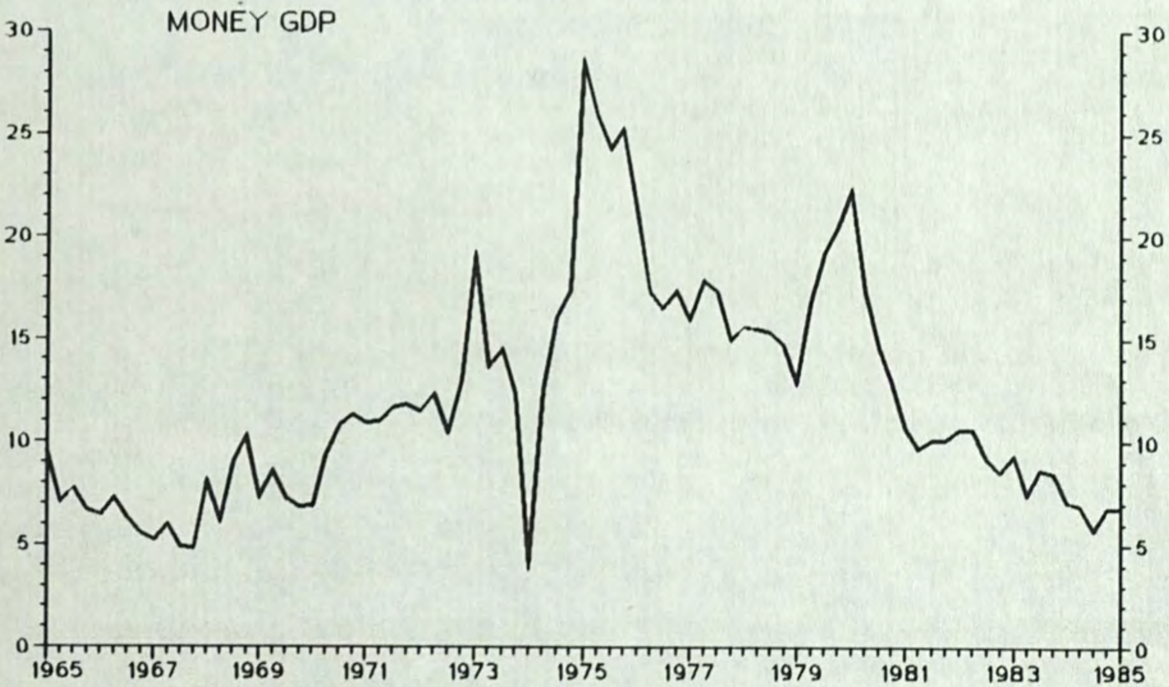
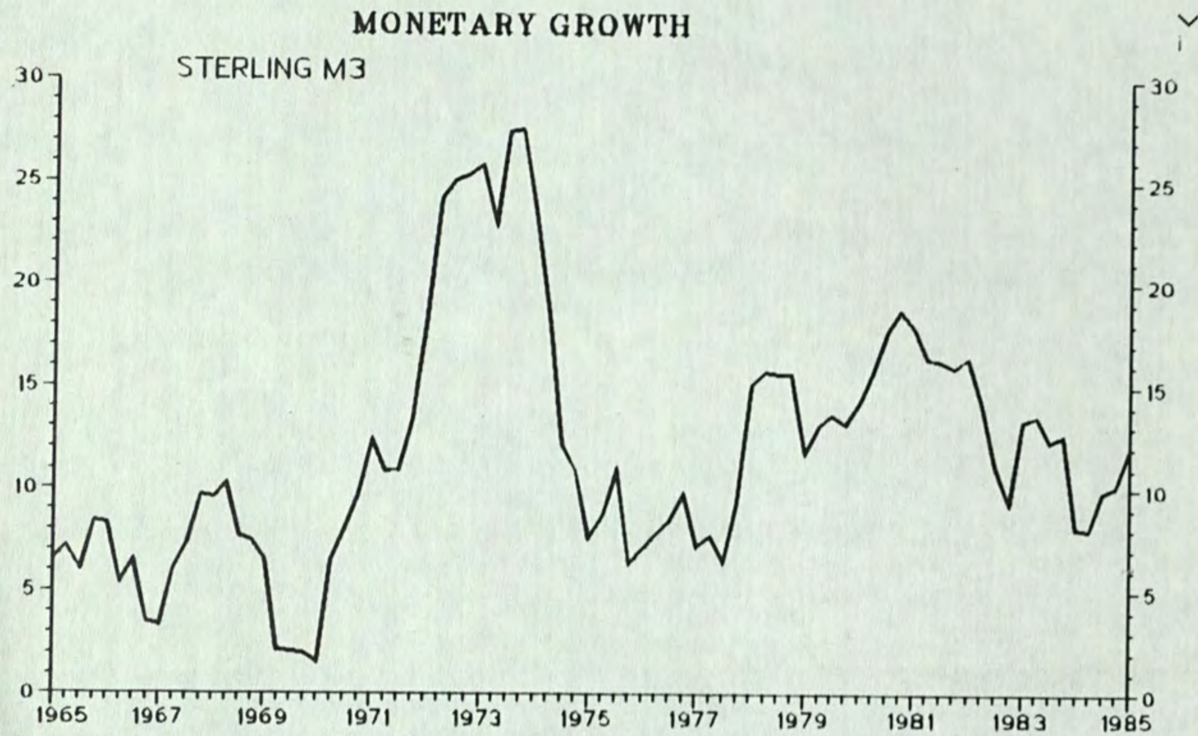


Chart 4

MONETARY GROWTH



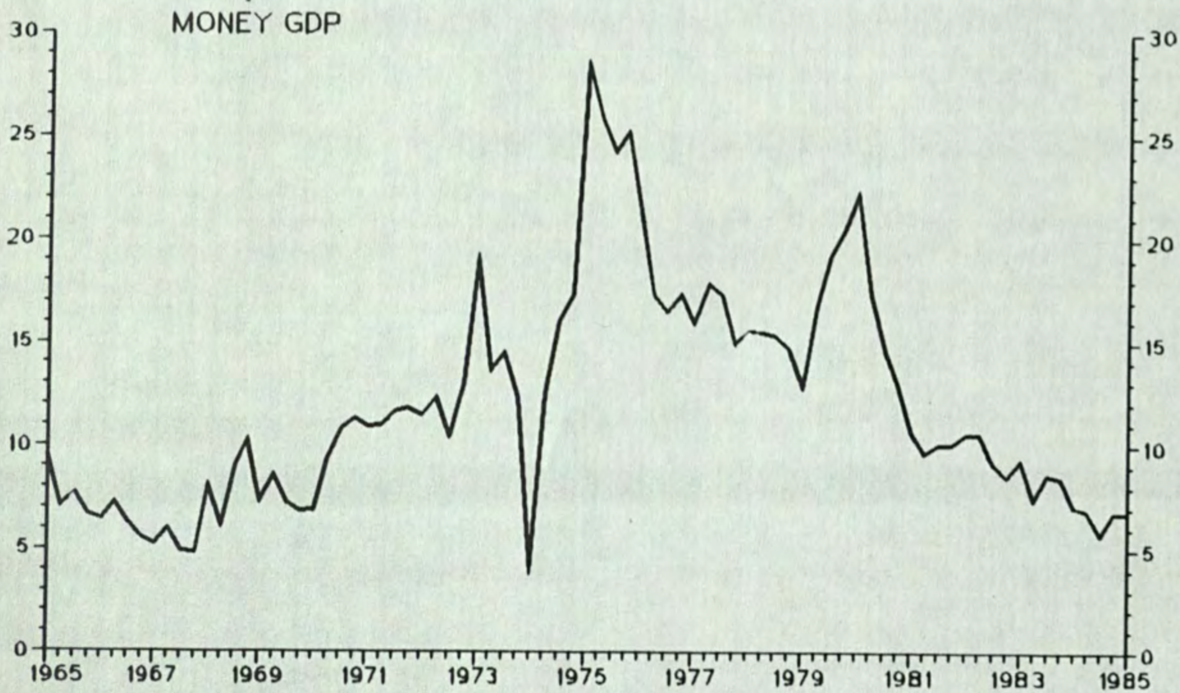
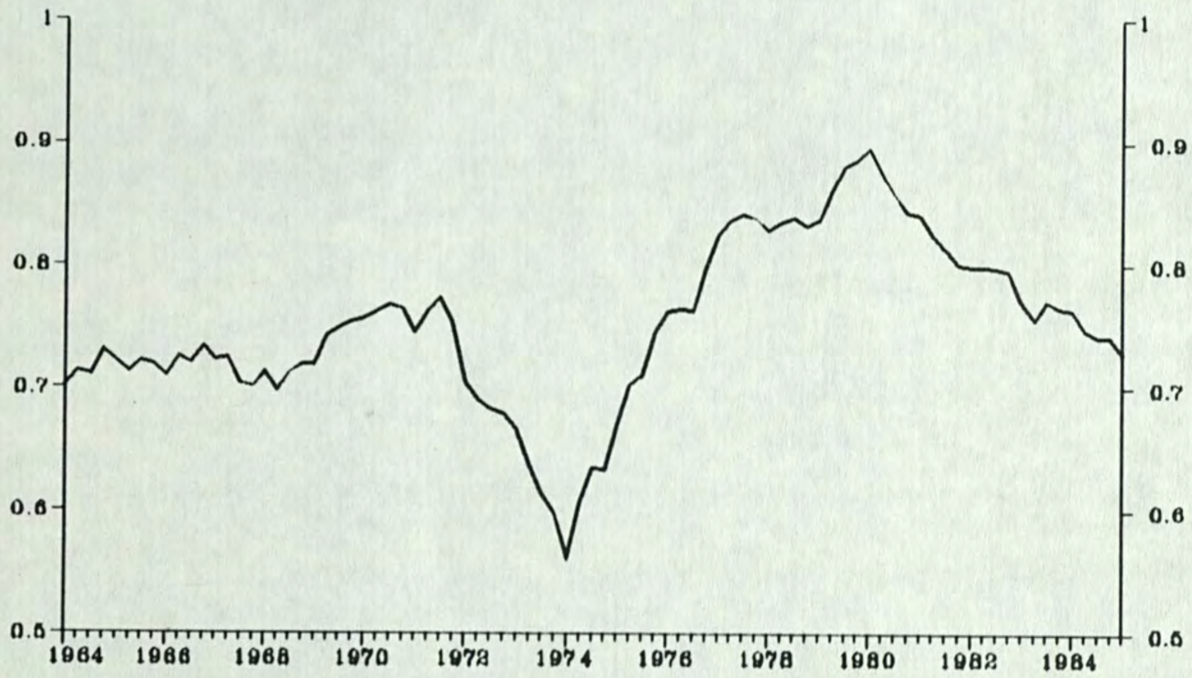


Chart 5



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H. M. TREASURY

Parliament Street, London SW1P 3AG, Press Office: 01-233 3415
Telex: 262405

20 June 1985

BANKING SUPERVISION AND JOHNSON MATTHEY BANKERS

The Chancellor of the Exchequer, the Rt Hon Nigel Lawson MP, made a statement today in the House of Commons on banking supervision and Johnson Matthey Bankers (JMB).

The Chancellor said that he was satisfied that in rescuing JMB the Governor was acting properly within his discretion. The cause of JMB's collapse had been serious management shortcomings within JMB. But the Bank of England supervisors could not escape criticism for failing to respond more quickly to the danger signals.

The Chancellor announced that he would consider very carefully the report, published today, of the Committee set up to review banking supervision. The Committee's two main recommendations are that:-

- the two-tier system of authorisation, distinguishing between recognised banks and licensed deposit-takers, should be abolished, and the powers given to the Bank under the Banking Act should apply to all authorised institutions.

- there should in future be a regular dialogue between the Bank of England supervisors and banks' auditors.

PRESS OFFICE
H M TREASURY
PARLIAMENT STREET
LONDON SW1P 3AG
01 233 3415

96/85

NOTES TO EDITORS

The Bank of England acquired Johnson Matthey Bankers (JMB) on 1 October 1984.

On 17 December 1984 the Chancellor of the Exchequer announced in the House of Commons that a Committee would be set up under the Chairmanship of the Governor consisting of senior Bank and Treasury officials and a senior outside expert, Mr Deryk Vander Weyer, to consider the present supervisory system and whether any early changes in supervisory procedures were called for in the light of the problems which had arisen in JMB. The Committee's Report is published today as Cmnd 9550.

The Bank of England has today published (as an annex to its Annual Report and Accounts) a note on the events leading to the failure of JMB, the subsequent rescue by the Bank, and the Bank's conduct of JMB's affairs since 1 October 1984.

BANKING SUPERVISION AND JOHNSON MATTHEY BANKERS

In my statement on 17 December, I told the House that the Johnson Matthey Bankers affair raised important issues about our present procedures of banking supervision, and the legislative framework within which it is conducted. I announced a full review, which would consider whether any early changes in present supervisory procedures were called for in the light of the problems which had arisen in Johnson Matthey Bankers, and whether there was a need to review or amend the Banking Act 1979.

2. The Review Committee has now presented its report, which I have arranged to be published as a Command Paper and have laid before the House. I shall be considering the Committee's proposals carefully. In the meantime, I have accepted the report as a basis for immediate consultation. Many of the recommendations do not require legislation. Some are already being implemented. But some of the Committee's proposals do require fresh legislation. I therefore propose to publish a White Paper later this year, with the intention of bringing a Banking Bill before the House as soon as possible. The group of Treasury and Bank officials which I set up under the Review Committee's terms of reference is continuing its detailed examination of the Banking Act 1979.

3. I am most grateful to the Governor of the Bank of England, who has chaired the Review Committee, and to its members, who comprised senior officials of the Bank of England and the Treasury, and a distinguished commercial banker, Mr Deryk Vander Weyer.

4. A note by the Bank of England on events leading to the failure of JMB, the subsequent rescue by the Bank, and its conduct of JMB's affairs is annexed to the Bank's Annual Report and Accounts, which have been laid before the House today.

5. The Bank's account makes it clear that serious shortcomings in the management of JMB led to its collapse - over-rapid expansion of the loan book, heavy concentration of exposures, and lack of

adequate control systems. JMB was also guilty of serious misreporting to the supervisory authority.

6. The circumstances described in the Bank's report must inevitably raise questions about the role of the auditors, Arthur Young. The board of JMB, which is a wholly-owned subsidiary of the Bank of England, has today announced that it will be initiating legal action against Arthur Young.

7. The Bank's account also explains its reasons for rescuing JMB. In mounting the rescue, I am satisfied that the Governor was acting properly within his discretion.

8. The board of JMB now estimates the company's losses at £248m. Of this £130m has been met by JMB's original capital, reserves and provisions, and £50m by a cash injection from Johnson Matthey plc, the former parent company. The rest of the losses are to be met from the indemnity of £150m, split pound for pound between the Bank of England and a group of private sector banks and members of the London gold market. Potential claims on the indemnity to date thus amount to £68m, of which £34m falls to the Bank. Though in many instances recoveries will be only over the long term, JMB's present board of directors are satisfied that the total eventual calls on the indemnity will fall comfortably within the £150m ceiling.

9. Since JMB is now its wholly owned subsidiary, the Bank of England of course stands fully behind it. On 22 November the Bank placed a deposit of £100m with JMB, which has since been converted into £100m of additional capital to strengthen JMB's balance sheet. This will, of course, be fully reflected in the price the Bank of England receives for the sale of JMB back to the private sector, which it plans to conclude as soon as practicable.

10. The Review Committee has made 34 specific recommendations. Their implementation will require action by the Bank of England, supervised institutions, their auditors and the Government. The Committee proposes two fundamental changes in the present arrangements, and several important modifications. It has taken the view, which I share, that the JMB case exposes serious

shortcomings in the present legislative framework and supervisory procedures. I shall in my statement outline only the Committee's main proposals. A full summary of their recommendations is annexed to their report.

11. The Banking Act 1979 draws a distinction between recognised banks and licensed deposit-takers. JMB was, and still is, a recognised bank.

12. Most of the Act's provisions, and of the Bank's powers set out in it, relate to licensed deposit-takers. A dual system of supervision has resulted. Licensed deposit-takers have been subject to a more rigorous regime of supervision, whereas the supervisors have relied heavily on the integrity and co-operation of the management of recognised banks. With most banks, this confidence has not been misplaced. But the banking industry has expanded rapidly, and its activities have diversified. Recognised bank status - as we have seen with JMB - has not always guaranteed prudence and responsibility.

13. The Committee recommends that the two-tier system be abolished and that the powers given to the Bank under the Act should apply to all authorised institutions. I accept this recommendation. The Committee accepts that all authorised institutions would in consequence be entitled to use banking names.

14. I also intend to tighten the criteria for authorisation, including the minimum net assets required.

15. The second fundamental change recommended by the Review Committee concerns bank auditors. In this context, I am grateful to the Institutes of Chartered Accountants of England and Wales and of Scotland for the co-operation they have afforded the Committee.

16. The Committee recommends that there should in future be a regular dialogue between the supervisors and banks' auditors. I strongly endorse this proposal.

17. A bank's auditors are uniquely placed to monitor its control systems and assess its financial prudence. The accountancy profession at present considers itself prevented by a duty of confidentiality to the client from passing information to the supervisors. At the same time, the supervisors are themselves inhibited by the Banking Act from communicating supervisory information to third parties without the institution's consent.

18. This is clearly an unsatisfactory state of affairs. It is in cases where consent is not forthcoming that dialogue might be most necessary. This is why I accept the Committee's recommendation that the constraints on contact between auditors and supervisors be removed.

19. I emphasise, however, that it is the directors and senior managers of banks who are responsible for the conduct of their business. They have duties both to depositors and to shareholders. This responsibility cannot be shuffled off to auditors or supervisors. The overriding lesson of the JMB collapse is that banks must have in place adequate management and control systems. I therefore endorse the Committee's suggestion that banks should appoint an audit committee and finance director where they do not already have them.

20. The Committee has also made important recommendations on the staffing and organisation of the Banking Supervision Division of the Bank of England.

21. The work of the Supervision Division has increased greatly in both complexity and volume in recent years, and the Bank of England now supervises over 600 institutions. In general it does a difficult job diligently and well. But in the case of JMB the supervisors cannot escape criticism for failing to respond more quickly to the danger signals.

22. The Committee has recommended that the staff of the division would benefit from wider commercial experience; that there should be more secondments in both directions between the division and commercial banks; that a significant cadre of experienced long-term

banking supervisors must be built up; and that there should be more professionally qualified accountants in the division. It has suggested that more staff are needed.

23. The Bank has already begun to implement these recommendations. The division is being strengthened both in numbers and in the range of expertise available. Some rearrangement of responsibilities has taken place within the division and further secondments to and from commercial banks have been arranged. To provide advice at a senior level, Mr Sidney Procter, Chief Executive of the Royal Bank of Scotland Group, who retires from that position on 30 September, has accepted the Governor's invitation to serve on a part-time basis as an adviser on banking supervisory issues.

24. JMB's failure stemmed directly from a number of large, related exposures. The Committee recommends - and the Bank of England has accepted - that in future no exposure to a borrower, or to closely related borrowers, should exceed 25 per cent of the lender's capital base, other than in the most exceptional circumstances.

25. An effective system of banking supervision is essential not merely for the protection of depositors but for the financial health of the economy as a whole.

26. The Review Committee's report brings out very clearly the lessons to be learned from the collapse of Johnson Matthey Bankers. But more than that, it proposes a number of important changes to banking supervision in this country, which I am confident will greatly strengthen the system and make a repetition of the JMB affair very much less likely to occur. I commend it to the House.

Bank of England

Press Notice

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

The Bank of England's Annual Report, laid before Parliament today, contains an annex commenting on Johnson Matthey Bankers Ltd (JMB). This draws attention to the deficiencies revealed in JMB's operations prior to its acquisition by the Bank last September.

The decision has been taken by JMB, after legal advice, to make a claim for damages against Arthur Young, who were its auditors until they agreed to resign on 30 January 1985. The claim is likely to be substantial. Because of this proposed litigation neither JMB nor the Bank is able to comment further on aspects of JMB's affairs which may have a bearing on the claim.

The annex also contains references to the proposal to recapitalise JMB. Following the approval of the High Court, the recapitalisation has now been effected and the Bank of England's deposit of £100 mn repaid.

20 June 1985.

Bank of England
Press Notice

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

CONFIDENTIAL UNTIL PUBLICATION

Bank of England Report and accounts for the year ended 28 February 1985

The *Report and accounts* is to be issued on Thursday 20 June following a statement by the Chancellor of the Exchequer in the House of Commons concerning Johnson Matthey Bankers Limited (JMB); a note on JMB is annexed to the Report.

The Bank's *Report* starts with a foreword by the Governor and goes on to describe operations and activities of the Bank during the year other than those concerned with the conduct of domestic monetary policy and external policy which are the subject of regular commentary in the *Quarterly Bulletin*. The three sections cover the Bank's management of the stock register and note issue (pages 7—9); other developments, including the Bank's involvement in changes taking place in payments systems, regulation of the securities industry and the gilt-edged and money markets (pages 10—11); and internal administration (pages 13—14).

The Bank's *accounts* (pages 15—30) show an operating profit for the Banking Department of £37.7 million, after provision for payments to be made under an indemnity given to JMB, compared with £65.3 million in 1983/84. After a payment to H M Treasury in lieu of dividend of £25.3 million (£21.7 million in 1983/84) and a tax charge of £4.9 million (£31.8 million in 1983/84), the profit transferred to reserves was £7.5 million (£11.8 million in 1983/84); on a current cost basis the profit before tax and dividend was some £9 million less than in the historical cost accounts. As stated by the Chancellor in the House of Commons, the payment in lieu of dividend has been determined in a way which is unaffected by the impact on the Bank of its liability to make payments to JMB under the indemnity.

The *Issue Department* accounts (page 30) show that the profits of the note issue, payable to the Treasury, amounted to £1,089.8 million (£1,198.0 million in 1983/84).

An annex to the Report (pages 31—42) describes the circumstances surrounding the failure of JMB and its acquisition by the Bank for a nominal consideration at the end of September 1984. This annex is in five parts. The first section outlines the development of JMB's business, particularly between 1980 and 1984, and discusses the causes of its failure. The Bank's supervision of JMB is then described and lessons drawn about ways the present system of supervision could be improved. Details of the rescue operation are given in the third section which is followed by an explanation of the reasons for the rescue. The annex concludes with an account of the Bank's stewardship of JMB since acquisition.

The annual report of the Bank on its supervisory activities under the Banking Act 1979 appears on pages 43—63. A section on supervisory developments notes the trend towards the formation of integrated financial services groups. The Bank's review of its approach to the consolidated supervision of groups containing a bank is discussed. The terms and treatment of subordinated debt issues are considered from the point of view of measuring capital adequacy, and off balance sheet risks are also discussed.

As in previous years the report includes a section on the interpretation and application of the Banking Act. At the end of the year, 605 institutions were authorised under the Act: 28 institutions were granted licences during the year and 6 were granted recognition as banks; 2 institutions had their deposit-taking authority revoked by the Bank and 14 surrendered their authority. During the year criminal proceedings in respect of illegal deposit-taking under Section 1 of the Act were concluded in two cases.

June 1985

The Bank of England and Johnson Matthey Bankers Limited

The Bank of England and Johnson Matthey Bankers Limited

This note is divided into five sections. First, the developments in Johnson Matthey Bankers Limited (JMB) up to September 1984 and the reasons for its failure; second, the Bank's supervision of JMB; third, the rescue operation which was mounted at the end of September 1984; fourth, the reasons for rescuing JMB; while the final section outlines the developments which have taken place since the Bank acquired JMB.

I The development of the business of JMB

JMB was established in 1965 to conduct the banking and bullion business of Johnson Matthey & Co.Ltd (now Johnson Matthey p.l.c.). It became an authorised bank under the Exchange Control Act in 1967 and obtained exemption under the Protection of Depositors Act in 1970. JMB was already being supervised by the Bank before the Banking Act came into effect. After the Banking Act came into effect, JMB was granted authorisation as a recognised bank in April 1980. As one of the five members of the London gold fixing, its business at that time was mainly concentrated on bullion and foreign exchange dealing, with the commercial banking side of the business specialising in trade finance. This spread of business was sufficient to enable JMB to obtain recognition under the normal criteria for a bank providing a wide range of banking services. (The provision of foreign exchange services and trade finance are two of the services required to be provided under the Act for authorisation as a recognised bank.)

Growth of the balance sheet

Total assets of the bank and its subsidiaries in 1980 were £874 million, of which bullion stocks and customers' dealing and metal accounts amounted to £678 million and commercial loans and overdrafts only £34 million. In 1981, the bank began to expand and diversify its loan portfolio. JMB's traditional trade finance business had tended to be based on connections with Pakistan, the Middle East and Nigeria and these areas provided a number of the customers for its expanding lending operations.

The balance sheet of the bank and its subsidiaries, set out in its annual accounts, more than doubled between March 1980 and March 1984 (broadly in line with those of other banks, in aggregate) by which time total assets stood at £2.1 billion (Table 1).

Table 1
£ millions

At end-March	1980	1981	1982	1983	1984
Loans and overdrafts	34	78	135	184	309
Holdings of bullion and customers' bullion-related accounts	678	786	804	1,226	1,359
Total assets	874	1,040	1,183	1,735	2,089

Commercial lending, in the form of loans and overdrafts, grew during the four years much faster than the overall balance sheet. Letters of credit, guarantees and acceptances outstanding also increased rapidly from £18 million in 1980 to £65 million in 1984. Nevertheless, JMB remained very much a specialised bullion trading bank: holdings of bullion and customers' bullion-related accounts, which had amounted to around three quarters of the bank's assets in 1980, still amounted to around two thirds of them at end-March 1984. Although the lending book had been increased markedly, no serious attempt was made to broaden the base of the banking services into, for example, corporate finance or investment management. The JMB group did however diversify to some extent into other financial services by purchasing subsidiaries engaged in soft commodities broking (in the United Kingdom, the United States and Singapore), insurance broking (United Kingdom and United States) and asset management (United States). The bank did not become involved in large scale financing of sovereign borrowers from developing countries.

Profits and provisions

According to its audited annual accounts, the JMB group's return on shareholders' funds was well over 20% between 1980 and 1983, and the return on total assets varied between 1.1% and 1.6%. This performance compared favourably with that of other banks. During the period between 1980 and 1984 well over three quarters of its profits came from bullion dealing and from sterling and foreign exchange operations partly connected with such dealing (Table 2). In the year to 31 March 1984 total profits fell, with the return on shareholders' funds declining to 9% and on total assets to 0.4%. The fall was attributed in the bank's annual report to 'flat conditions in world bullion markets, intense commission-reducing competition for base metal and commodity futures business, and growing trading problems for our banking customers at home and abroad'.

Table 2

£ millions

Year to end-March	1980	1981	1982	1983	1984
Pre-tax profits	14.4	11.6	16.6	24.3	9.4
of which:					
Dealing (including bullion operations)	13.4	10.0	14.7	20.8	8.9
Banking	1.0	1.6	1.9	3.5	0.5

It was the policy of the JMB board not to make specific bad debt provisions, but rather to write off directly any bad debts. A general provision of £8.0 million was maintained from May 1981 until March 1984. In JMB's quarterly return for June 1984, the Bank was informed that the general provision had been increased to £12.0 million, as from March 1984. After the Bank acquired JMB, it discovered that the general provision had in fact been increased to some £16 million[1] and that part of the general provision was in fact earmarked against a long-standing claim related to an earlier bullion trading transaction. As such this part was more in the nature of a specific than a general provision.

The causes of the failure

JMB entered into several large exposures, each of them equivalent to over 10% of the bank's capital base, as part of its banking operations. The two largest commercial debtors which eventually precipitated the crisis had been customers of JMB for several years; both were loosely associated groups of companies run by businessmen from Pakistan. By June 1983 the sizes of the exposures to these debtors were equivalent to 26% and 17% of JMB's capital base respectively. They had grown to 51% and 25% of capital base by December 1983. They continued to grow rapidly during the first half of 1984, reaching some 76% and 39% of JMB's capital base, respectively, in June 1984. The differences between the actual exposures and the levels reported to the Bank are set out on page 25. The total loan book also grew very rapidly in 1984 increasing by over a third, in sterling terms, in the six months between end-March 1984 and the time of the rescue. (The larger part of this rise reflected an increase in JMB's lending but since much of this was in US dollars, the total was also affected by the downward movement in the sterling/US dollar exchange rate in this period.) Many of JMB's other debts have since proved to be bad or doubtful, including some other large exposures.

In 1984 problems began to arise with the two large exposures. JMB was faced with a familiar banker's dilemma of deciding whether to lend more to help the customer trade out of its problems or to refuse further credit and bring about the customer's failure. JMB chose the former course.

The roots of JMB's problems were, however, more deep-seated. The loan book had grown very rapidly since 1981 and it has become clear since JMB's acquisition by the Bank that the controls and systems were inadequate; that the organisation and management of the commercial banking and credit monitoring activities had serious shortcomings; and that insufficient attention had been given to the concentration of risks involved. Security was not required from borrowers when this might have been expected under normal banking practice; and even when security was required the steps necessary to

(1) The figure of £20 million for general provisions as at March 1984 given in a press release issued by the Bank of England on 13 May 1985 includes certain debts which had previously been written off in accordance with JMB's normal policy but which have been written back into the accounts and provided against for the purposes of the indemnity arrangements referred to on page 30.

give the bank title to the security were not always taken properly. The need for provisions against bad and doubtful debts was not assessed with the proper degree of caution. The judgement of management in approving so many loans which have required substantial provisions was clearly defective. However, no evidence of fraud by the directors or staff of JMB has been discovered, except in one case dealt with before, and immaterial to, the collapse. Lending against bullion was not a factor in the loan losses. (Further references to the problems and shortcomings which the new, post-September 1984, management discovered in JMB will be found in the last section of this note.)

II The Bank's supervision of JMB

In 1981 and the first half of 1982 JMB's capital ratios were more than adequate and, even allowing for the nature of its business, left room on the Bank's normal criteria for an appreciable expansion of the balance sheet. The ratios weakened during late 1982 and the first half of 1983 before stabilising at the level which prevailed until the late summer of 1984. At that level they were still in line with those of many other banks.

Until the year ending on 31 March 1984, JMB's profit performance had been good and the Bank's knowledge of their bad debt experience, up to and including that year, gave no indication of any sizable problems. The annual accounts carried unqualified audit reports and included a note that 'Provision is made for all known doubtful debts'. The Bank was told by JMB's management of downward revisions to their profit forecasts for the year to 31 March 1984, which were confirmed by lower profits reported on the quarterly returns. These were blamed on quiet trading in the bullion markets. Profit forecasts were not being reduced as they should have been, because the extent of the provisions required was not recognised by the management.

Particular attention was devoted at regular prudential interviews to discussing bullion trading, which was the dominant part of JMB's business. The Bank drew JMB's attention, in the course of 1983, to some concerns it had about the adequacy of its liquidity position. Management responded positively and the position was improved over the following months. Inadequate liquidity was not a serious problem at the time of the crisis. Also during 1983, there was a rapid increase in lending to JMB's commodity subsidiaries. The Bank took up with JMB's management the scale of the exposures, which suggested weak controls in the bank, and the exposures were substantially reduced after the Bank had made clear its concern about them. In the five months, October 1983 to February 1984, the Bank held three meetings with JMB's management at which the two concerns described in this paragraph were particularly discussed.

The Bank's identification of the problems building up in the commercial loan book was seriously hindered by misreporting of the large exposures (which were significantly understated in the returns), and by late reporting, particularly for the March 1984 quarter. Table 3 shows the exposures to the two largest borrowers as they have subsequently been discovered to be and as they were reported to the Bank from June 1983 to June 1984.

Table 3
Percentage of capital base

	Reported		Actual	
Customer:	A	B	A	B
1983				
June	15	12	26	17
September	18	—	45	21
December	27	18	51	25
1984				
March	42	30	65	34
June	38	34	76	39

In December 1983 these exposures, reported at 27% and 18% of capital, were not significantly out of line with the size of exposures carried by many other banks (though JMB's exposures were not to first-class names). One other large commercial exposure, which is now considered doubtful, was reported in the March 1984 return as equivalent to 14% of capital; this was about half the true exposure. A further doubtful exposure equivalent to 27% of capital was omitted altogether. The levels of the largest exposures at the end of March, even as reported, would have caused the Bank to request

an early meeting with JMB's management. But the report for March, which was due in the middle of April, was not received until June in spite of JMB being pressed to provide it on several occasions.

After the March return was received, the Bank asked for a meeting with JMB in July; but this was delayed at the request of JMB's management and a meeting was arranged early in August. This meeting was held on JMB's premises and lasted for most of the day. By the time of this meeting the end-June returns had also been received. Although the two exposures then stood at some 76% and 39% of capital respectively, the returns showed that the larger of the two exposures had been reduced from 42% to 38% of capital, while the smaller had increased from 30% to 34%. A new exposure equivalent to 17% of capital was reported for the first time. It was not until just before the August meeting that the Bank discovered that the new exposure was to a company related to the larger of the two other borrowers, bringing that exposure apparently to 55% of JMB's capital, still an understatement. It was following the August meeting, at which the Bank expressed serious concern about these loans that JMB requested its auditors to examine the loans in greater depth. As a result of this examination, the extent of the provisions required began to become clear to the management of JMB. The management then advised the Bank on 25 September that provisions were required against these loans which would substantially reduce the bank's net worth. The development of the rescue operation is covered in Section III.

Lessons for the future

The problems which arose at JMB give rise to a number of questions about ways in which the present system of supervision should be improved. Two features of the existing system of supervision, which were highlighted by the problems which arose at JMB, are the Bank's lack of any detailed analysis of the quality of the loans in a large part of a bank's loan book and the difficulties for the supervisors of assessing the quality and effectiveness of control procedures. The Bank relies heavily on a bank's external auditors to cover these subjects during the course of their work. The auditors need to satisfy themselves as to the basis on which the directors arrive at their valuation of a bank's assets if they are to give a clean audit report. They can also be expected to review the adequacy of a bank's controls and systems during the course of an audit and to make comments to management on any aspects they consider to be less than satisfactory.

Other features of the Bank's supervision are the practice of relying on the accuracy of banks' returns and the encouragement given to banks' managements to bring their concerns to the Bank at an early stage. The Bank's reliance on these features has, on the whole, been justified; but it proved not to have been justified in the case of JMB. One of the problems may have been that management and the parent company did not themselves realise the extent to which JMB was building up problems and subsequently did not appreciate their seriousness. In addition, reporting was inaccurate and misleading and at a critical point was late—and significantly later than the Bank stipulates. It appears that most of the misreporting was due to the deficient systems in JMB, a lack of understanding of the Bank's reporting requirements and lack of co-ordination between different departments, rather than to a deliberate attempt to mislead the Bank.

Some of the problems which arose in JMB in 1983 such as weak liquidity and excessive lending to the commodity subsidiaries, were addressed by the management but only after these shortcomings had been raised with JMB's management by the Bank. In late 1983, the attention accorded to the adequacy of the liquidity of the bullion business and the control systems associated with intra-group lending reflected the importance given to these factors by the Bank at that time. Both were features which, had they not been rectified, could have led to serious difficulties for the bank. In this connection, it should be emphasised that the critical problem which surfaced in September 1984 was in no way connected with the bullion business, which was generally well managed and profitable. The problems related exclusively to JMB's commercial lending business.

In the commercial lending part of the business, the problems of deficient systems, poor lending judgements and inadequate monitoring and control were not identified or pursued by the board or the parent company of JMB. The information in the regular returns made to the Bank gave some clues to possible problems in these areas—for example, the rapid growth of the commercial loan book, the large exposures to less than first-class names and the declining risk asset ratio. But, as has been seen, much of the information was seriously deficient and for the period between December 1983 and June 1984 not available. Had accurate end-March figures been received on time and the August meeting, at which the Bank's concerns about the loans were made clear to management, been held earlier, it should have been possible to prevent some of the late rapid growth of the loan book as a whole, and in particular of the major problem loans. This might have made it possible to contain the bank's difficulties. Even then, however, JMB's ultimate losses would have been very substantial.

The issues raised in this section about the system of supervision are covered in the Report of the Committee set up by the Chancellor of the Exchequer, to consider changes to the system. The Committee comprised the Governor (Chairman), the Deputy Governor, Mr W P Cooke (Associate Director with responsibility for banking supervision), Sir Peter Middleton (the Permanent Secretary to H M Treasury), Mr Frank Cassell (Deputy Secretary, H M Treasury) and Mr Deryk Vander Weyer (Deputy Chairman of British Telecommunications p.l.c., and a director of Barclays Bank p.l.c.).

The Committee was asked by the Chancellor to consider in particular: the relationship between auditors and supervisors; the handling of concentrations of risk and the assessment of the quality of assets; the notification and collection of statistics; the adequacy and deployment of staff resources and the experience and training of staff in the Banking Supervision Division of the Bank; and whether any changes were needed to the Banking Act.

III The rescue operation

The Bank was advised by JMB on Tuesday, 25 September 1984, after its auditors, Arthur Young, had examined the two largest loans, that the directors considered that substantial provisions were required against these loans to an extent which drastically reduced JMB's net worth but did not make it insolvent. At the Bank's urging, the auditors during the next two days carried out a review of a wider cross-section of the loan book. Meanwhile the Bank discussed with the clearing banks the provision of liquidity support for JMB to deal with any withdrawal of deposits when the need for large scale provisions was announced. The further work by the auditors identified the need for other provisions which effectively exhausted the capital of the JMB group. It was then evident that liquidity support for the bank would not be sufficient on its own and that if JMB could not be recapitalised, or its losses underwritten by a third party, it would have to cease trading. An investigation of the loan book was undertaken by a team from the clearing banks, which worked through the Thursday night, 27/28 September and identified the probable need for substantially greater provisions, although the amount could not be accurately assessed in the time available. Their findings were confirmed by a separate examination of the loan book by Price Waterhouse, commissioned by the Bank.

As soon as the need for large scale provisions against the two large loans was known, the Bank discussed with JMB and other parties the ways in which support could be provided. The parent company of JMB, Johnson Matthey p.l.c., was approached first. While acknowledging its responsibility to stand behind the bank, Johnson Matthey p.l.c. indicated that it would be unable to provide from its own resources all the support which would be required.

Certain possible purchasers of the bank, including a clearing bank, a major overseas bank and the members of the London gold market collectively, were approached. However, none of them felt able to commit themselves in the time available, given

the considerable uncertainties over the level of the provisions required. Other solutions, such as the sale of the loan book and the introduction of new minority shareholders, were being explored simultaneously but had to be abandoned for the same reason.

The final potential purchaser withdrew during the late evening of Sunday, 30 September. The early stages of the negotiations for a rescue had been conducted with complete secrecy but questions had started to be raised in the domestic and international markets on Friday 28 September. By the Sunday night, news agency tapes were reporting that a London bullion house was in difficulties. It was clear to all those present in the Bank that night, including representatives of Johnson Matthey p.l.c., the clearing banks and the other members of the gold market, that without a solution being agreed JMB would be unable to open for business on the Monday morning. If this was to be avoided, the only possible solution in the time available was for the Bank itself to take responsibility for providing the support required.

Once the decision to rescue JMB had been taken in principle, for the reasons described in the next section, the Bank sought the co-operation of Johnson Matthey p.l.c., of other members of the gold market and of major commercial banks in meeting the cost of the operation. The parent company agreed to sell JMB to the Bank for a nominal £1 and to inject £50 million into the bank before it was sold. This sum was judged by all concerned in the rescue operation to be the maximum that Johnson Matthey p.l.c. could contribute without seriously impairing its own creditworthiness. Undertakings to contribute support were secured from the banks and other members of the gold market. This support was later embodied in an agreement under which the Bank provided JMB with an indemnity of up to £150 million to meet losses in the commercial loan book, while the banks and the other members of the gold market agreed to counter-indemnify the Bank for half of any such losses. The counter-indemnitors have agreed to share any calls on them in the following proportions. The clearing banks have agreed to divide £35 million between them, the members of the gold market £30 million and the other Accepting Houses £10 million.

IV The reasons for the rescue operation

The Bank's fundamental reason for rescuing JMB was a deep concern for the systemic consequences if it was allowed to fail. The Bank, the commercial banks and the other members of the gold market involved on the night of 30 September 1984 were convinced that, had JMB not been rescued, there would have been unacceptable consequences for the banking system as a whole. This belief the Bank still holds.

At first sight, it might seem implausible that the failure of a relatively small bank like JMB, not widely known outside the bullion markets, could have such consequences. Certainly there should be no presumption that the failure of any bank would be thought to carry such risk for the system that it would be rescued. But, in the particular circumstances of JMB last September, several special factors were present which were judged to be conclusive. They are as follows.

JMB is a member of the London gold market. This is not simply a market in a sense analagous to, say, the copper market. It comprises a group of banks and members of banking groups, a substantial proportion of whose liabilities are in the form of deposits of gold, traditionally withdrawable at short notice. London is probably the most important international gold market and is involved in placing and taking gold deposits with a large number of institutions all over the world. The members of the market also do a substantial amount of business with each other. The failure of one of the five main participants would therefore have created a situation of extreme uncertainty.

The other members of the gold market would, because of their presumed exposure to JMB, have come under immediate suspicion and there would probably have been a very rapid withdrawal of liquid funds from all of them. The pressure that this would have been likely to put on the other four members could quite quickly have been translated, in the classical manner of confidence crises, to other

banks, in Britain and, perhaps, because of the international nature of the market, to banks abroad. The Bank believed, and still believes, that it would not have been possible to have convinced the markets in the first few days after the crisis that the problems did not derive from JMB's bullion business. Equally, no statements or promises of liquidity support could have been relied on to contain an ensuing loss of confidence in other members of the gold market and other banks. The possibility of allowing JMB to fail and seeking to contain the consequences of its failure was considered during the week of the rescue operation, but was rejected. This was partly for the reason just given and partly because providing the necessary liquidity in gold would have been beyond the Bank's own resources. It would have necessitated recourse either to the gold owned by the Government in the Exchange Equalisation Account or to a Government guarantee for the borrowing of gold from other sources. It was quite impractical, certainly in the time available, to have set up what would have been an open-ended and possibly very large commitment of this kind.

At the time the rescue occurred, confidence in financial markets generally was fragile in the wake of the continuing international debt problems and particularly of the crisis at Continental Illinois National Bank where, despite the action taken by the US authorities to rescue that bank, US banks suffered some loss of confidence for some time afterwards. The speed and magnitude of the problems that could have developed in the wake of the failure of JMB were demonstrated to the Bank in the early hours of Monday, 1 October. While the form of the rescue operation was still being discussed, and there had been no announcement made about the difficulties in JMB, it was learned that in the Far East some major foreign banks were refusing to deal with first-class British banks (including some not belonging to the gold market) with whom they had very long-standing connections. This strongly underlined the need for speedy and decisive action.

During the Continental Illinois crisis large amounts of money had moved from US banks into UK, other European and Japanese banks. The failure of JMB, because of its prominence as a member of the gold market, risked provoking a similar movement away from British banks. Much of the funds which moved out of the US banks remained in dollars, but sterling lacks the dollar's pre-eminent position and it was clearly a possibility that the move would have been out of sterling as well as out of British banks.

In addition to the foregoing general concerns, there were two other important, if subsidiary, factors which related to JMB itself. Although JMB is only one of the five members of the daily gold fixing, it is the only one which is part of a group which has refining capacity. This refinery constitutes for two reasons an important encouragement to overseas traders to use the London market. It possesses the facility to break down standard bars into smaller bars for which there is an increasing demand; and it has a capacity to refine gold in other forms into standard bars. This refining capacity was a major part of the Johnson Matthey group outside JMB. The failure of JMB would have virtually certainly brought down the whole of the group and could thereby have damaged the position of the gold market.

The second factor was a consideration of a rather different kind. As part of its bullion operations JMB received substantial deposits of gold from a number of foreign governments and central banks. Losses on these official deposits could have had particularly serious implications for the standing of and confidence in British banks generally.

V Developments since the Bank acquired JMB

Immediately following the acquisition of JMB by the Bank steps were taken to reorganise the board: Mr R D Galpin, an Executive Director of the Bank, was appointed Chairman and the resignations were accepted of six members of the previous board. Two of the former directors, Mr J J Shaw and Mr P J K Smith, were confirmed in their appointments and five new directors appointed. These were: Mr P Brenan as Finance Director, Mr G R A Copus and Mr M J Harper as Banking Directors, Mr P W Moss to oversee JMB's commodity subsidiaries and Mr L T G Preston who, with Mr

Smith, has responsibility for the bullion and markets area. Mr Shaw is also Chairman of JMB's insurance broking subsidiary.

Mr Brenan, a member of the Council of the Institute of Chartered Accountants, was at one time the Finance Director of Hambros Bank Ltd; Mr Copus was previously Senior Director of Standard Chartered Merchant Bank Ltd and Mr Harper a Managing Director of Charterhouse Japhet p.l.c. Mr Moss had been Finance Director of Czarnikow Ltd and Mr Preston a Director of Standard Chartered Bank and previously in charge of the foreign exchange operations of the Bank.

Price Waterhouse were appointed as investigating accountants to review and report on the financial condition of the JMB Group as at 30 September 1984. They were asked to cover all aspects of JMB's business. Their report has confirmed the belief held by the Bank when JMB was acquired that its problems were confined to its commercial lending activities.

An important task for the new board of JMB, in consultation with Price Waterhouse, has been to establish the level of provisions required by a review in detail of each of its loan facilities. The detailed review of the loan portfolio is largely complete. In the light of then current circumstances the level of provisions deemed appropriate by the new board of JMB as at 31 March 1985 was £245 million, of which only £20 million had been provided by the previous management.

Price Waterhouse have reported that the capital, reserves and bad debt provisions of the JMB Group stood at some £130 million as at 30 September 1984 before the additional provisions required for loan losses had been made. This amount, together with the £50 million injected by Johnson Matthey p.l.c., has been absorbed in meeting these provisions; consequently approximately £180 million of the identified £245 million of provisions has been met from JMB's own resources. To meet the balance of the provisions against JMB's commercial loan book, together with a contribution towards funding costs, the Bank has provided JMB with an indemnity of up to a maximum of £150 million. The Bank's liability is offset by counter-indemnities of up to £75 million from a number of banks and members of the London gold market. The indemnity agreement, signed on 29 March, after lengthy and complex negotiations, provides for calls to be made as at 31 March, with subsequent adjustments, upwards or downwards, on a quarterly basis until 31 March 1986. The total amount for which the Bank and the counter-indemnitors are liable as at 31 March this year is likely to be of the order of £65 million. By 30 April the directors of JMB had identified the need to increase provisions by £3 million. This, and any subsequent adjustment, upwards or downwards, found necessary before the end of June, will be reflected in the indemnitors' liability to be calculated at that date. The Bank has thought it right, however, to provide in its own accounts for half of the adjustment identified at the end of April.

In its efforts to recover as much as possible of the expected losses, the board of JMB is intent to pursue all the legal and other remedies open to it.

An immediate step taken on acquisition was to halt the outward flow of lending where lending limits had been breached or were not properly established. Most of the authorities granted to individuals to commit JMB were temporarily withdrawn and an Executive Committee established, meeting on a daily basis, to control JMB's activities. Control of JMB's operations by the new management was thus quickly established, and as the new directors joined the board the process of appraising its activities was put in train. Immediate action was required in handling, with the help of merchant bank advisers appointed for this purpose, the two largest exposures which had precipitated the crisis. Shortly afterwards, in one case, suits were instituted in the US Courts by the debtor against JMB and the Bank, each for an amount of $300 million. Both actions lapsed on 24 May.

Much of JMB's lending had been in US dollars and

where provisions against such loans have had to be made, it has been necessary to purchase currency to cover these potential losses. Such cover has been effected using a deposit of £100 million placed with JMB by the Bank in November. This deposit has also enabled JMB to make two-way business in the money markets.

A comprehensive review of JMB's lending operations was started in early October. This revealed deficiencies in JMB's records, and it soon became clear that the work involved in reordering the loan portfolio and records was too large and too complicated to be undertaken under the direction of the new board by the existing staff. Accordingly, approaches were made to a number of clearing and other banks for secondees to assist in this process. There was an immediate and helpful response and within a matter of days seconded staff with the necessary skills and experience had arrived. There are currently some 35 such staff working in the banking area of JMB.

With their assistance, significant repayments and reductions in JMB's commitments totalling some £65 million have been achieved. Facilities and credit files are now in better order. A complete reorganisation of the trade finance and bill department has taken place with fundamental improvements being made in its systems, records and controls. In this area there has been a need to reconstruct over a period of some years the facts surrounding over 1,500 separate accounts.

The structure of JMB's banking department has been reorganised and a number of banking review teams established with particular responsibilities. Such teams are led by secondees who have brought to the task skills, such as experience in realisations and credit assessment, which have been essential in dealing with the complicated lending situations which have been discovered.

The operations of the banking division have been the subject of a review by outside consultants and a team of secondees selected for that purpose. The manner in which funds were allocated in support of the banking operations of JMB has also been subject to close examination, following which a number of necessary changes were made. Management below director level has been strengthened through the use of senior secondees from other banks or by direct recruitment of individuals with the requisite experience.

All these developments have increased the demand for space and, in the interests of efficiency, considerable relocation of functions and staff has been necessary.

In addition to the Executive Committee already mentioned, which now meets weekly, a new Credit Committee has been formed; its responsibilities have been closely defined and the procedures which existed before have been reorganised and tightened. An Audit Committee of the board and an internal audit function have been established; neither existed before. Arthur Young agreed to resign as JMB's auditors and Price Waterhouse have been appointed in their place. Freshfields have been appointed JMB's legal advisers, Deloitte, Haskins and Sells its tax consultants and R Watson & Sons have been appointed actuaries to the new Pension Fund which has been established by transfer of the actuarially calculated proportion of Johnson Matthey p.l.c.'s Pension Fund. A Staff Committee of the board has also been set up. The former parent company provided a variety of management services, including payroll, security and insurance, to JMB. These have all been subject to review and have been taken over by JMB; and a security manager has been appointed.

Arrangements have been entered into with each member of staff for JMB to take over his or her contract of employment which had been with Johnson Matthey p.l.c.; and steps taken to inculcate within the banking area a more thorough understanding of banking procedures.

Under the direction of the Finance Director, new budgeting and financial reporting methods have been introduced; and management information improved. The implementation of a new computer

system has been put in hand with significant enhancements to remedy serious deficiencies and replace inadequate manual records. The Chief Accountant of JMB has been given a more active role in the executive of the Bank; his function had previously been more one of book-keeping than of monitoring and reporting on financial performance and risk. The working capital requirements of the JMB Group's overseas subsidiaries have been examined; some repatriation of funds has already taken place and more is in prospect. The boards of the subsidiary companies have been reconstructed and in the currently quiet conditions of the commodity futures markets, a reduction of some 40 staff in total has been made in JMB's broking subsidiaries in London and New York. The activities of two further subsidiaries, Johnson Matthey and Wallace Singapore Pte Ltd and Johnson Matthey Asset Management Inc., neither of which had been making profits, have been brought to a close.

Overall control of JMB's lending operations was found to be generally deficient both in its nature and extent. This was not true of the dealing areas where a review of the operating systems and procedures revealed no serious weaknesses—and none which could not be quickly addressed. Steps have been taken to ensure the continued smooth operation of the bullion business in international markets. Various visits to dealing counterparties abroad have been undertaken and JMB, which continues to participate in the London gold fixing, continues to trade profitably overall in the bullion markets and elsewhere outside the banking area.

The new board recognised that some of its decisions would involve additional overhead costs. However these have been kept to the minimum necessary and are in line with the new board's intention to correct the deficiencies in JMB's organisation and systems which existed at the time of acquisition; and to strengthen the control and supervision of its banking operations. The board is also working to retain and develop sound profitable business within the banking area. All steps being taken should facilitate JMB's return to the private sector.

It is the Bank's intention to dispose of JMB at the earliest practicable opportunity. A number of institutions have already expressed interest in acquiring JMB and Baring Brothers & Co. Ltd have been appointed by the Bank to advise on the strategy for disposal. With disposal in mind, and to provide JMB with a capital base appropriate to its level of business, the intention to reorganise the capital of JMB has recently been announced in a press release on 13 May. This will involve the cancellation of 59,999,900 issued and 15,000,000 unissued Ordinary Shares of £1 each and the subscription by the Bank of £75 million of fresh equity, of which £25 million will be in redeemable form, together with £25 million of subordinated loan stock with a final maturity date of 1995. The end of JMB's current accounting period has been postponed from 31 March to 30 June to enable the reconstruction to take effect prior to its accounting date. Following the reconstruction, the deposit made by the Bank last autumn, referred to on page 31, will be repaid.

The past six months have created considerable pressure on the staff of JMB who, to their credit, have responded well in difficult circumstances. The Bank is grateful to them and also to those financial institutions who joined in the indemnity arrangements; to the clearing and other banks who so readily seconded experienced staff to JMB to assist in the recovery process; to the secondees themselves; and to the new board.

SECRET

File

6

10 DOWNING STREET

From the Private Secretary 19 June 1985

STATEMENT ON BANKING SUPERVISION

The Prime Minister has seen the draft of the statement which was attached to the Chancellor's letter of 17 June to the Secretary of State for Trade and Industry. She was content with it.

I am copying this letter to John Mogg (Department of Trade and Industry), Len Appleyard (Foreign and Commonwealth Office), Hugh Taylor (Home Office), Neil Ward (Northern Ireland Office), David Morris (Lord Privy Seal's Office), Murdo Maclean (Chief Whip's Office), and David Beamish (Lords' Whips Office).

ANDREW TURNBULL

Mrs Rachel Lomax,
H M Treasury

SECRET

OMP 7

File

18 June 1985

PRIME MINISTER

I attended the Funding meeting today.

National Savings may run a little below target this summer as NS rates are not very competitive, but it was decided not to put rates up yet.

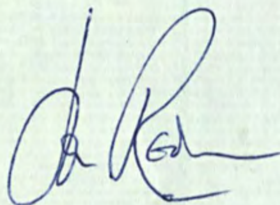
The outlook for £M_3 for banking June is poor - a forecast rise of 1.7%, with an estimated 0.3% in July and 1% in August. This would leave £M_3 growing quickly.

The other indicators - sterling, M_0, interest rates, indicate tight money.

The Bank argued for a new full 25 year stock. The Treasury and I steered them away from this. It was agreed to try to sell £1.25 billion a month.

The Bank argued there was no demand for any stock at the moment. Others argued for a range of taplets to be available to find out where demand is. Currently on offer are the 2004 big tap, some index-linked, and a low coupon short.

The Bank is unhappy about the downgrading of the £M_3 target, and believe conditions are still quite loose. Everyone is perplexed by the continuing high growth in bank lending by companies.



JOHN REDWOOD

002/1941

SECRET

Prime Minister (1)
The Chancellor's latest draft of the statement - Flag C - incorporates the changes you suggested
No need to read Annexes A+B which you have already seen
AT 17/6

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

17 June 1985

The Rt. Hon. Norman Tebbit MP
Secretary of State for Trade and Industry

Dear Norman

STATEMENT ON BANKING SUPERVISION

You may recall that in a statement on 17 December 1984, I announced the establishment of a Review Committee to look at our system of banking supervision in the light of the Johnson Matthey Bankers affair. I asked the Governor to chair the Committee, and its members included Sir Peter Middleton and an experienced clearing banker, Derek Vander Weyer.

The Committee has now submitted its report, which I attach as Annex A. Its recommendations are summarised on pages 25-30. It is a competent and authoritative piece of work, with which I largely agree. While I do not feel committed to every single detail of its recommendations, I propose to publish the report as a Command Paper on 20 ~~January~~ June. It will be used as a basis for early consultation, supplemented as necessary by consultative papers on particular topics. I would then hope to publish a White Paper on Banking Supervision in the autumn, and to prepare legislation for introduction in the 1986-87 session. You will recall that QL Committee has already provisionally allocated a firm place in the legislative programme for a Banking Bill.

I also enclose at Annex B an account by the Bank of England of events leading to the collapse of JMB and the subsequent rescue operation by the Bank. This will be published with the Bank of England's Annual Report and accounts.

I intend to lay both these documents before the House and to make a statement on 20 June. I attach a draft of this at Annex C. I would welcome your comments and those of other colleagues.

The terms of reference of the Review Committee were confined to reviewing the supervisory system. The Committee were not asked to conduct a post-mortem into JMB. This is covered in the account at Annex B, which has been prepared by the Bank, who are solely responsible for it.

The Bank intend to announce on 20 June that they will be initiating, through JMB (now, of course, a wholly-owned

subsidiary of the Bank of England) legal action against JMB's former auditors, Arthur Young. This clearly has a bearing on the tone of the statement and the Bank's note on JMB.

You will be aware that my officials have been in touch with yours about the proposals on the role of bank auditors. This has been useful to us, and I hope you will feel that we have been able to meet your Department's concerns. My officials will keep yours closely in touch as we prepare the White Paper and subsequent Bill. I am particularly alert to the read-across to your Financial Services legislation.

None of the recommendations is incompatible with EC obligations. Indeed the Commission are likely to welcome the proposal to abolish the two-tier system.

I am copying this letter to the Prime Minister; to the Foreign & Commonwealth Secretary, Home Secretary and Secretary of State for Northern Ireland, because of their interest in recommendations 31 and 32 of the report on confidentiality and enforcement; and to the Leader of the House, the Chief Whip and the Leader of the House of Lords.

Yours
Nigel

NIGEL LAWSON

ANNEX A

REPORT OF THE COMMITTEE SET UP TO CONSIDER THE SYSTEM OF BANKING SUPERVISION

Section	Subject	Page
I	Introduction	1
II	The nature of the supervisory process	3
III	The two-tier system of authorisation under the Banking Act	4
IV	The relationships between the managements, supervisors and auditors of banks	7
V	Large exposures	12
VI	Quality of assets and control systems	15
VII	The adequacy, scope and timeliness of data received for supervisory purposes	16
VIII	Parental support	17
IX	Staffing and organisation of the Banking Supervision Division	19
X	Consolidated supervision	21
XI	Matters raised with the Committee by the official group considering the desirability of amendments to the Banking Act	22
XII	Towards implementation of the Committee's proposals	25
XIII	Summary of recommendations	25
Appendix	Terms of Reference	

REPORT OF THE COMMITTEE SET UP TO CONSIDER THE SYSTEM OF BANKING SUPERVISION

I Introduction

1 The Chancellor of the Exchequer and the Governor of the Bank of England agreed in December 1984 that a Committee should be established, under the Chairmanship of the Governor, to consider the present system for supervising banks* and whether any early changes in supervisory procedures were called for in the light of the problems which had arisen in Johnson Matthey Bankers Limited (JMB). The members of the Committee were:

Mr R Leigh-Pemberton	Governor, Bank of England (Chairman)
Mr C W McMahon	Deputy Governor, Bank of England
Mr W P Cooke	Associate Director, Bank of England
Sir Peter Middleton	Permanent Secretary, H M Treasury
Mr F Cassell	Deputy Secretary, H M Treasury
Mr D Vander Weyer	Deputy Chairman, British Telecom plc, Director, Barclays Bank plc

The Secretary was Mr I M Cobbold of the Bank of England.

2 Within the broad terms of reference set out in the previous paragraph, the Committee was asked to give particular attention to the relationship between auditors and supervisors; staff experience and training and the adequacy and deployment of staff resources in the Banking Supervision Division of the Bank of England; the handling of concentrations of risk; the assessment of quality of assets; and notification and collection of statistics. The Committee was asked to draw attention to any areas where, if changes were to be made in supervisory arrangements, these would support the need for the review or

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* In this report the word "banks" is used to include both banks and licensed deposit-takers authorised under the Banking Act 1979, except where recognised banks are specifically referred to.

amendment of the Banking Act 1979. The Committee was asked to produce its report as soon as possible after the end of the year. The full terms of reference, which were published on 17 December, are attached as an appendix.

3 We were not asked to examine the reasons why the particular problems which arose in the case of JMB occurred, nor to consider the reasons for mounting the rescue operation, both of which will be discussed in the Bank of England's Annual Report. Our brief was rather to draw lessons for the system of supervision from the circumstances which gave rise to the decision by the Bank at the beginning of October 1984 to acquire JMB and to consider more widely the Bank's existing supervisory procedures.

4 We have met as a Committee on fifteen occasions and have considered a range of papers produced by the Banking Supervision Division and by an official group drawn from the Treasury and the Bank, set up to consider the desirability of making amendments to the Banking Act. We have also held discussions with senior officials of the Banking Supervision Division and with Mr T P Lankester of the Treasury, the Chairman of the official group.

5 We requested the views of the Institutes of Chartered Accountants in England and Wales and of Scotland on the relationship between banks' auditors and the supervisors. They prepared a memorandum for us, which has been published, and we have held discussions with their representatives. We have also held discussions with a number of senior bankers and received written representations from certain representative bodies and individuals. As indicated in paragraph 79 below, we believe that further consultations will be necessary before a number of our recommendations can be put into practice.

6 We are grateful to all those who have assisted us in our work, and in particular to the Secretary of the Committee.

II <u>The nature of the supervisory process</u>

7 No system of banking supervision has yet been developed which avoids all bank failures. The special characteristics of the system of banking supervision currently in operation in the United Kingdom are its flexible nature and the part played in it by the co-operation of banks secured through regular contacts between the supervisors and banks' managements. The current supervisory regime in this country is widely held to be an important factor in the maintenance of London's role as an international centre.

8 We did not examine in any detail the possibility of changing to a basically different system. We do not believe that the present system is fundamentally flawed but we have identified a number of important improvements which we believe should be made.

9 Continued reliance on a flexible system has three major implications. First, if the Bank is not itself to carry out detailed inspections of banks' books, it must be able to rely on the assistance and co-operation of the professional firms who do carry out this task: the banks' auditors. As will be seen in Section IV below, we believe it is important that co-ordination and contact between supervisors and auditors be improved in a number of ways. Secondly, it requires the continued co-operation of the banks which are supervised. We believe that the existing high level of co-operation between the banks and the supervisors can be maintained and that banks will remain responsive to the concerns of the supervisors. The system cannot, however, rely totally on this responsiveness in all circumstances; the supervisors must have adequate powers to deal with cases where this co-operation is not forthcoming. Thirdly, we believe that for the proper working of the present system, it is essential to improve the capacity of the supervisors to exercise the crucial qualitative judgments on the management, the loan book, the adequacy of capital and other elements of the business of the banks which they are supervising. It will be seen that most of the recommendations made in the rest of this report are directed to that end.

III The two-tier system of authorisation under the Banking Act

10 The Banking Act provides for the authorisation of a deposit-taking institution either as a recognised bank or as a licensed deposit-taker. The relevant criteria are set out in the Banking Act (Schedule 2); the most important differences are that for recognition as a bank the applicant must demonstrate that it provides a wide range of banking services and possesses a high reputation and standing in the financial community.

11 When the Banking Act was introduced, it was the intention that the two-tier system would allow the Bank to continue its traditional style of supervision over the major banks but would give it somewhat greater legal powers over licensed deposit-takers, many of which had not previously been subject to supervision. It was also intended that by broadly restricting the use of banking names and descriptions to recognised banks the system should make the general public aware of the difference of function and/or standing of the institutions within the two tiers.

12 Following from this differentiation in the legal framework, the styles of supervision of the two types of institution have developed somewhat differently. Supervision of recognised banks takes account of the experience and standing of the institutions and relies considerably on mutual trust and the co-operation of management. The smaller licensed institutions accept and generally appreciate a more direct form of supervision with clearer guidance on the standards expected of them. JMB's position as a recognised bank was a factor in the delay in the supervisors becoming aware of, and reacting to, its growing problems.

13 More generally, the two-tier system has not fully achieved its objective of signalling some differentiation between the institutions in the two tiers and has led to confusion in the public mind on the way in which the related criteria of function and status are applied. There is also no clear division in the use of banking names and descriptions between the institutions in the two tiers. Branches of overseas banks which are licensed are allowed to use their names with the qualification "licensed

deposit-taker" shown equally prominently and licensed institutions are able to describe their services as "banking services". Personal depositors also seem to attach more importance to the fact that an institution is officially authorised than to whether or not it is a recognised bank.

14 We were told by the Banking Supervision Division that the administration of the two-tier system has caused considerable difficulties and that a great deal of time and effort has had to be expended in order to apply the criteria fairly and consistently. Moreover the desire to achieve recognised status and meet the services criterion has in some cases encouraged institutions to diversify or expand in ways which are artificial and, at worst, could be counter-prudential. It has also become evident that, in practice, movement between the tiers would normally only be upwards from licensed to recognised status. Revocation of recognition and replacing it with a licence carries some risk. The change in category of authorisation would immediately become public knowledge and could lead to a serious loss of confidence in the bank. The benefit of closely controlling its business by applying stringent conditions to its licence while its problems were being resolved in an orderly manner could be jeopardised and its difficulties intensified.

15 When considering the arguments for and against retaining the two-tier system, we took into account that there were only relatively small differences in the powers of the Bank in respect of recognised banks and licensed deposit-takers. The most important difference in the existing powers is that the Bank is able to obtain information from licensed deposit-takers, but was not given similar powers in respect of recognised banks because it was felt that these banks would always comply voluntarily with requests for information. We noted that the existence of the difference in powers has in one respect proved to be perverse. When requests were made to some banks for information on individual large exposures, where considerations of customer confidentiality were a factor, the lawyers for the banks expressed concern because the absence of a legal requirement to provide the information left the banks at risk if a customer challenged the

disclosure of the information. Although the Bank believes that the banks are already adequately protected at law, we concluded that the Bank's powers to obtain information should be extended to recognised banks.

16 For all these reasons, we recommend that the Banking Act should be amended to replace the two-tier system with a single authorisation to take deposits. All the powers given to the Bank under the Act would then apply equally to all authorised institutions and we accept that all authorised institutions would in consequence be entitled to use banking names and descriptions.

17 We do not intend that the change to a single tier of authorisation should affect to any significant extent the way in which the Bank conducts its supervision of major banks which are soundly run, or its relationship with them. The change will, however, make it easier for the Bank to deal with any problems that may arise in future amongst what are currently recognised banks.

18 We consider that, if the amalgamation of the two tiers takes place, the criteria for authorisation under the Banking Act should remain broadly unchanged - apart from the two major additional requirements for recognition referred to in paragraph 10, which would be removed. There are certain differences between the criteria for recognition and for a licence, however, which will need to be resolved in drawing up a new set of criteria. We noted, in particular, that two of the existing criteria, while having broadly the same meaning, carry slightly different emphases, each of which we believe should be retained. They are the present requirement that all directors, controllers and managers of licensed deposit-takers should be "fit and proper" and the requirement that the business of recognised banks should be carried on with integrity and prudence and those professional skills which are consistent with the range and scale of the bank's business. We recommend that both requirements should be included in the new single set of criteria.

19 The only other significantly different requirement between the two existing sets of criteria is that recognised banks require minimum net assets of £5 million at the time of authorisation (£250,000 if a highly specialised banking service is provided), while licensed deposit-takers require minimum net assets of £250,000. We consider that the move to a single tier and the availability of banking names to all institutions justifies some increase in the minimum net assets requirement from £250,000. Inflation since 1979 would in any case justify an increase to over £400,000. We recommend that the minimum should be set at £1 million.

20 We do not recommend that existing institutions with net assets below £1 million should lose their authorisation as a result of this change. However, we noted that the purchase of such an existing institution would provide a method of obtaining authorisation under the Act without meeting the revised minimum net assets criterion for new applicants (assuming that the institution under its new owner continued to fulfil the other criteria for authorisation). We therefore recommend that an amendment should be made to the Banking Act to require an existing institution to meet the new minimum requirement for net assets on a change of ownership.

IV The relationships between the managements, supervisors and auditors of banks

21 The management of a bank lies in the hands of its directors and executives. It is not the function of either the auditors or the supervisors to take over the role of management; they all have their own discrete functions.

22 In our view, it is most important that all the directors, not only those in executive positions, involve themselves in a bank's affairs. In particular, non-executive directors should ensure that they are given sufficient information to be able to satisfy themselves that the policy guidelines and systems approved by the Board are being followed. We also believe that this is essential in order that the non-executive directors are able to make a constructive contribution to the direction of the bank's business, including forming their own view of the quality of its lending and other risk assets.

23 Audit committees, which are normally composed largely of non-executive directors, can play a particularly useful role in monitoring the operations of a bank. To do so, however, they must not restrict their activities to matters related to the preparation of the annual accounts. They must become involved in assessing and monitoring the bank's control systems and receiving reports from both internal and external auditors.

24 Banks have been relatively slow to follow the example of commercial companies and appoint finance directors to their boards. This may be understandable in the sense that all the executive directors are "financial". We believe, however, that there is an important role to be played by a finance director who, apart from the managing director and the chairman, will be best placed to take an overall view of the business. It is not an easy role, as the finance director must be prepared to question and challenge the decisions of his colleagues, but it can be a most important one. JMB had neither a finance director nor an audit committee.

25 An audit committee and a finance director share many of the concerns of the external auditors and the supervisors and can assist them in carrying out their functions. The auditor is required to make a judgment on the totality of the picture presented by a bank's accounts, drawn up by the management, and to certify that they present a true and fair picture of the affairs of the bank and not a misleading one. The supervisors must satisfy themselves that the business of the bank is being conducted prudently and that depositors' money is not being put at risk to an unacceptable degree. The work carried out by the auditors can greatly assist the supervisors, particularly where the latter do not, as part of their regular supervisory processes, carry out on-site inspections. The auditors will be assisted if they are aware of any concerns or requirements the supervisors may have.

26 If the auditors and the supervisors are to be able to assist each other to carry out their respective functions there must be a dialogue between them. This process is at present hindered by the confidentiality constraints on both parties. The auditors of

a bank have the same duties under the Companies Acts as the auditors of other companies. The auditors are appointed by the shareholders and report to them. Under present conventions and practices, auditors feel constrained by the duty of confidentiality which they owe to their client not to disclose information to third parties, including the supervisors. The supervisors, for their part, are bound by the confidentiality provisions in Section 19 of the Banking Act from disclosing information obtained in the course of supervision to the auditors.

27 Confidentiality constraints on both the supervisors and the auditors can be overcome by obtaining the specific permission of the bank concerned for a dialogue to take place. Such permission has been sought and given in certain cases. It could be withheld, however, in circumstances where such a dialogue was very necessary. We recommend that the Bank should, as an interim measure, seek the agreement of all authorised institutions for such dialogues to take place and should obtain it as a matter of routine from all newly authorised institutions. While a great deal of progress can be made by obtaining the agreement of banks in this way, we believe that provisions should be included in legislation to remove the confidentiality restraints. These would clearly establish the position of both parties and remove the possibility that in certain cases consent might be withheld.

28 We do not wish the arrangements for a dialogue between the supervisors and banks' auditors to upset the basic relationship between the auditors and their clients, the banks. The lines of communication should normally be between the supervisors and a bank and between a bank and its auditors. The bank would commission from the auditors any information required by the supervisors and its representatives would normally be able to attend any meetings between the two. Although direct communication between the supervisors and the auditors is only likely to be necessary in exceptional circumstances, it should be possible for this to take place.

29 We believe, following our discussions with bankers and the representatives of the Institutes, that the auditors can provide valuable assistance to the supervisors, in particular with their

assessment of the design and operation of a bank's control systems. It will also be helpful for the supervisors to be aware of the discussions which have taken place between the management and the auditors on the need for provisions against bad and doubtful debts. In particular the supervisors will want to know whether the auditors feel that the bank is being cautious or whether they have only reluctantly been convinced that the provisions made are adequate. It will be helpful to the auditors, in their turn, to know of the supervisors' requirements for a bank and to be aware of any areas which are causing them concern.

30 We envisage that the dialogue between supervisors and auditors will take place partly through meetings and partly through written material. Auditors frequently send their clients a "management letter" at the end of an audit, commenting on various matters which have come to their attention. We consider that this letter should be made available as a matter of course to the supervisors. The supervisors will, however, also wish to receive some further information from the auditors, for example, on provisions and the adequacy of control systems which may not always be covered in an appropriate way in the management letter. It should be possible to adapt the management letter to meet the supervisors' requirements but this will need to be discussed between the supervisors, the banks and the accountancy profession. The supervisors may also wish a bank to commission special reports from its auditors from time to time. A bank would be expected to make available to its auditors copies of letters from the supervisors setting out any requirements for that bank or raising points of concern.

31 The supervisors rely to a large extent for information on the returns submitted to them by banks, mainly on a quarterly basis. The principal return used for supervisory purposes is certified by a director or senior manager of the bank and the accuracy of the data provided has not been a major cause for concern. We nevertheless consider that improvements in the standards of reporting could be effected if the supervisors were given powers to require these returns to be audited. It is not proposed that

these powers should be used as a matter of routine; but they should be available for carrying out spot checks and for following up any inaccuracies which are detected.

32 The supervisors are rightly concerned that they should be able to rely on the work done by the auditors since this work can give them much of the assurance about the health and general soundness of a bank which would otherwise have to be obtained through inspections by the supervisors themselves. The dialogue proposed between auditors and supervisors in the previous paragraphs will greatly assist in this respect. It is obviously necessary, however, that the supervisors should have full confidence in the competence of the auditors themselves; in particular that they are properly qualified in terms of training and experience for the rather specialised business of auditing banks. The Institutes of Chartered Accountants already provide guidance to auditors operating in specialised fields such as banking, and offer training courses. This advice is very valuable and we hope that the Institutes will consider ways of extending the assistance which they offer.

33 In some countries, the supervisors have to approve a bank's auditors before they can take up their appointment. We considered whether to recommend this procedure but decided against it on the grounds that it could conflict with the right of shareholders to appoint the auditor and would make it more difficult for firms which had not previously done so to begin to audit banks. We also considered but rejected a proposal that the supervisors should have powers to require the dismissal of auditors because this would again conflict with the position under the Companies Acts. Occasional cases may arise where the supervisors consider that the auditors are not competent to audit a bank or have been negligent. We propose that, in order that the supervisors may have a report on which they can rely, the Bank should be given powers to require a bank to appoint a second firm of accountants to make a report, covering similar ground to a statutory audit, and at the bank's expense. The Bank already has some powers under Sections 16 and 17 of the Banking Act to obtain information from licensed deposit-takers and to commission

investigations into all authorised institutions, but we believe that these powers will need some amendment in order to implement this proposal.

34 If the performance of the auditors, or of other professional advisers to a bank, is found to be seriously deficient by the supervisors, we recommend that the Bank should be given powers to pass information to the relevant professional body so that the possibility of disciplinary proceedings can be considered. This proposal would require an amendment to Section 19 of the Banking Act.

35 We have been greatly assisted in our consideration of the relationship between the supervisors and banks' auditors by our discussions with representatives of the Institutes of Chartered Accountants. We believe that the proposals outlined in this Section are generally acceptable to the accountancy profession.

V Large exposures

36 Concentrations of lending and other exposures to individual borrowers or economic sectors have recently been the most important cause of difficulties in banks. This was true, not only in the case of JMB but also in the failures of certain small licensed deposit taking companies in this country. Abroad, the recent problems in Continental Illinois and Penn Square in the United States, Schroeder, Munchmeyer, Hengst & Co in Germany and Kronebanken in Denmark have had similar roots.

37 Many countries have imposed limits in terms of some measurement of capital on large exposures to individual borrowers or groups of related borrowers.* The United Kingdom does not have such legal limits.

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* For example, in the following countries the basic limits, which are subject to various qualifications, are:

United States	15% unsecured
	25% secured by fully marketable securities
Japan	20%-30%
Switzerland	20% unsecured
	40% secured
France	50%
Germany	50%

38 In April 1983, the Bank issued guidance to all authorised institutions stating that "Experience suggests that exposures (loans, acceptances, guarantees etc) to one customer or group of customers should not normally exceed around 10% of an institution's capital base". The notice went on to say that the more an exposure exceeded 10%, the more rigorous the Bank would be in requiring justification for the exposure and that where such loans had been made, the institution would normally be requested to maintain a significantly higher level of capital resources than would otherwise be required.

39 We considered the case for imposing specific limits on large exposures in legislation but concluded that this was not desirable. Other countries' experience has shown that to do so encourages banks to find ways around the requirements and may encourage them to trade up to the specified limit. For some institutions an exposure of even as much as 10% of capital may be excessive and the supervisors need flexibility to agree appropriate policies with individual institutions within overall guidelines.

40 A policy on large exposures has to start from an "at worst" position. The judgment on the acceptable level of exposure is in part a question of the balance of the bank's portfolio and in part a view of the damage which could be suffered if a particular exposure or exposures were to go bad. It is not a judgment on the likelihood of the exposure going bad. Nor is it simply a question of whether the loan is secured or unsecured as this does not necessarily determine the real exposure to risk.

41 A limit placed on large exposures should not be too restrictive. Major corporate borrowers expect to be able to deal in large amounts; too low a limit may force banks to forego good business and make instead smaller, perhaps less good quality, loans. This is particularly a problem for smaller but growing banks which need to take on what are for them relatively large exposures if they are to obtain the business of larger companies. It is much less of a problem for the larger banks.

42 We agree with proposals put forward by the Banking Supervision Division that each bank should be asked to set out in writing its policy on large exposures and that this policy should be formally adopted by its Board. All exposures (including undrawn commitments and contingent liabilities) above 10% of capital would be reported to the Bank and closely examined by the supervisors. No exposure to a single borrower, or to a group of closely related borrowers taken together, should exceed 25% of capital except in the most exceptional circumstances. The existence of exposures over 10% of capital would normally require a bank to maintain greater capital resources than would otherwise be required. Factors such as a long-standing relationship with the borrower, particular expertise in the type of lending, the overall financial standing of the borrower and the security for the loan would be factors to be taken into account when considering different levels of exposure up to 25% of capital, but would not justify an increase beyond that level. Large exposures to borrowers connected with the bank through membership of the same group of companies, by common directors or in other ways, would continue to be particularly closely scrutinised by the Bank and should generally be strongly discouraged.

43 Legitimate concern about political sensitivities makes it undesirable for the Bank to publish general guidelines on the appropriate level of exposures to particular countries. However, control of country exposures is as important as control of exposures to individual customers. We endorse the Banking Supervision Division's present policy of monitoring country risk exposures over 10% of capital and discussing them in detail with banks, except in the cases of lending to the most creditworthy countries.

44 The Bank also needs to monitor banks' exposures to economic sectors both within the United Kingdom and worldwide. The particular monitoring system used will have to have regard to the nature of the individual bank's business. While a broad industrial classification may be appropriate for a large bank, and statistics are already obtained on this basis for exposures within the United Kingdom, a small institution needs to adopt a more closely defined and detailed approach more appropriate to the

scale and range of its activities. We believe banks which do not already have such internal monitoring systems should develop them and that the supervisors should obtain this information from them.

45 While no direct legal penalties are proposed for exceeding the 25% of capital level, breaches should lead to a bank being required to maintain significantly greater capital resources and would reflect on the prudence of its management. Sustained breaches of the 25% ceiling should lead the Bank to consider revoking the bank's deposit-taking authority.

VI Quality of assets and control systems

46 Sustaining the quality of a bank's assets is one of the essential factors in ensuring its continued health. Although it is not the supervisors' role to take individual lending decisions in place of management, the supervisors must always be alert for signs of a deterioration in the quality of a bank's loan book. To complement the information already available to them on banks' loan portfolios, we believe that there are further steps which the supervisors should take to satisfy themselves that banks' control systems, particularly for lending, liquidity and other exposures to risk, are appropriate and are being properly applied in practice. Poor controls were one of the roots of the problems which arose at JMB. The size of the bank's loan book had grown very rapidly since 1981 and the systems in place and their operation in practice proved to be completely inadequate to approve and monitor the volume of lending undertaken. In addition, the administrative processes for taking security against loans were often not properly carried out and the need for provisions not properly identified.

47 We recommend that in addition to the regular meetings which the managements of all banks attend at the Bank, the supervisors should from time to time visit each bank. Some visits already take place, more particularly in the licensed sector, but we believe they should be extended to cover all authorised institutions. The frequency and length of these visits would vary with circumstances. The objective of these visits would not

be to carry out a detailed examination of the bank's books but to assess a wider range of the bank's management team and to consider in greater detail the design of the bank's control systems. The information on control systems obtained through these visits will complement that obtained through the dialogues with banks' auditors, recommended in Section IV.

48 The Banking Supervision Division has developed over the years a capability to carry out investigations where problems arise in a bank or are suspected. We recommend that the Division should be more ready to carry out such detailed investigations at an early stage when there are suspicions that problems are developing. One concern which has arisen in the past has been that knowledge of such an investigation might leak out and cause a loss of confidence in the bank. The visits to banks proposed in the previous paragraph will make it less likely that a special investigation will appear to be an exceptional event.

49 As part of our review, we considered the grading systems used, particularly in the United States, by both banks and supervisors to classify loans. Such systems rely in part on objective criteria and in part on subjective judgments. We believe that these systems can provide useful information to management, auditors and supervisors and that banks which do not already have them should consider introducing them. The systems need to be designed to take account of the particular features of an individual bank's types of lending and do not appear to be easily adaptable to a system-wide reporting mechanism, which would become excessively complex. The supervisors would therefore need to obtain information from individual banks' systems.

VII The adequacy, scope and timeliness of data received for supervisory purposes

50 The Bank has for a number of years collected statistics from the banking system for the purposes of monetary policy and economic and financial analysis. When the system of supervision was extended and enhanced in the mid-1970s, the information required for prudential purposes was to a large extent integrated into the existing returns. Only one of the returns completed by each institution is used exclusively by the supervisors.

51 While there are certain drawbacks in the need to co-ordinate the requirements of all the users of the statistics, we concluded that the present integrated system should be continued. To collect a separate set of data for prudential purposes would overlap to a large extent with the data required by other users, and would place a considerable burden on the banking system and the Bank, which would not be justified by the benefits obtained.

52 We did not identify any major deficiencies in the data received by the supervisors. Minor improvements can always be made and these will doubtless continue to be pursued with the banking system in the normal way. In particular, some additional statistics will be required following the Banking Supervision Division's review of its approach to consolidated supervision which is referred to in Section X. Certain other statistics on exposures to economic sectors and the grading of loans would be obtained outside the integrated reporting system.

53 A substantial delay in providing a return at a crucial time was a factor in delaying the supervisors' identification of the acute problems emerging in JMB. Late reporting may be a sign of problems in an institution. We therefore recommend that the Bank should tighten its procedures for ensuring that all returns used for supervisory purposes are submitted promptly and should consider carrying out an investigation into any bank which fails to provide information within the time allowed.

54 Inaccuracy in the information provided has not proved to be a major problem for the supervisors (although in the case of JMB some of the information given to the Bank on large exposures was significantly misleading). Our recommendation in Section IV that the Bank should be empowered to require banks' auditors to certify their statistical returns will provide an independent check from time to time on the accuracy of the data.

VIII Parental support

55 We were advised that the Bank has always believed that a bank should stand behind its subsidiaries and other related companies,

especially if those companies themselves take deposits. Its view is based on the premise that failure to rescue a subsidiary which got into difficulties would quickly cause a loss of confidence in the parent bank itself. This view is acknowledged and accepted by British banks.

56 The Bank also believes that owners of banks have an additional responsibility not present in the ownership of most other commercial or industrial undertakings, because of the special fiduciary responsibilities on those who run businesses which take deposits from the public. In the mid-1970s, the Bank began to seek letters of comfort from overseas banks with shareholdings in United Kingdom banks which recognised their moral responsibility to stand behind the bank should the need arise. Since then, this practice has been extended to a wider range of non-bank shareholders from both the United Kingdom and overseas. Johnson Matthey plc, the parent company of JMB, had not been asked to provide a comfort letter but had demonstrated its willingness to support the bank in the past. It acknowledged its responsibility to do so when the crisis arose. The problem was its lack of resources to discharge this responsibility.

57 We considered proposals from the Banking Supervision Division to extend its requests for comfort letters to all significant shareholders in United Kingdom banks. These would broadly entail comfort letters being sought from all shareholders who control 15% or more of the voting power, and in some cases shareholders who control 10% or more. The Bank believes that in most cases it is not necessary to formalise the position in respect of shareholdings by United Kingdom banks because of their agreement that they must stand behind their subsidiaries and other related companies in all but the most exceptional circumstances.

58 Having obtained letters of comfort, it is obviously necessary that the Banking Supervision Division should monitor the ability of the givers of those letters to honour their responsibilities should the need arise. We noted that the Division intends to take a closer interest in the position of parent companies and

other large shareholders than it has done previously. We therefore endorse the proposals which are now being implemented. The related question of the consolidated supervision of groups containing a bank is discussed briefly in Section X.

IX Staffing and organisation of the Banking Supervision Division

59 The staff of the Banking Supervision Division totals 94, of whom 23 are senior officials and managers. In addition, there are 36 support staff. The staff are very largely career Bank staff, most of whom have had experience in other parts of the Bank before joining the Banking Supervision Division. The size of the banking supervisory function has grown very substantially since the system of supervision was revised and enhanced in the mid-1970s. However, with growing domestic and international pressures on the banking system, so has the burden of work. An increase in staff numbers is justified to meet the existing level of work and we recognise that certain of our proposals will give rise to the need for some further expansion.

60 We consider that the quality and commitment of the existing staff are high. But we believe that they need to be able to draw on a wider commercial experience in order to improve their ability to make judgments about the quality of lending, liquidity and other risk exposures. This experience can best be obtained by a period working in a commercial bank. A few of the existing staff have already had periods on secondment with commercial banks and there have been some inward secondments from commercial banks. We recommend that this programme of secondments in both directions should be significantly increased. In the short term, commercial experience can only be brought into the Division by inward secondments from commercial banks or the recruitment of staff with banking experience. In the longer term, the staffing policies followed should allow for all managers and senior analysts to have spent a period with a commercial bank; some permanent recruitment of experienced commercial bankers should also be considered.

61 The staff of the Division are subject to the Bank's normal policies on recruitment, promotion and staff development. Members of staff normally spend from three to four years in the

Division, although some have been there for much longer. Supervision is essentially a job which can only be learnt through its practice, although commercial experience and training, for example in accountancy, are also very important. It is essential that the managers and analysts responsible for a group of banks get to know them thoroughly and this cannot be done quickly. The banks also appreciate continuity in their contacts with the Division. For these reasons we believe that the Banking Supervision Division should take steps to develop a significant cadre of long-term banking supervisors.

62 The Banking Supervision Division at present has two qualified accountants whose role is primarily to give advice on any accountancy matters which arise. We recommend that some increase in the number of qualified accountants should be made, particularly taking account of our recommendation in Section IV that a dialogue should take place between the supervisors and banks' auditors.

63 The working practices and systems of communication within the Division have needed to develop to take account of the growth in staff numbers, the larger number of institutions supervised and the greater complexity of the work. We have considered, and approved, plans for a number of improvements in the system presented to us by the Division. These plans, which are now being implemented, define more clearly the scope of the responsibilities of senior officials and managers in the Division, clarify the lines of responsibility and control and improve the flows of information. In addition, senior management within the Division has been strengthened. As a result of these changes, the Division should be better able to identify problems and, equally important, to react quickly and decisively by bringing together the necessary staff and expertise when problems do arise.

64 One of the practical difficulties faced by the Division is the need to deal quickly with large volumes of statistics each quarter when they are first received, in order to identify any significant changes in the circumstances of particular banks. We believe that it is important that the returns of all institutions are examined as soon as they are received and that

any questions raised are followed up without delay. Greater use of desk-top computer facilities would assist in this respect, and we welcome the Bank's intention to introduce more terminals in the near future. Greater selectivity in the use of the very large information base will help the senior supervisors to concentrate on the essential problems in a bank and reduce their considerable workload. Our proposals on the staffing of the Division and for improving the supervisors' knowledge of a bank and its management, for example through the contacts with auditors and visits to the bank, will also improve the supervisors' ability to assess the nature of changes identified from the returns.

65 We considered work done by the Banking Supervision Division into the use of computerised early warning systems as a means of identifying the banks which are most at risk. This work concluded that these systems do not, at present, provide a sufficiently reliable means of detecting such banks. However, the subject merits some continued study and experience gained in other countries might usefully be further investigated.

X Consolidated supervision

66 The matters discussed in the previous Sections of the report all derive from particular issues which arose in the case of JMB. Our terms of reference were not, however, confined to such questions and we have also considered certain other issues related to the system of supervision. These are discussed in this Section and the next.

67 In the light of both recent moves towards the formation of financial conglomerates, and the European Communities' Directive on Consolidated Supervision, the Bank has been reviewing its approach to the consolidated supervision of groups containing a bank or banks. We considered a paper setting out the issues raised by the Bank's proposals and accepted its approach. Consultations have subsequently been started with the banks. In due course a paper setting out the approach to be adopted, agreed by the Treasury, will be sent to the EC Commission in order to demonstrate that the United Kingdom is complying with the Directive.

68 We also considered the problems raised by the supervision of conglomerate financial groups where different parts of the group are the responsibility of different supervisory authorities and no one supervisor has the responsibility for the group as a whole. Close co-operation between the various supervisory authorities will obviously be required: in particular, and subject to appropriate safeguards, barriers to the exchange of information between them will need to be removed. Section 19 of the Banking Act provides such a barrier at present. The need to remove these barriers has already been referred to in the White Paper on Financial Services (Cmnd 9432).

69 The supervision of conglomerate groups raises a number of difficult questions which range beyond our terms of reference and which we have not discussed in any detail. We noted, however, that they will need careful consideration by the relevant government departments and supervisory authorities.

XI Matters raised with the Committee by the official group considering the desirability of amendments to the Banking Act

70 The official group, under the chairmanship of Mr Lankester, has assisted us in our study of the various matters covered by our review of the system of supervision. Additionally, as part of its own work into the desirability of amending the Banking Act, the official group has sought our views on certain issues.

(a) Confidentiality of information provided to the Bank

71 Section 19 of the Banking Act provides that information obtained by the Bank under the Act may only be disclosed to other persons in certain specified circumstances. We have already proposed that the Bank should, in certain circumstances, be able to disclose information to a bank's auditors; to the professional body of a bank's advisers where the possibility of disciplinary action being taken against the adviser exists; and to other supervisory bodies.

72 The Bank is at present able to disclose information to the Treasury where it believes this to be in the interests of depositors or in the public interest. Neither the Bank nor the Treasury is permitted to disclose information on these grounds to other government departments. A number of cases have arisen where the Bank and the Treasury have felt the need to have such a power. Examples include disclosure to the Northern Ireland Office, where local knowledge could have assisted in resolving problems in a licensed deposit-taker based in the province; and to the Foreign Office where action to be taken under the Act against overseas institutions could have been diplomatically sensitive.

73 We endorse a proposal by the official group that the Bank should be given power to disclose information to other government departments, with the consent of the Treasury, where the Bank considers this to be in the interests of depositors or in the public interest. We believe however that disclosure to the Revenue departments of information provided for supervisory purposes should continue to be prohibited.

(b) The Bank's enforcement powers in relation to unauthorised institutions

74 The Bank is one of the prosecuting authorities under the Banking Act. In practice, it is likely to be responsible for pursuing most of the cases which arise in England and Wales, except for those which involve other criminal offences, particularly fraud. The more serious offences occurring under the Act are likely to involve institutions which are not authorised to take deposits; indeed, the most common is taking deposits without authorisation. Ironically, however, the Bank has no powers to obtain books and papers from unauthorised institutions in order to provide the evidence for a prosecution.

75 The official group, after preliminary consultations with other interested Departments, has recommended that the Bank should be given powers similar to those enjoyed by the Department of Trade and Industry under Sections 447 and 448 of the Companies Act 1985. Such powers would enable the Bank to require books and papers from any person who appears to be in breach of the Act and

to apply to a magistrate for a warrant to enter premises, accompanied by the police, and seize books and papers. We support this recommendation.

(c) Deposit Protection Scheme

76 The official group has put certain proposals to us for changes to the Deposit Protection Scheme contained in Part II of the Banking Act. We endorse these proposals:

(i) to increase the amount of a protected deposit from £10,000 to £20,000. Inflation since the Banking Act was passed would justify an increase to £16,500. We also favour some closer alignment between the scheme for depositors with banks and that for depositors and investors with building societies who are at present covered up to £30,000 under the societies' voluntary scheme.

(ii) to increase the minimum initial contribution to the Fund from £2,500 to £10,000. This increase would recognise in part that failures are more likely to occur among the smaller institutions and would be in line with the proposed increase (recommended in Section III) in the minimum net assets criterion for authorisation from £250,000 to £1 million.

(iii) to revoke the provisions which enable H M Treasury to exempt from contributing to the Deposit Protection Scheme, overseas banks whose sterling deposits with their United Kingdom offices are as well protected by arrangements in their home countries as they would be under the Scheme. We consider that the Scheme is intended to protect all depositors with sterling deposits placed with banks in the United Kingdom and that all banks authorised under the Banking Act should share the cost of providing that protection. We are also conscious that the existing provisions have proved extremely difficult and time-consuming to apply in practice.

77 The first two proposals set out in the previous paragraph can be effected by Statutory Instrument, subject to affirmative resolution by Parliament. We believe that it is not necessary to change the other monetary amounts specified in the Scheme; in particular that the cash fund does not need to be raised to accommodate the increase in the limit on a protected deposit. The third proposal would require an amendment to the Banking Act.

XII Towards implementation of the Committee's proposals

78 If adopted, some of our proposals can be implemented by the Bank administratively; some can be implemented by statutory instrument; while others will require amendments to the Banking Act. Most will require prior consultation with the banking system and other interested parties.

79 We urge the Government to allocate time for a Banking Bill in the 1986/87 Parliamentary session. If this is agreed, drafting instructions would need to be prepared for Parliamentary Counsel by the beginning of next year. That would suggest that a White Paper should be published in the Autumn. Some of the proposals for amendments to the Banking Act are covered in this report; others will be considered further by the official group. Many of our proposals deal with complex matters and will require detailed consultations before they could be implemented. If the proposed timetable is to be met, informal consultations should be started with the Banking Associations and other interested parties as early as possible in the Summer.

XIII Summary of recommendations

80 The following is a summary of our recommendations:-

The two-tier system of authorisation under the Banking Act

i) The present two-tier system of authorisation should be replaced by a single authorisation to take deposits under the Act. All the powers given to the Bank under the Act should apply to all authorised institutions and all authorised institutions should be entitled to use banking names (paragraph 16).

ii) The new criteria for authorisation should include both a requirement that all directors, controllers and managers are "fit and proper" and a requirement that the business of the bank should be carried on with integrity, prudence and appropriate professional skills (paragraph 18).

iii) The minimum net assets criterion for authorisation should be increased from £250,000 to £1 million (paragraph 19).

iv) Banks already authorised should be required to meet the £1 million minimum net assets criterion on a change of ownership (paragraph 20).

v) If a two-tier system were to be retained, the Bank's powers to obtain information from licensed deposit-takers should be extended to recognised banks (paragraph 15).

<u>The relationships between the managements, supervisors and auditors of banks</u>

vi) Banks should consider the appointment of an audit committee and a finance director where they do not already have them (paragraphs 23, 24).

vii) A mechanism should be established to enable a regular dialogue to take place between the supervisors and banks' auditors. Existing confidentiality restraints on both parties should be removed, initially by obtaining the agreement of each bank to a dialogue taking place and, as soon as possible, through legislation (paragraph 27).

viii) The dialogue between the supervisors and banks' auditors should not interfere with the present relationship between a bank and its auditors. The bank should commission from the auditors information required by the supervisors and should normally attend meetings between the two (pargraph 28).

ix) Powers should be taken to permit direct communication between the supervisors and the auditors in exceptional circumstances (paragraph 28).

x) The Bank should be given powers to require that statistical returns used for supervisory purposes are examined by the auditors. This should not become a matter of routine but the powers should be used to carry out spot checks and to follow up any inaccuracies which are detected (paragraph 31).

xi) The Bank should have powers to require a bank to commission a report covering similar ground to a statutory audit from a second firm of accountants where the Banking Supervision Division considers that the bank's auditors are not competent or have been negligent (paragraph 33).

xii) The Bank should be empowered to pass information to the appropriate professional body about a bank's auditors or other advisers to assist that body to consider whether disciplinary action should be taken against the advisers (paragraph 34).

Large exposures

xiii) No exposure to an individual borrower, or to a group of closely related borrowers taken together, should exceed 25% of a bank's capital base, except in the most exceptional circumstances (paragraph 42).

xiv) The Bank should continue to monitor and investigate all exposures in excess of 10% of a bank's capital base (paragraphs 42, 43).

Quality of assets and control systems

xv) The Bank should take further steps to ensure that effective procedures are in place to check that banks' control systems, particularly for lending, are adequate and are being properly applied in practice (paragraph 46).

xvi) To broaden their knowledge of banks' managements and to help in the assessment of their control systems, the supervisors should increase the number of visits paid to banks. The frequency and length of the visits would vary from case to case (paragraph 47).

xvii) Where suspicions of problems arise, a detailed investigation of a bank should be undertaken more readily than has been the case in the past. The increased number of visits recommended above should reduce the risk that such an investigation might itself cause a loss of confidence in the bank (paragraph 48).

xviii) Banks should consider introducing loan grading systems if they do not already have them. The Banking Supervision Division should make use of the information provided by such systems to monitor changes in the quality of a bank's assets (paragraph 49).

<u>The adequacy, scope and timeliness of data received for supervisory purposes</u>

xix) The present integrated system for collecting statistical data for various uses, including supervision, should be retained (paragraph 51).

xx) The Bank should tighten its procedures for ensuring that all returns used for supervisory purposes are submitted promptly and should consider carrying out an investigation into any bank which fails to provide information within the time allowed (paragraph 53).

<u>Parental support</u>

xxi) We endorse the Banking Supervision Division's proposals on comfort letters (paragraphs 57, 58).

<u>Staffing and organisation of the Banking Supervision Division</u>

xxii) Some further increase in staff numbers is justified to meet the existing workload and to carry out certain of our other recommendations (paragraph 59).

xxiii) The staff of the Banking Supervision Division would benefit from wider commercial experience to assist them in their work as supervisors (paragraph 60).

xxiv) The programme of secondments in both directions between the Division and commercial banks should be expanded (paragraph 60).

xxv) A significant cadre of experienced, long-term banking supervisors needs to be built up (paragraph 61).

xxvi) Some increase should be made in the number of professionally qualified accountants working in the Division (paragraph 62).

xxvii) We endorse the proposals produced by the Banking Supervision Division for clarifying the lines of communication within the Division, defining more clearly responsibilities and work practices and improving information flows (paragraph 63).

Consolidated supervision

xxviii) Barriers to the exchange of information between supervisory authorities should be removed (paragraph 68).

xxix) The relevant government departments and supervisory authorities should consider carefully the issues raised by the supervision of financial conglomerates, parts of which are supervised by different supervisory authorities (paragraph 69).

Matters raised with the Committee by the official group considering the desirability of amendments to the Banking Act

xxx) The Bank, with the consent of the Treasury, should be able to disclose information to other government departments (except the Revenue departments) where it considers this to be in the interests of depositors or in the public interest (paragraph 73).

xxxi) The Bank should be given powers in respect of unauthorised institutions similar to those enjoyed by the Department of Trade and Industry under Sections 447 and 448 of the Companies Act 1985 in order to facilitate investigation of offences under the Banking Act (paragraph 75).

xxxii) The amount of a protected deposit under the Deposit Protection Scheme should be increased from £10,000 to £20,000 (paragraph 76).

xxxiii) The amount of the minimum initial contribution to the Deposit Protection Fund should be increased from £2,500 to £10,000 (paragraph 76).

xxxiv) The provisions of the Deposit Protection Scheme which allow the exemption of certain overseas banks should be repealed (paragraph 76).

R. Leigh-Pemberton

C W McMahon

W.P. Cooke

P E Middleton

[illegible]

[illegible]

31 May 1985

APPENDIX

TERMS OF REFERENCE

1 A Committee shall be established under the chairmanship of the Governor and with the participation of the Permanent Secretary to the Treasury consisting of representatives of H M Treasury and the Bank. It is intended to appoint a senior outside expert experienced in commercial banking to enquire and report to the Committee. The Secretary shall be provided by the Bank.

2 The Committee shall consider the present supervisory system and whether any early changes in supervisory procedures are called for in the light of the problems which have arisen in Johnson Matthey Bankers.

3 Issues to which particular attention should be given are the relationship between auditors and supervisors; staff experience and training; the handling of concentrations of risk and the assessment of quality of assets; notification and collection of statistics; and the adequacy and deployment of staff resources in the Banking Supervision Division.

4 The Committee should also draw attention to any areas where, if changes are to be made in supervisory arrangements, these may support the need for review or amendment of the provisions of the 1979 Banking Act.

5 A report should be prepared setting out the Committee's views as soon as possible after the end of the year.

6 Detailed consideration of the desirability for legislative changes will be undertaken by an official group under the Chairmanship of the Treasury with the object of making recommendations in the spring in 1985.

The Bank of England and Johnson Matthey Bankers Limited

The Bank of England and Johnson Matthey Bankers Limited

This note is divided into five sections. First, the developments in Johnson Matthey Bankers Limited (JMB) up to September 1984 and the reasons for its failure; second, the Bank's supervision of JMB; third, the rescue operation which was mounted at the end of September 1984; fourth, the reasons for rescuing JMB; while the final section outlines the developments which have taken place since the Bank acquired JMB.

I The development of the business of JMB

JMB was established in 1965 to conduct the banking and bullion business of Johnson Matthey & Co.Ltd (now Johnson Matthey p.l.c.). It became an authorised bank under the Exchange Control Act in 1967 and obtained exemption under the Protection of Depositors Act in 1970. JMB was already being supervised by the Bank before the Banking Act came into effect. After the Banking Act came into effect, JMB was granted authorisation as a recognised bank in April 1980. As one of the five members of the London gold fixing, its business at that time was mainly concentrated on bullion and foreign exchange dealing, with the commercial banking side of the business specialising in trade finance. This spread of business was sufficient to enable JMB to obtain recognition under the normal criteria for a bank providing a wide range of banking services. (The provision of foreign exchange services and trade finance are two of the services required to be provided under the Act for authorisation as a recognised bank.)

Growth of the balance sheet

Total assets of the bank and its subsidiaries in 1980 were £874 million, of which bullion stocks and customers' dealing and metal accounts amounted to £678 million and commercial loans and overdrafts only £34 million. In 1981, the bank began to expand and diversify its loan portfolio. JMB's traditional trade finance business had tended to be based on connections with Pakistan, the Middle East and Nigeria and these areas provided a number of the customers for its expanding lending operations.

The balance sheet of the bank and its subsidiaries, set out in its annual accounts, more than doubled between March 1980 and March 1984 (broadly in line with those of other banks, in aggregate) by which time total assets stood at £2.1 billion (Table 1).

Table 1
£ millions

At end-March	1980	1981	1982	1983	1984
Loans and overdrafts	34	78	135	184	309
Holdings of bullion and customers' bullion-related accounts	678	786	804	1,226	1,359
Total assets	874	1,040	1,183	1,735	2,089

Commercial lending, in the form of loans and overdrafts, grew during the four years much faster than the overall balance sheet. Letters of credit, guarantees and acceptances outstanding also increased rapidly from £18 million in 1980 to £65 million in 1984. Nevertheless, JMB remained very much a specialised bullion trading bank: holdings of bullion and customers' bullion-related accounts, which had amounted to around three quarters of the bank's assets in 1980, still amounted to around two thirds of them at end-March 1984. Although the lending book had been increased markedly, no serious attempt was made to broaden the base of the banking services into, for example, corporate finance or investment management. The JMB group did however diversify to some extent into other financial services by purchasing subsidiaries engaged in soft commodities broking (in the United Kingdom, the United States and Singapore), insurance broking (United Kingdom and the United States) and asset management (United States). The bank did not become involved in large scale financing of sovereign borrowers from developing countries.

Profits and provisions

According to its audited annual accounts, the JMB Group's return on shareholders' funds was well over 20% between 1980 and 1983, and the return on total assets varied between 1.1% and 1.6%. This performance compared favourably with that of other banks. During the period between 1980 and 1984 well over three quarters of its profits came from bullion dealing and from sterling and foreign exchange operations partly connected with such dealing (Table 2). In the year to 31 March 1984 total profits fell, with the return on shareholders' funds declining to 9% and on total assets to 0.4%. The fall was attributed in the bank's annual report to 'flat conditions in world bullion markets, intense commission-reducing competition for base metal and commodity futures business, and growing trading problems for our banking customers at home and abroad'.

Table 2

£ millions

Year to end-March	1980	1981	1982	1983	1984
Pre-tax profits	14.4	11.6	16.6	24.3	9.4
of which:					
Dealing (including bullion operations)	13.4	10.0	14.7	20.8	8.9
Banking	1.0	1.6	1.9	3.5	0.5

It was the policy of the JMB board not to make specific bad debt provisions, but rather to write off directly any bad debts. A general provision of £8.0 million was maintained from May 1981 until March 1984. In JMB's quarterly return for June 1984, the Bank was informed that the general provision had been increased to £12.0 million, as from March 1984. After the Bank acquired JMB, it discovered that the general provision had in fact been increased to some £16 million[(1)] and that part of the general provision was in fact earmarked against a long-standing claim related to an earlier bullion trading transaction. As such this part was more in the nature of a specific than a general provision.

(1) The figure of £20 million for general provisions as at March 1984 given in a press release issued by the Bank of England on 13 May 1985 includes certain debts which had previously been written off in accordance with JMB's normal policy but which have been written back into the accounts and provided against for the purposes of the indemnity arrangements referred to on page 00.

The causes of the failure

JMB entered into several large exposures, each of them equivalent to over 10% of the bank's capital base, as part of its banking operations. The two largest commercial debtors which eventually precipitated the crisis had been customers of JMB for several years; both were loosely associated groups of companies run by businessmen from Pakistan. By June 1983 the sizes of the exposures to these debtors were equivalent to 26% and 17% of JMB's capital base respectively. They had grown to 51% and 25% of capital base by December 1983. They continued to grow rapidly during the first half of 1984, reaching some 76% and 39% of JMB's capital base, respectively, in June 1984. The differences between the actual exposures and the levels reported to the Bank are set out on page 00. The total loan book also grew very rapidly in 1984 increasing by over a third, in sterling terms, in the six months between end-March 1984 and the time of the rescue. (The larger part of this rise reflected an increase in JMB's lending but since much of this was in US dollars, the total was also affected by the downward movement in the sterling/US dollar exchange rate in this period.) Many of JMB's other debts have since proved to be bad or doubtful, including some other large exposures.

In 1984 problems began to arise with the two large exposures. JMB was faced with a familiar banker's dilemma of deciding whether to lend more to help the customer trade out of its problems or to refuse further credit and bring about the customer's failure. JMB chose the former course.

The roots of JMB's problems were, however, more deep-seated. The loan book had grown very rapidly since 1981 and it has become clear since JMB's acquisition by the Bank that the controls and systems were inadequate; that the organisation and management of the commercial banking and credit monitoring activities had serious shortcomings; and that insufficient attention had been given to the concentration of risks involved. Security was not required from borrowers when this might have been expected under normal banking practice; and even when security was required the steps necessary to

give the bank title to the security were not always taken properly. The need for provisions against bad and doubtful debts was not assessed with the proper degree of caution. The judgement of management in approving so many loans which have required substantial provisions was clearly defective. However, no evidence of fraud by the directors or staff of JMB has been discovered, except in one case dealt with before, and immaterial to, the collapse. Lending against bullion was not a factor in the loan losses. (Further references to the problems and shortcomings which the new, post-September 1984, management discovered in JMB will be found in the last section of this note.)

II The Bank's supervision of JMB

In 1981 and the first half of 1982 JMB's capital ratios were more than adequate and, even allowing for the nature of its business, left room on the Bank's normal criteria for an appreciable expansion of the balance sheet. The ratios weakened during late 1982 and the first half of 1983 before stabilising at the level which prevailed until the late summer of 1984. At that level they were still in line with those of many other banks.

Until the year ending on 31 March 1984, JMB's profit performance had been good and the Bank's knowledge of their bad debt experience, up to and including that year, gave no indication of any sizable problems. The annual accounts carried unqualified audit reports and included a note that 'Provision is made for all known doubtful debts'.

Particular attention was devoted at regular prudential interviews to discussing bullion trading, which was the dominant part of JMB's business. The Bank drew JMB's attention, in the course of 1983, to some concerns it had about the adequacy of its liquidity position. Management responded positively and the position was improved over the following months. Inadequate liquidity was not a serious problem at the time of the crisis. Also during 1983, there was a rapid increase in lending to JMB's commodity subsidiaries. The Bank took up with JMB's management the scale of the exposures, which suggested weak controls in the bank, and the exposures were substantially reduced after the Bank had made clear its concern about them. In the five months, October 1983 to February 1984, the Bank held three meetings with JMB's management at which the two concerns described in this paragraph were particularly discussed.

The Bank's identification of the problems building up in the commercial loan book was seriously hindered by misreporting of the large exposures (which were significantly understated in the returns), and by late reporting, particularly for the March 1984 quarter. Table 3 shows the exposures to the two largest borrowers as they have subsequently been discovered to be and as they were reported to the Bank from June 1983 to June 1984.

Table 3
Percentage of capital base

	Reported		Actual	
Customer:	A	B	A	B
1983				
June	15	12	26	17
September	18	—	45	21
December	27	18	51	25
1984				
March	42	30	65	34
June	38	34	76	39

In December 1983 these exposures, reported at 27% and 18% of capital, were not significantly out of line with the size of exposures carried by many other banks (though JMB's exposures were not to first-class names). One other large commercial exposure, which is now considered doubtful, was reported in the March 1984 return as equivalent to 14% of capital; this was about half the true exposure. A further doubtful exposure equivalent to 27% of capital was omitted altogether. The levels of the largest exposures at the end of March, even as reported, would have caused the Bank to request an early meeting with JMB's management. But the report for March, which was due in the middle of April, was not received until June in spite of JMB being pressed to provide it on several occasions.

After the March return was received, the Bank asked for a meeting with JMB in July; but this was delayed at the request of JMB's management and

meeting was arranged early in August. This meeting was held on JMB's premises and lasted for most of the day. By the time of this meeting the end-June returns had also been received. Although the two exposures then stood at some 76% and 39% of capital respectively, the returns showed that the larger of the two exposures had been reduced from 42% to 38% of capital, while the smaller had increased from 30% to 34%. A new exposure equivalent to 17% of capital was reported for the first time. It was not until just before the August meeting that the Bank discovered that the new exposure was to a company related to the larger of the two other borrowers, bringing that exposure apparently to 55% of JMB's capital, still an understatement. It was following the August meeting, at which the Bank expressed serious concern about these loans that JMB requested its auditors to examine the loans in greater depth. As a result of this examination, the extent of the provisions required began to become clear to the management of JMB. The management then advised the Bank on 25 September that provisions were required against these loans which would substantially reduce the bank's net worth. The development of the rescue operation is covered in Section III.

Lessons for the future

The problems which arose at JMB give rise to a number of questions about ways in which the present system of supervision should be improved. Two features of the existing system of supervision, which were highlighted by the problems which arose at JMB, are the Bank's lack of any detailed analysis of the quality of the loans in a large part of a bank's loan book and the difficulties for the supervisors of assessing the quality and effectiveness of control procedures. The Bank relies heavily on a bank's external auditors to cover these subjects during the course of their work. The auditors need to satisfy themselves as to the basis on which the directors arrive at their valuation of a bank's assets if they are to give a clean audit report. They can also be expected to review the adequacy of a bank's controls and systems during the course of an audit and to make comments to management on any aspects they consider to be less than satisfactory.

Other features of the Bank's supervision are the practice of relying on the accuracy of banks' returns and the encouragement given to banks' managements to bring their concerns to the Bank at an early stage. The Bank's reliance on these features has, on the whole, been justified; but it proved not to have been justified in the case of JMB. One of the problems may have been that management and the parent company did not themselves realise the extent to which JMB was building up problems and subsequently did not appreciate their seriousness. In addition, reporting was inaccurate and misleading and at a critical point was late—and significantly later than the Bank stipulates. It appears that most of the misreporting was due to the deficient systems in JMB, a lack of understanding of the Bank's reporting requirements and lack of co-ordination between different departments, rather than to a deliberate attempt to mislead the Bank.

Some of the problems which arose in JMB in 1983 such as weak liquidity and excessive lending to the commodity subsidiaries, were addressed by the management but only after these shortcomings had been raised with JMB's management by the Bank. In late 1983, the attention accorded to the adequacy of the liquidity of the bullion business and the control systems associated with intra-group lending reflected the importance given to these factors by the Bank at that time. Both were features which, had they not been rectified, could have led to serious difficulties for the bank. In this connection, it should be emphasised that the critical problem which surfaced in September 1984 was in no way connected with the bullion business, which was generally well managed and profitable. The problems related exclusively to JMB's commercial lending business.

In the commercial lending part of the business, the problems of deficient systems, poor lending judgements and inadequate monitoring and control were not identified or pursued by the board or the

parent company of JMB. The information in the regular returns made to the Bank gave some clues to possible problems in these areas—for example, the rapid growth of the commercial loan book, the large exposures to less than first class names and the declining risk asset ratio. But, as has been seen, much of the information was seriously deficient and for the period between December 1983 and June 1984 not available. Had accurate end-March figures been received on time and the August meeting, at which the Bank's concerns about the loans were made clear to management, been held earlier, it should have been possible to prevent some of the late rapid growth of the loan book as a whole, and in particular of the major problem loans. This might have made it possible to contain the bank's difficulties. Even then, however, JMB's ultimate losses would have been very substantial.

The issues raised in this section about the system of supervision are covered in the Report of the Committee set up by the Chancellor of the Exchequer, to consider changes to the system. The Committee comprised the Governor (Chairman), the Deputy Governor, Mr W P Cooke (Associate Director with responsibility for banking supervision), Sir Peter Middleton (the Permanent Secretary to H M Treasury), Mr Frank Cassell (Deputy Secretary, H M Treasury) and Mr Deryk Vander Weyer (Deputy Chairman of British Telecommunications p.l.c., and a director of Barclays Bank p.l.c.).

The Committee was asked by the Chancellor to consider in particular: the relationship between auditors and supervisors; the handling of concentrations of risk and the assessment of the quality of assets; the notification and collection of statistics; the adequacy and deployment of staff resources and the experience and training of staff in the Banking Supervision Division of the Bank; and whether any changes were needed to the Banking Act.

III The rescue operation

The Bank was advised by JMB on Tuesday, 25 September 1984, after its auditors, Arthur Young, had examined the two largest loans, that the directors considered that substantial provisions were required against these loans to an extent which drastically reduced JMB's net worth but did not make it insolvent. At the Bank's urging, the auditors during the next two days carried out a review of a wider cross-section of the loan book. Meanwhile the Bank discussed with the clearing banks the provision of liquidity support for JMB to deal with any withdrawal of deposits when the need for large scale provisions was announced. The further work by the auditors identified the need for other provisions which effectively exhausted the capital of the JMB group. It was then evident that liquidity support for the bank would not be sufficient on its own and that if JMB could not be recapitalised, or its losses underwritten by a third party, it would have to cease trading. An investigation of the loan book was undertaken by a team from the clearing banks, which worked through the Thursday night, 27/28 September and identified the probable need for substantially greater provisions, although the amount could not be accurately assessed in the time available. Their findings were confirmed by a separate examination of the loan book by Price Waterhouse, commissioned by the Bank.

As soon as the need for large scale provisions against the two large loans was known, the Bank discussed with JMB and other parties the ways in which support could be provided. The parent company of JMB, Johnson Matthey p.l.c., was approached first. While acknowledging its responsibility to stand behind the bank, Johnson Matthey p.l.c. indicated that it would be unable to provide from its own resources all the support which would be required.

Certain possible purchasers of the bank, including a clearing bank, a major overseas bank and the members of the London gold market collectively, were approached. However, none of them felt able to commit themselves in the time available, given the considerable uncertainties over the level of the provisions required. Other solutions, such as the sale of the loan book and the introduction of new

minority shareholders, were being explored simultaneously but had to be abandoned for the same reason.

The final potential purchaser withdrew during the late evening of Sunday, 30 September. The early stages of the negotiations for a rescue had been conducted with complete secrecy but questions had started to be raised in the domestic and international markets on Friday 28 September. By the Sunday night, news agency tapes were reporting that a London bullion house was in difficulties. It was clear to all those present in the Bank that night, including representatives of Johnson Matthey p.l.c., the clearing banks and the other members of the gold market, that without a solution being agreed, JMB would be unable to open for business on the Monday morning. If this was to be avoided, the only possible solution in the time available was for the Bank itself to take responsibility for providing the support required.

Once the decision to rescue JMB had been taken in principle, for the reasons described in the next section, the Bank sought the co-operation of Johnson Matthey p.l.c., of other members of the gold market and of major commercial banks in meeting the cost of the operation. The parent company agreed to sell JMB to the Bank for a nominal £1 and to inject £50 million into the bank before it was sold. This sum was judged by all concerned in the rescue operation to be the maximum that Johnson Matthey p.l.c. could contribute without seriously impairing its own creditworthiness. Undertakings to contribute support were secured from the banks and other members of the gold market. This support was later embodied in an agreement under which the Bank provided JMB with an indemnity of up to £150 million to meet losses in the commercial loan book, while the banks and the other members of the gold market agreed to counter-indemnify the Bank for half of any such losses. The counter-indemnitors have agreed to share any calls on them in the following proportions. The clearing banks have agreed to divide £35 million between them, the members of the gold market £30 million and the other Accepting Houses £10 million.

IV The reasons for the rescue operation

The Bank's fundamental reason for rescuing JMB was a deep concern for the systemic consequences if it was allowed to fail. The Bank, the commercial banks and the other members of the gold market involved on the night of 30 September 1984 were convinced that, had JMB not been rescued, there would have been unacceptable consequences for the banking system as a whole. This belief the Bank still holds.

At first sight, it might seem implausible that the failure of a relatively small bank like JMB, not widely known outside the bullion markets, could have such consequences. Certainly there should be no presumption that the failure of any bank would be thought to carry such risk for the system that it would be rescued. But, in the particular circumstances of JMB last September, several special factors were present which were judged to be conclusive. They are as follows.

JMB is a member of the London gold market. This is not simply a market in a sense analagous to, say, the copper market. It comprises a group of banks and members of banking groups, a substantial proportion of whose liabilities are in the form of deposits of gold, traditionally withdrawable at short notice. London is probably the most important international gold market and is involved in placing and taking gold deposits with a large number of institutions all over the world. The members of the market also do a substantial amount of business with each other. The failure of one of the five main participants would therefore have created a situation of extreme uncertainty.

The other members of the gold market would, because of their presumed exposure to JMB, have come under immediate suspicion and there would probably have been a very rapid withdrawal of liquid funds from all of them. The pressure that this would have been likely to put on the other four members could quite quickly have been translated in the classical manner of confidence crises, to other banks, in Britain and, perhaps, because of the international nature of the market, to banks

abroad. The Bank believed, and still believes, that it would not have been possible to have convinced the markets in the first few days after the crisis that the problems did not derive from JMB's bullion business. Equally, no statements or promises of liquidity support could have been relied on to contain an ensuing loss of confidence in other members of the gold market and other banks. The possibility of allowing JMB to fail and seeking to contain the consequences of its failure was considered during the week of the rescue operation, but was rejected. This was partly for the reason just given and partly because providing the necessary liquidity in gold would have been beyond the Bank's own resources. It would have necessitated recourse either to the gold owned by the Government in the Exchange Equalisation Account or to a Government guarantee for the borrowing of gold from other sources. It was quite impractical, certainly in the time available, to have set up what would have been an open-ended and possibly very large commitment of this kind.

At the time the rescue occurred, confidence in financial markets generally was fragile in the wake of the continuing international debt problems and particularly of the crisis at Continental Illinois National Bank where, despite the action taken by the US authorities to rescue that bank, US banks suffered some loss of confidence for some time afterwards. The speed and magnitude of the problems that could have developed in the wake of the failure of JMB were demonstrated to the Bank in the early hours of Monday, 1 October. While the form of the rescue operation was still being discussed, and there had been no announcement made about the difficulties in JMB, it was reported from the Far East that some major foreign banks were refusing to deal with first-class British banks (including some not belonging to the gold market) with whom they had very long-standing connections. This strongly underlined the need for speedy and decisive action.

During the Continental Illinois crisis large amounts of money had moved from US banks into UK, other European and Japanese banks. The failure of JMB, because of its prominence as a member of the gold market, risked provoking a similar movement away from British banks. Much of the funds which moved out of the US banks remained in dollars, but sterling lacks the dollar's pre-eminent position and it was clearly a possibility that the move would have been out of sterling as well as out of British banks.

In addition to the foregoing general concerns, there were two other important, if subsidiary, factors which related to JMB itself. Although JMB is only one of the five members of the daily gold fixing, it is the only one which is part of a group which has refining capacity. This refinery constitutes for two reasons an important encouragement to overseas traders to use the London market. It possesses the facility to break down standard bars into smaller bars for which there is an increasing demand; and it has a capacity to refine gold in other forms into standard bars. This refining capacity was a major part of the Johnson Matthey group outside JMB. The failure of JMB would have virtually certainly brought down the whole of the group and could thereby have damaged the position of the gold market.

The second factor was a consideration of a rather different kind. As part of its bullion operations JMB received substantial deposits of gold from a number of foreign governments and central banks. Losses on these official deposits could have had particularly serious implications for the standing of and confidence in British banks generally.

V Developments since the Bank acquired JMB

Immediately following the acquisition of JMB by the Bank steps were taken to reorganise the board: Mr R D Galpin, an Executive Director of the Bank, was appointed Chairman and the resignations were accepted of six members of the previous board. Two of the former directors, Mr J J Shaw and Mr P J K Smith, were confirmed in their appointments and five new directors appointed. These were Mr P Brenan as Finance Director, Mr G R A Copus and Mr M J Harper as Banking Directors, Mr P W Moss to oversee JMB's commodity subsidiaries and Mr L T G Preston who, with Mr

Smith, has responsibility for the bullion and markets area. Mr Shaw is also Chairman of JMB's insurance broking subsidiary.

Mr Brenan, a member of the Council of the Institute of Chartered Accountants, was at one time the Finance Director of Hambros Bank Ltd; Mr Copus was previously Senior Director of Standard Chartered Merchant Bank Ltd and Mr Harper a Managing Director of Charterhouse Japhet p.l.c. Mr Moss had been Finance Director of Czarnikow Ltd and Mr Preston a Director of Standard Chartered Bank and previously in charge of the foreign exchange operations of the Bank.

Price Waterhouse were appointed as investigating accountants to review and report on the financial condition of the JMB Group as at 30 September 1984. They were asked to cover all aspects of JMB's business. Their report has confirmed the belief held by the Bank when JMB was acquired that its problems were confined to its commercial lending activities.

An important task for the new board of JMB, in consultation with Price Waterhouse, has been to establish the level of provisions required by a review in detail of each of its loan facilities. The detailed review of the loan portfolio is largely complete. In the light of then current circumstances the level of provisions deemed appropriate by the new board of JMB as at 31 March 1985 was £245 million, of which only £20 million had been provided by the previous management.

Price Waterhouse have reported that the capital, reserves and bad debt provisions of the JMB group stood at some £130 million as at 30 September 1984 before the additional provisions required for loan losses had been made. This amount, together with the £50 million injected by Johnson Matthey p.l.c., has been absorbed in meeting these provisions; consequently approximately £180 million of the identified £245 million of provisions has been met from JMB's own resources. To meet the balance of the provisions against JMB's commercial loan book, together with a contribution towards funding costs, the Bank has provided JMB with an indemnity of up to a maximum of £150 million. The Bank's liability is offset by counter-indemnities of up to £75 million from a number of banks and members of the London gold market. The indemnity agreement, signed on 29 March, after lengthy and complex negotiations, provides for calls to be made as at 31 March, with subsequent adjustments, upwards or downwards, on a quarterly basis until 31 March 1986. The total amount for which the Bank and the counter-indemnitors are liable as at 31 March this year is likely to be of the order of £65 million. By 30 April the directors of JMB had identified the need to increase provisions by £3 million. This, and any subsequent adjustment, upwards or downwards, found necessary before the end of June, will be reflected in the indemnitors' liability to be calculated at that date. The Bank has thought it right, however, to provide in its own accounts for half of the adjustment identified at the end of April.

In its efforts to recover as much as possible of the expected losses, the board of JMB is intent to pursue all the legal and other remedies open to it.

An immediate step taken on acquisition was to halt the outward flow of lending where lending limits had been breached or were not properly established. Most of the authorities granted to individuals to commit JMB were temporarily withdrawn and an Executive Committee established, meeting on a daily basis, to control JMB's activities. Control of JMB's operations by the new management was thus quickly established, and as the new directors joined the board the process of appraising its activities was put in train. Immediate action was required in handling, with the help of merchant bank advisers appointed for this purpose, the two largest exposures which had precipitated the crisis. Shortly afterwards, in one case, suits were instituted in the US Courts by the debtor against JMB and the Bank, each for an amount of $300 million. Both actions lapsed on 24 May.

Much of JMB's lending had been in US dollars [illegible]

where provisions against such loans have had to be made, it has been necessary to purchase currency to cover these potential losses. Such cover has been e[illegible]ted using a deposit of £100 million placed with JMB by the Bank in November. This deposit has also enabled JMB to make two-way business in the money markets.

A comprehensive review of JMB's lending operations was started in early October. This revealed deficiencies in JMB's records, and it soon became clear that the work involved in reordering the loan portfolio and records was too large and too complicated to be undertaken under the direction of the new board by the existing staff. Accordingly, approaches were made to a number of clearing and other banks for secondees to assist in this process. There was an immediate and helpful response and within a matter of days seconded staff with the necessary skills and experience had arrived. There are currently some 35 such staff working in the banking area of JMB.

With their assistance, significant repayments and reductions in JMB's commitments totalling some £65 million have been achieved. Facilities and credit files are now in better order. A complete reorganisation of the trade finance and bill department has taken place with fundamental improvements being made in its systems, records and controls. In this area there has been a need to reconstruct over a period of some years the facts surrounding over 1,500 separate accounts.

The structure of JMB's banking department has been reorganised and a number of banking review teams established with particular responsibilities. Such teams are led by secondees who have brought to the task skills, such as experience in realisations and credit assessment, which have been essential in dealing with the complicated lending situations which have been discovered.

The operations of the banking division have been the subject of a review by outside consultants and a team of secondees selected for that purpose. The manner in which funds were allocated in support of the banking operations of JMB has also been subject to close examination, following which a number of necessary changes were made. Management below director level has been strengthened through the use of senior secondees from other banks or by direct recruitment of individuals with the requisite experience.

All these developments have increased the demand for space and in the interests of efficiency, considerable relocation of functions and staff has been necessary.

In addition to the Executive Committee already mentioned, which now meets weekly, a new Credit Committee has been formed; its responsibilities have been closely defined and the procedures which existed before have been reorganised and tightened. An Audit Committee of the board and an internal audit function have been established; neither existed before. Arthur Young agreed to resign as JMB's auditors and Price Waterhouse have been appointed in their place. Freshfields have been appointed JMB's legal advisers, Deloitte, Haskins and Sells its tax consultants and R Watson & Sons have been appointed actuaries to the new Pension Fund which has been established by transfer of the actuarially calculated proportion of Johnson Matthey p.l.c.'s Pension Fund. A Staff Committee of the board has also been set up. The former parent company provided a variety of management services, including payroll, security and insurance, to JMB. These have all been subject to review and have been taken over by JMB; and a security manager has been appointed.

Arrangements have been entered into with each member of staff for JMB to take over his or her contract of employment which had been with Johnson Matthey p.l.c.; and steps taken to inculcate within the banking area a more thorough understanding of banking procedures.

Under the direction of the Finance Director, new budgeting and financial reporting methods have been introduced; and management information improved. The implementation of a new computer

system has been put in hand with significant enhancements to remedy serious deficiencies and replace inadequate manual records. The Chief Accountant of JMB has been given a more active role in the executive of the Bank; his function had previously been more one of book-keeping than of monitoring and reporting on financial performance and risk. The working capital requirements of the JMB Group's overseas subsidiaries have been examined; some repatriation of funds has already taken place and more is in prospect. The boards of the subsidiary companies have been reconstructed and in the currently quiet conditions of the commodity futures markets, a reduction of some 40 staff in total has been made in JMB's broking subsidiaries in London and New York. The activities of two further subsidiaries, Johnson Matthey and Wallace Singapore Pte Ltd and Johnson Matthey Asset Management Inc., neither of which had been making profits, have been brought to a close.

Overall control of JMB's lending operations was found to be generally deficient both in its nature and extent. This was not true of the dealing areas where a review of the operating systems and procedures revealed no serious weaknesses—and none which could not be quickly addressed. Steps have been taken to ensure the continued smooth operation of the bullion business in international markets. Various visits to dealing counterparties abroad have been undertaken and JMB, which continues to participate in the London gold fixing, continues to trade profitably overall in the bullion markets and elsewhere outside the banking area.

The new board recognised that some of its decisions would involve additional overhead costs. However these have been kept to the minimum necessary and are in line with the new board's intention to correct the deficiencies in JMB's organisation and systems which existed at the time of acquisition; and to strengthen the control and supervision of its banking operations. The board is also working to retain and develop sound profitable business within the banking area. All steps being taken should facilitate JMB's return to the private sector.

It is the Bank's intention to dispose of JMB at the earliest practicable opportunity. A number of institutions have already expressed interest in acquiring JMB and Barings Brothers & Co Ltd have been appointed by the Bank to advise on the strategy for disposal. With disposal in mind, and to provide JMB with a capital base appropriate to its level of business, the intention to reorganise the capital of JMB has recently been announced in a press release on 13 May. This will involve the cancellation of 59,999,900 issued and 15,000,000 unissued Ordinary Shares of £1 each and the subscription by the Bank of £75 million of fresh equity, of which £25 million will be in redeemable form, together with £25 million of subordinated loan stock with a final maturity date of 1995. The end of JMB's current accounting period has been postponed from 31 March to 30 June to enable the reconstruction to take effect prior to its accounting date. Following the reconstruction, the deposit made by the Bank last autumn, referred to on page 00, will be repaid.

The past six months have created considerable pressure on the staff of JMB who, to their credit, have responded well in difficult circumstances. The Bank is grateful to them and also to those financial institutions who joined in the indemnity arrangements; to the clearing and other banks who so readily seconded experienced staff to JMB to assist in the recovery process; to the secondees themselves; and to the new board.

ANNEX C

REVIEW OF BANKING SUPERVISION

In my statement on 17 December, I told the House that the Johnson Matthey Bankers affair raised important issues about our present procedures of banking supervision, and the legislative framework within which it is conducted. I announced a full review, which would consider whether any early changes in present supervisory procedures were called for in the light of the problems which had arisen in Johnson Matthey Bankers, and whether there was a need to review or amend the Banking Act 1979.

2. The Review Committee have now presented their report, which I have arranged to be published as a Command Paper and have laid before the House. I shall be considering the Committee's proposals carefully. In the meantime, I have accepted the report as a basis for immediate consultation. Many of the recommendations do not require legislation. Some are already being implemented. But some of the Committee's proposals do require fresh legislation. I therefore propose to publish a White Paper later this year, with the intention of bringing a Banking Bill before the House as soon as possible. The group of Treasury and Bank officials to which I referred in my earlier statement is continuing its detailed examination of the Banking Act 1979.

3. I am extremely grateful to the Governor of the Bank of England, who has chaired the Review Committee, and to its members, who comprised senior officials of the Bank of England and the Treasury, and a distinguished commercial banker, Mr Derek Van der Weyer.

4. A note by the Bank of England on events leading to the failure of JMB, the subsequent rescue by the Bank, and its conduct of JMB's affairs is annexed to the Bank's Annual Report and Accounts, which have been laid before the House today.

5. The Bank's account makes it clear that serious shortcomings in the management of JMB led to its collapse - over-rapid expansion of the loan book, heavy concentration of exposures, and lack of adequate control systems. JMB was also guilty of serious misreporting to the supervisory authority.

6. The circumstances described in the Bank's report must inevitably raise questions about the role of the auditors, Arthur Young. The board of JMB, which is a wholly-owned subsidiary of the Bank of England, have today announced that they will be initiating legal action against Arthur Young.

7. The Bank's account also explains their reasons for rescuing JMB. In mounting the rescue, I am satisfied that the Governor was acting properly within his discretion.

8. The Review Committee have made 34 specific recommendations. Their implementation will require action by the Bank of England, supervised institutions, their auditors and the Government. The Committee propose two fundamental changes in the present arrangements, and several important modifications. They have taken the view, which I share, that the JMB case exposes serious shortcomings in the present legislative framework and supervisory procedures. I shall in my statement outline only the Committee's main proposals. A full summary of their recommendations is annexed to their report.

9. The Banking Act 1979 draws a distinction between recognised banks and licensed deposit-takers. JMB was, and still is, a recognised bank.

10. Most of the Act's provisions, and of the Bank's powers set out in it, relate to licensed deposit-takers. A dual system of supervision has resulted. Licensed deposit-takers have been subject to a more rigorous regime of supervision, whereas the supervisors have relied heavily on the integrity and co-operation of the management of recognised banks. With most banks, this confidence has not been misplaced. But the banking industry has expanded rapidly, and its activities have

diversified. Recognised bank status - as we have seen with JMB - has not always guaranteed prudence and responsibility.

11. The committee recommends that the two-tier system be abolished and that the powers given to the Bank under the Act should apply to all authorised institutions. I accept this recommendation. It follows that all authorised institutions would then be entitled to use banking names.

12. I also intend to tighten the criteria for authorisation, including the minimum net assets required.

13. The second fundamental change recommended by the Review Committee concerns bank auditors. In this context, I am grateful to the Institutes of Chartered Accountants of England and Wales and of Scotland for the co-operation they have afforded the Committee.

14. The Committee recommend that there should in future be a regular dialogue between the supervisors and banks' auditors. I strongly endorse this proposal.

15. A bank's auditors are uniquely placed to monitor its control systems and assess its financial prudence. The accountancy profession at present considers itself prevented by a duty of confidentiality to the client from passing information to the supervisors. At the same time, the supervisors are themselves inhibited by the Banking Act from communicating supervisory information to third parties without the institution's consent.

16. This is clearly an unsatisfactory state of affairs. It is in cases where consent is not forthcoming that dialogue might be most necessary. This is why I accept the Committee's recommendation that the constraints on contact between auditors and supervisors be removed.

17. I emphasise, however, that it is the directors and senior managers of banks who are responsible for the conduct of their

business. They have duties both to depositors and to shareholders. This responsibility cannot be shuffled off to auditors or supervisors. The overriding lesson of the JMB collapse is that banks must have in place adequate management and control systems. I therefore endorse the Committee's suggestion that banks should appoint an audit committee and finance director where they do not already have them.

18. The Committee has also made important recommendations on the staffing and organisation of the Banking Supervision Division of the Bank of England.

19. The work of the Supervision Division has increased greatly in both complexity and volume in recent years, and the Bank of England now supervises over 600 institutions. In general it does a difficult job diligently and well. But in the case of JMB the supervisors cannot escape criticism for failing to respond more quickly to the danger signals.

20. The Committee have recommended that the staff of the division would benefit from wider commercial experience; that there should be more secondments in both directions between the division and commercial banks; that a significant cadre of experienced long-term banking supervisors must be built up; and that there should be more professionally qualified accountants in the division. They have suggested that more staff are needed.

21. The Bank has already begun to implement these recommendations. The division is being strengthened both in numbers and in the range of expertise available. Some rearrangement of responsibilities has taken place within the division and further secondments to and from commercial banks have been arranged. To provide advice at a senior level, Mr Sidney Procter, Chief Executive of the Royal Bank of Scotland Group, who retires from that position on 30 September, has accepted the Governor's invitation to serve on a part-time basis as an adviser on banking supervisory issues.

22. JMB's failure stemmed directly from a number of large, related exposures. The Committee recommend - and the Bank of England have accepted - that in future no exposure to a borrower, or to closely related borrowers, should exceed 25 per cent of the lender's capital base, other than in the most exceptional circumstances.

23. An effective system of banking supervision is essential not merely for the protection of depositors but for the financial health of the economy as a whole.

24. The Review Committee's report brings out very clearly the lessons to be learned from the collapse of Johnson Matthey Bankers. But more than that, it proposes a number of important changes to banking supervision in this country, which I am confident will greatly strengthen the system and make a repetition of the JMB affair very much less likely to occur. I commend it to the House.

Prime Minister (2)
I have sent copies to Alan Walters and the Chancellor.
AT 17/6

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THE CITY UNIVERSITY BUSINESS SCHOOL

Frobisher Crescent,
Barbican Centre, London EC2Y 8HB
telephone: 01-920 0111 telex: 263896

Dean: Professor Brian Griffiths

14 June 1985

The Rt. Hon. Margaret Thatcher MP
Prime Minister
10 Downing Street
London SW1

Dear Prime Minister,

I was invited by Andrew Turnbull to submit a very short note to you on the subject of monetary policy. It is a little longer than I had intended but I hope it may be of some use. In view of the fact that the subject is a highly complex one, you may feel at times that it over simplifies the issue. I would naturally be delighted at any subsequent stage to expand any of the points which I have made.

Yours sincerely

Brian Griffiths

Brian Griffiths

UK MONETARY POLICY AND TECHNIQUES OF MONETARY CONTROL

Introduction

1. Increasing concern is being expressed at present regarding the current thrust of UK monetary policy and the rise in the rate of inflation. This concern raises two major questions:

   (i) how temporary is the current increase in inflation when judged against existing monetary policy? and

   (ii) are the techniques of monetary control which were introduced in 1981 working well or not?

Monetary policy and rising inflation

2. Inflation has remained at a rate of approximately 5 per cent since 1983. There is no reason to think that the present increase is other than temporary, reflecting the fall in sterling in late 1984 and early 1985 and the increase in mortgage rates by 3 per cent in April. This expectation is based on (a) the recovery in sterling, (b) the correction of a rather lax monetary policy towards the end of 1984 through higher short term interest rates, and (c) the possible strengthening of sterling against the dollar.

   Given the present stance of interest rate policy there is good reason to think that inflation will fall again to around 5 per cent, even though it may take some time. While inflation should fall from its current rate of 7 per cent it is doubtful if it will fall to 3 per cent on the basis of present policy.

3. Against this general background, there is nevertheless cause for concern over the behaviour of unit wage costs and the rapid growth in liquid assets. Unit wage costs have risen from around 1 per cent in the second half of 1983 to over 5 per cent in the first quarter of

this year. Because of the rise in inflation this trend could continue throughout the next wage round. If monetary policy is to be set to achieve an inflation rate of 5 per cent or even 3 per cent, then rising unit labour costs, while not necessarily implying a rising inflation trend, may have serious short term implications for unemployment.

4. The growth in liquidity over the past twelve months, measured by any of the broad aggregates (£M_3, PSL2), is considerably greater than the growth in money income. These growth rates, however, are not a good predictor of inflation because of the high level of interest rates which makes various kinds of interest-bearing bank and building society deposits especially attractive. Put differently, there has been a rise in the demand for broad money at the same time as the supply has been increasing.

But if these liquid assets are used at some future date by individuals and companies to finance expenditure, they could have a nasty - if short term - inflationary impact. As a consequence, it is important that monetary growth judged by M_0 should not rise much above its present level and that bank interest rates be allowed to rise to the appropriate levels to contain the growth of money.

5. **Techniques of control**

There are a number of reasons for thinking that the present techniques of monetary control which were introduced in 1981 are not working well. Symptoms of the problem are:

(a) the need to raise interest rates abruptly - for example the rise in base rates in June 1984 by 2 per cent and then in January 1985 by 4 per cent;

(b) the rise in £M3 of no less than 3 per cent in one month (April 1985);

(c) the size of the 'bill mountain' - which has now reached £15bn.

6. The present system of control works by the authorities announcing a £M3 target, influencing the level of short term rates, overfunding if the growth of assets backing £M3 is greater than the target figure, and then relieving the shortage of cash in the money markets by purchasing bills (so enlarging the 'bill mountain').

7. Writing in 1981, shortly after the new system was introduced, my firm expectation was that the new system had the same ingredients for creating distortions as the old.

> In fact, it turns out that the new system of control is open to all of the objections of the previous system. By operating in the money markets within an interest rate band the authorities are still forced to choose a particular interest rate range in order to influence money supply growth. Yet we know from the past ten years that this is the very thing the authorities find it very difficult to do successfully. Why, then, continue with a system which makes it virtually certain that money supply growth will proceed by fits and starts as it has done over the past decade? The fact is that there is nothing in the new system which gives one any confidence that the authorities will perform more efficiently in controlling the money supply in the eighties than in the seventies. The Bank still retains enormous discretion over interest rates and over the rate of growth of its own balance sheet. Not until this is removed can we expect to see a more stable and lower pattern of money supply growth.

Annual Monetary Review, December 1981

The reason for this judgement was that in introducing change the authorities were concerned primarily to introduce a new system of short term interest rate determination, rather than a system which would control the cash resources of the banking system and so provide a constraint on the growth of bank deposits.

8. It also turns out that even though the reforms of 1981 were an attempt to create greater flexibility in short term rates, they have not succeeded in this respect, so that we know no more now than we did then about the banks' demand for cash.

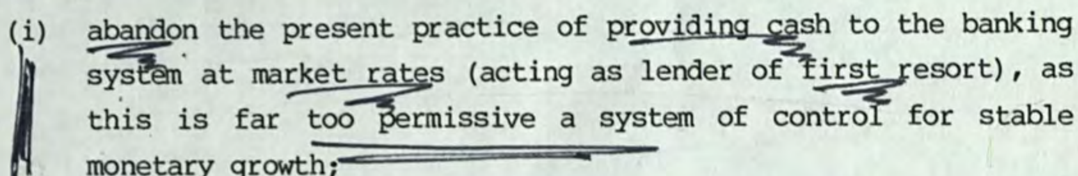
Options for change

9. The present system of control depends on the authorities targetting £M3. The important reason for targetting £M3 is that it is a way of controlling inflation. Because of distortions such as round-tripping and high interest rates £M3 is less useful as an indicator of monetary policy than previously. Nevertheless for the Chancellor to drop £M3 when its rate of growth is above target and inflation is rising may have a perverse effect on confidence; and previous experience in ignoring broad money, namely 1971-73, was disastrous.

The argument which is sometimes put forward - that £M3 is a convenient way of linking monetary policy to fiscal policy, interest rate policy and debt management policy - while understandable, may well be counter-productive if it provides the authorities with a set of explanations for failing to hit monetary targets which crucially omits their own lack of control of cash being supplied to the banking system.

My own judgement is that while it is presentationally useful to retain £M3 as an indicator, it is an increasingly unreliable target for monetary policy.

10. The fundamental feature of change, however, should be a change in the target and operating procedures of the authorities. The authorities should be required to:



(i) abandon the present practice of providing cash to the banking system at market rates (acting as lender of first resort), as this is far too permissive a system of control for stable monetary growth;

(ii) provide cash to the banking system only at penal rates;

(iii) retain £M_3 as an indicator but adopt Mo as an operational target

For this policy to work, the authorities must be explicit in announcing their intentions to the market. On the basis of the announced penalties which banks would face if they were to borrow cash from the Bank, the banking system will clearly wish to increase its holding of bank reserves. At present the authorities know very little about the banking system's demand to hold bank reserves.

If arrangements could be devised for the transition from the present system of monetary control to one in which the authorities targetted the cash base, so that there was no risk of the money supply careering off-target (and I for one see no reason why not), then I believe that monetary policy under such a system would be subject to less uncertainties and would therefore be more stable than under the present system.

In order to create the condition in which the authorities can pursue a more flexible interest rate policy, it would be useful to fund the 'bill mountain'.

11. There are, however, two institutional implications of trying to achieve a more stable monetary policy which must be emphasised:

(a) it requires that short term interest rates, and especially base rates, should be allowed to move freely and without intervention of any kind; and

(b) in the transitional period, but not subsequently, the banks and discount houses should expect to find that short term interest rates move rather more quickly than they have come to expect - which for some could be uncomfortable.

Any attempt to intervene in the money markets to prevent or affect these developments could well render the system ineffective.

Brian Griffiths

Dean
City University Business School

14 June 1985

PRIME MINISTER

MONETARY POLICY

Gordon Pepper has sent a copy of his latest bulletin which was written after discussion with Alan Walters. He has also telephoned me to discuss it. He shares with Alan the view that current monetary conditions are probably not too lax but that the build up of liquidity, as seen in the rapid growth of £M3 and PSL2, is a cause for concern. This build up of liquidity could create problems in two ways. First, those holding liquidity could accelerate their spending which would manifest itself in faster growth of transactions balances, i.e. MO. Secondly, liquidity could, at short notice, be switched abroad putting pressure on the exchange rate as happened earlier this year. In either case the result would be faster inflation. Gordon Pepper's proposed remedy is to move to monetary base control, i.e. quantitative limits on the supply of cash to the banking system. He recognises that this cannot be done overnight. If the banks are not first induced to hold significant reserves at the Bank of England, variations in the cash surplus or deficit of the public sector, which can arise for purely technical reasons, can have a major impact on interest rates. It would be essential to build in some cushion to prevent the system being unstable.

Gordon Pepper added, regretfully, that he did not think adoption of supply side control of money was feasible at present. It would be a mistake to impose on those responsible for carrying it out a system which they did not believe in. He thought the second best was therefore to recognise that monetary targets had lost their effect in influencing expectations and that the Government should steer the economy by reference to money GDP and the exchange rate as is increasingly happening in the United States.

It seems to me that monetary policy has reached a crossroads. The option of setting a target for £M3 and varying interest rates according to whether £M3 is growing above or below

target is no longer credible. The alternatives are:

(i) to return to the true spirit of monetarism by controlling the supply of monetary base; or

(ii) to move away from monetarism towards a less specific anti-inflation policy in which the Government responds not to deviations in monetary growth from the target, or even to whether the exchange rate has moved from a certain parity, but according to a judgement of whether inflation is accelerating or is being brought down fast enough. The Chancellor began to move down this road in the last Budget.

If the Government were to adopt (i), it would again be identifying itself politically with a very specific objective of monetary control. It would be essential to deliver if the Government's credibility were not to be damaged. Above all, the Government would have to accept that determination of interest rates would pass out of its hands.

It can be argued that one of the objectives of the 1981 changes was, indeed, to give market forces the dominant role in setting interest rates. Conditions in the money market have, for technical reasons made this impossible to achieve. But I, for one, am sceptical about how Ministers would in practice have gone in abdicating control over interest rates. There was, however, another objective which was to depoliticise interest rate changes and reduce the "bias for delay". In this respect, the new arrangements have been successful and base rates have moved more frequently and with less drama than was the case with bank rate or MLR. Market forces have provided the camouflage which have enabled Ministers to bring about unpleasant but necessary interest rates changes while laying some of the blame elsewhere.

If one looks at the record of the past four years to detect what have been the factors which have induced changes in interest rates one will not find that variations in the

growth of money or the level of the exchange rate have played a significant part. The only thing which has consistently induced a rise in interest rates has been when the Government's inflationary objectives have been threatened, in particular when the exchange rate has fallen rapidly.

AT

ANDREW TURNBULL

14 June 1985

W. Greenwell & Co.
Bow Bells House, Bread Street, London EC4M 9EL
Telephone : 01-236 2040   Telex : 883006 GRNWLL G
Facsimile (Groups 3, 2 & 1) 01-248 0702

W. Greenwell Inc.
535 Madison Avenue, New York, N.Y. 10022
Telephone : 0101 212 702 5480   Telex : 429654
Facsimile (Groups 3, 2 & 1) 0101 212 702 5490

Monetary Bulletin

No. 173 June 1985

Sterling M3 responds quite quickly to changes in relative interest rates. M1 used to respond quite quickly to changes in interest rate levels. Mo, in contrast, does not respond quickly to changes in either interest rate levels or interest rate relatives. The Chancellor has, therefore, focused attention on an aggregate which the Bank is unable to control with its current mechanisms.

The greatest cause for concern in the present monetary situation is that the accumulation of liquidity which has been building up over the last few years could start to be spent, thereby generating renewed inflation. A mechanism is therefore required to hinder the amount of liquidity which can be encashed in the aggregate. Instead of being ready at all times and in all circumstances to buy whatever quantity of eligible bills the market wishes to sell, the Bank should decide on the amount it is willing to buy. If the market wants to sell a greater amount, the extra finance should be supplied by the Bank at a penal rate.

History

Monetarists originally argued that the supply of money should be controlled. The UK authorities decided instead to try to control the amount of money by influencing people's demand for it. They planned to do this by altering interest rates which, together with the level of nominal national income, are the main determinants of the demand for money. In other words, the authorities adopted a demand-side approach instead of the supply-side one advocated by most monetarists. Our last Bulletin argued that the current approach has just about reached the end of the road.

The authorities also decided to focus attention on M3 rather than the narrower aggregates Ml and Mo favoured by most North American and Swiss monetarists. They did so for various reasons.

First, M3 suited many in the Bank of England because blame for any excessive monetary growth could be placed on the Treasury for failing to control the PSBR.

Secondly, it suited the Treasury because the associated target for the PSBR strengthened the case of Treasury Ministers when arguing with Ministers in charge of Expenditure Departments for lower public expenditure.

R.H. Lawson, G.T. Pepper, The Lord Annaly, J.A. Rickards, L. Gooderham, T. Quinn, M.T. Higgins, D.G. Thomson, H.N. Seely, T.G. Wakeley, J.F.R. Hammond, J. Wigglesworth, E.J. Fenton, A.J. Bonner, N.S. King, G.P.P. Stewart, K.P. Joseph, A.G.P. Davidson, P.D. Jones, R.L. Thomas, K.C. Brown, J.C. Finch, S.J.D. Posford, R.W. Walker, W.E.A. Bain, R.M. Harvey, R.B. Pomphrett, M.R.F. Wonfor, A.L. Bucknall, M.S. Jaskel, P.B. Lilley M.P., A.J.E. O'Sullivan, G.R. Addison, K.M. Feeny, P.H. Beaufrère, K.A.J. Crawford, J.B. Lake, L. Maddy, R.J.M.L. Ottley, S.H. Wamsley, I.S. White, S.L. Greenwell

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Thirdly, it suited many academics, especially those who specialised in computerised models of the economy, because M3 allowed their neo-Keynesian approach to embrace monetarism much more easily than if attention had been focused on the narrow aggregates.

Summarising, the demand-side approach to controlling M3 adopted in the UK was a distinctly neo-Keynesian variant of monetarism.

Sterling M3

The first detailed mistake the authorities made was soon apparent in the early 1970s. They had focused attention on changes in the level of interest rates and had ignored the importance of interest rate relatives. Once they realised their mistake, they were reasonably successful in controlling the money supply because M3 responds quite quickly to changes in the rates of interest on bank deposits relative to those on similar investments. People switch between bank deposits and other investments reasonably freely and the Bank could control sterling M3 by operating on the difference in interest rates.

After a few years, this method of controlling the money supply ran into difficulties for two reasons. First, the Bank's ability to organise its desired interest rate relatives was progressively hindered by the problem of its growing bill mountain (which is itself a by-product of neglect of supply-side control). Secondly, the very high level of real interest rates, which is a consequence of the policy, increased people's demand for bank deposits as an excellent home for genuine savings. The result has been buoyant growth of the broader aggregates.

M1

The authorities then started to pay more attention to M1. Unlike sterling M3, M1 responded quite quickly to a change in interest rate levels. This was, however, when the non-interest bearing component of M1 was substantial. As the level of interest rates rose, people switched out of non-interest bearing deposits into interest bearing ones. M1, accordingly, fell because it contained relatively few interest bearing sight deposits.

More recently, starting in 1982, there has been a big increase in the interest bearing sight deposits which are included in M1. As interest rates rise, people now tend to switch from non-interest bearing deposits into interest bearing sight deposits, which leaves the total of M1 unchanged. Further, if there is an inverted money market yield curve, e.g. if the rate of interest on sight deposits exceeds that on seven day deposits, there will be a tendency for people to leave more money on deposit on an overnight basis. If so, M1 increases. Summarising, the growth of interest bearing sight deposits, and high interest bearing chequing accounts offered by clearing banks, has meant that the Bank can no longer control M1 reasonably quickly by altering the level of interest rates.

Mo

The Treasury has recently switched its focus of attention to Mo. It is widely known that the Bank has tried hard to resist this development. One of the Bank's reasons is, presumably, that Mo is different from M1 and sterling M3 because neither changes in the level of interest rates nor changes in interest rate relatives have a quick effect on it. As stated in our last Bulletin, a recent Treasury paper acknowledged that it takes about a year before the effect materialises, ie interest rates affect the level of activity in the economy as a whole and then the level of retail sales, which then affects the public's demand for notes and coin which currently amount to 90% of Mo. **In short, the Chancellor has focused attention on an aggregate which the Bank is unable to control with its current mechanisms.**

Attempts to control Mo from the demand-side are almost certainly doomed to failure. The Fed tried to do this in November 1979 and the result was a shambles (as reported in Bulletin No.131, April 1982). The lags in the system were such that the Fed persisted for too long with alterations in interest rates. This caused reverse swings to take place in due course. The result was not merely volatility. The system threatened to become unstable and the Fed abandoned its experiment in August 1982.

It will be no surprise if the target for Mo gradually lapses in the same way as those for M1 and sterling M3. It might subsequently be supplemented by a target for M2 but there are apparently technical problems with this series. Further, the credibility of introducing yet another target variable would be low. Overall, the discipline on the government of having published targets for the money supply is likely to progressively disappear, with the policy becoming almost wholly discretionary.

The experiences of the 1960s and early 1970s indicate that it is most unwise to rely on a discretionary policy. The main danger, however, will come from the continued build up of excess liquidity in the economy, which the authorities are currently attempting to contain by operations which result in the Bank's bill mountain.

Excessive liquidity and the bill mountain

When making new loans, banks normally bid for the necessary funds, ie they pay whatever rate of interest is necessary to attract the required amount of deposits. We have already argued that the current rate of interest which banks are offering is so high in real terms that bank deposits are an excellent home for genuine savings. Buoyant growth of bank deposits because of an accumulation of such saving is not an immediate cause for concern. The economy is, nevertheless, becoming considerably more liquid. The cause for concern is that people may at some time in the future decide to spend their liquidity. The mechanism to stop this from happening is currently not in place and the accumulation of liquidity could suddenly become inflationary if something happens to ignite the bonfire.

The authorities have been trying to limit the build up of liquidity. Cutting through the complications, the Bank has, through its purchases of commercial bills, provided no less than £15,000m to banks so that the latter can satisfy the demand for bank loans without having to bid for even more deposits. The incredible fact is that the amount of money which the Bank has needed to borrow for this purpose, by overfunding in the gilt-edged market, is almost twice as much as this year's PSBR. Further, the transactions are causing enormous distortions to markets.

The permanent solution to the problem would be to open up other sources of credit so that the demand for bank loans subsides. The obvious source was the long dated corporate bond market but attempts to revive it have so far had very disappointing results. More recently, attention has switched from long dated to short dated (1-5 year) corporate bonds. Another possibility is to induce banks to parcel up their loans into packages, convert them into negotiable securities and raise the necessary finance by selling the securities rather than by bidding for deposits. The same could apply to building societies with packages of mortgages. The securities could have either a floating or fixed rate of interest.

If recent policy moves are successful, genuine savings will accumulate in securities rather than in bank deposits. The securities will, however, be highly liquid. A very short dated floating rate corporate bond, for example, is quite a close substitute for "primary liquid assets" which the Bank stands ready to purchase. Although reduced in degree, the problem of the excessive build up of liquidity will remain.

Recapitulating on liquidity:-

i) Wholesale deposits are being held in overnight sight deposits rather than in 7 day deposits, and retail deposits are being held in high interest bearing chequing accounts rather than in deposit accounts.
ii) Inspite of this, interest bearing bank deposits for terms longer than overnight are growing.
iii) Building society deposits are also growing.
iv) Substantial holdings of very short dated bonds may well accumulate.

Restricting the encashment of liquidity

There is a strong argument for reinforcing current policy by putting a mechanism in place which would hinder people in aggregate from encashing liquidity. We suggest that the Bank should change its tactics in the bill market in a similar way to the change which occurred in the gilt-edged market in 1971 (explained in "Competition and Credit Control").

In the 1960s the principal aim of debt management was "to maximise investors' desire to hold gilt-edged stock over the long term". The authorities considered that a very important reason why investors were prepared to hold gilt-edged stock was confidence that they could always be sold close to middle market prices. The Bank, accordingly, stood ready to take stock off the gilt-edged jobbers whenever there was substantial selling. When the authorities withdrew this facility in 1971 there were fears that the liquidity of the gilt-edged market would dry up without the support from the Bank. In the event it did not. A very important reason for it not doing so was that the authorities had been interfering so much that they had been inadvertently damaging the market mechanism. Market participants returned to fill the gap left by the authorities. The parallels with the bill market are obvious.

The important strategic change in 1971 was that investors in aggregate could no longer encash gilt-edged stock but, as explained, this did not prevent one investor from being able to sell to another.

Turning to the bill market, under the current procedures the Bank stands willing to buy whatever quantity of eligible bills the market wants to sell. The Bank cannot withdraw to the extent that it did in the gilt-edged market because it needs to buy bills if the Exchequer is in surplus. The Bank could, however, decide on the amount of bills which it will buy rather than leave it to the market. This would prevent holders of bills from encashing them in aggregate.

The change which we are suggesting is more profound than it may seem. To be workable, any amount of cash wanted by the market in addition to that provided by the Bank's bill purchases should continue to be provided by the Bank. But the rate of interest charged by the Bank should carry a penalty (unless there is a genuine need for lending of last resort because a bank is in trouble). One consequence would be that banks would keep much larger balances with the Bank than at present to avoid paying the penal rate. These balances would be included in Mo and, to accomodate the shift in demand, the base of the target for Mo would have to be correspondingly adjusted.

If the changes we are suggesting were to be adopted, the authorities could legitimately be much more sanguine, in circumstances similar to those at present, about the growing liquidity in the economy.

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SECRET (AND PERSONAL UNTIL THURSDAY 13 JUNE)

File 4a

MONTHLY MONETARY REPORT: MAY-AUGUST

- The narrow and broad aggregates continue to give different messages. The 12 month growth rates for MO and NIBM1 are 5½ and 4 per cent; the equivalent rates for £M3 and PSL2A 11½ and 13 per cent. Other indicators, particularly real interest rates and the exchange rate, suggest that monetary conditions remain tight.

- Bank lending increased by £1½ billion in May tending to confirm that last month's extra lending to benefit from the 1984-85 capital allowances may take some months to unwind. April's massive increase in the externals has not been reversed.

- The forecast still suggests that June may be a month of high growth for £M3 and slightly higher growth for MO than recently. The exceptionally high level of gross gilt sales in June will be offset by large redemptions, and its impact of £M3 may be blunted by high overseas interest. We have revised upwards our forecast of bank lending - in part in recognition of our record of consistent underestimation in previous forecasts.

- By the end of banking August we are forecasting 12 month growth rates of MO and £M3 of around 5¾ and 13 per cent respectively. £M3 would have to grow by no more than ½% a month from now on to be within its target range by the end of 1985-6.

- The introduction of new accounts which happen to be classified as term shares has distorted PSL2 downwards in the last 2 months. PSL2A is unaffected and has remained remarkably stable over the last year with its 12 month growth rate staying in the 12%-14% range.

- All the major clearing banks have undertaken or announced foreign currency floating rate note issues, totalling around £3 billion. These are assumed to have little effect on £M3, causing offsetting changes in nndls and the externals. We are considering a redefinition of these counterparts to exclude such foreign currency issues.

HF3 June 1985

SECRET (AND PERSONAL UNTIL THURSDAY 13 JUNE)

MONTHLY MONETARY REPORT: MAY-AUGUST

Monetary Aggregates

In banking May £M3 grew by 0.5 per cent, 0.3 per cent above forecast. MO was marginally above forecast, falling by 0.1 per cent. 12 month growth in £M3 is now 11.6 per cent, with 6 month growth slightly lower and 3 month growth considerably higher. Annual growth in MO is now 5.5 per cent, where it has been throughout the last year. 3 and 6 month growth in MO is lower still. Table 1 below shows recent growth in the target aggregates, and annex table 1 provides further detail, also covering real MO and real £M3. Other measures of money are shown in annex table 4.

Table 1 Target Aggregates: Recent Experience

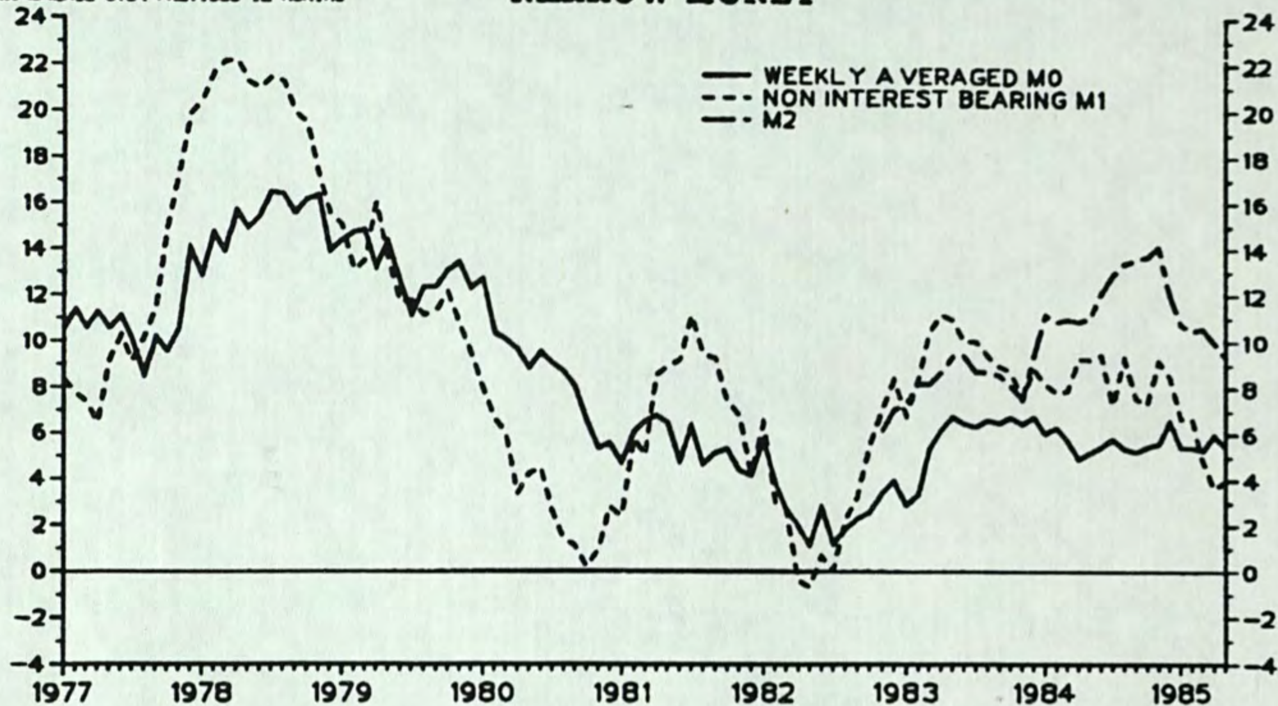
per cent, s.a.

	MO	£M3
Monthly change		
March	0.4	1.0
April	0.7	2.8
May	-0.1	0.5
Growth to mid-May at an annual rate over past:-		
3 months	4.4	19.0
6 months	3.7	10.6
12 months	5.5	11.6

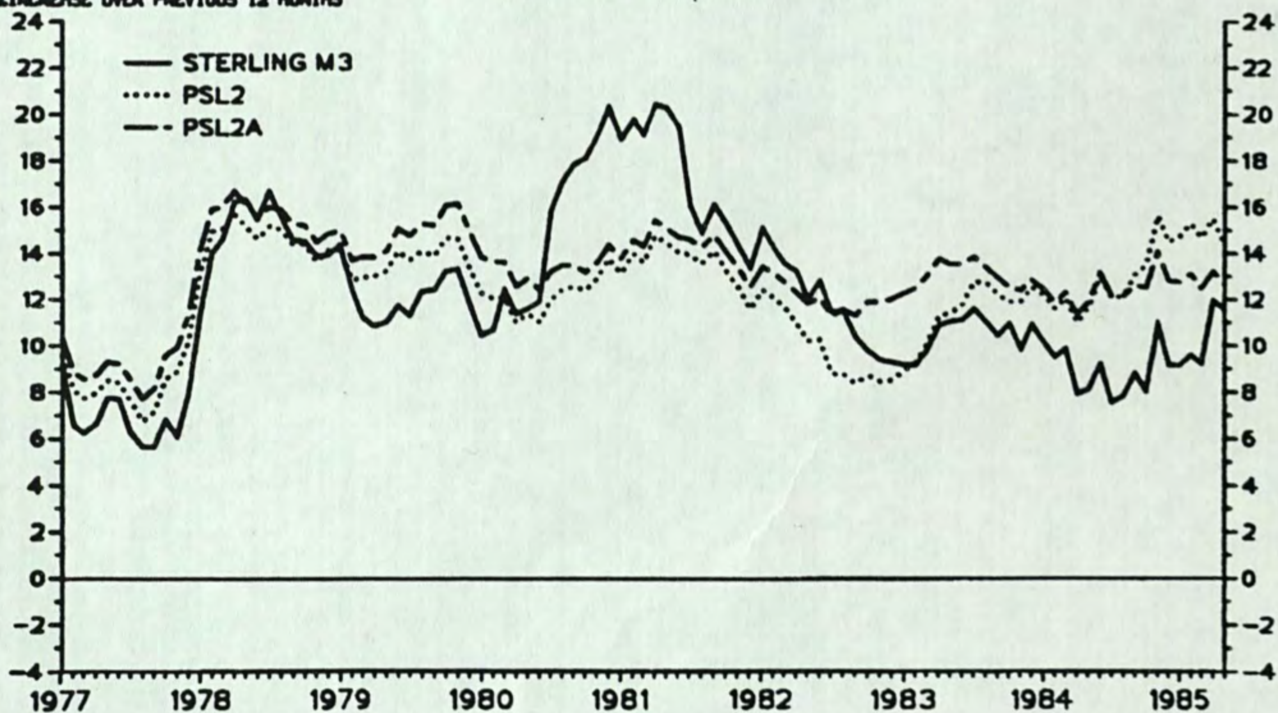
2. The replacement of the £1 note by the £1 coin has not proved to be smooth, and perhaps as a consequence the monthly path of MO growth has been erratic. However the longer period growth rates suggest that there is little reason to believe that the underlying growth rate has shifted from the 5-6% (annual rate) range, evident since early last year.

CHART I : ANNUAL GROWTH RATES OF MONETARY AGGREGATES

NARROW MONEY



BROAD MONEY



3. The British Aerospace oversubscription may have inflated £M3 this month. To the extent that deposits were built up in anticipation of the sale this will have distorted £M3 upwards this month, since the money will still have been in the system, on suspense account, on make-up day. Though no accurate assessment of this effect can be made, the £¼ billion distortion assumed in last month's forecast remains a reasonable central view. NIBM1 is the only aggregate we can be fairly certain was affected by the BAe oversubscription. This is because on make-up day the partially successful applicants' refunds were in suspense accounts, 60% of which are conventionally allocated to non-interest bearing deposits. This partly explains why NIBM1 grew by 0.8 per cent last month, some way above recent experience.

4. Of the public sector counterparts to £M3 the "PSBR" was close to forecast (with lower own account requirements more than offset by higher "other public sector" borrowing), while debt sales to the nbps were slightly lower then forecast. Overall the public sector impact on £M3 was neutral.

5. As to the other counterparts we have been looking for any signs that last month's erratic increases might be beginning to unwind. Sterling lending, at £1.4 billion was some £0.4 billion lower than the average for the last 6 months. But this was still some £150 million above the forecast, which allowed for some net unwinding of round tripping, and for the beginning of the unwinding of April's investment borrowing surge. But it does look therefore as if the underlying growth in bank lending may now be higher than the £1½ billion a month on which last month's forecast was based. Our assumption for underlying lending has therefore been increased this month.

6. The other counterparts taken together were close to forecast. After allowing for identifiable factors the externals were expansionary again this month, and their make-up provides little evidence of an unwinding of last month's massive build up of foreign currency assets by the banks (the counterpart to a run down in

such assets - and a build-up of sterling assets in £M3 - by the nbps).

7. Though building society retail inflows have improved since the rise in rates on April 1 they are still below the level we believe the societies desire. The introduction of a new type of term share by some of the major building societies has been the major influence on those aggregates which include building society liabilities. Substantial inflows into these accounts appear to have been at the expense of other building society accounts. Since term shares are outside PSL2, this has depressed the growth of PSL2, but has not affected PSL2A, which includes them. This goes some way to offset the drift out of term shares, and into other building society accounts, which has distorted PSL2 upwards over the last year or so. PSL2A, in contrast, has not been subject to these distortions, and its 12 month growth rate has remained fairly steady at around 12½ to 13 per cent for most of the last year.

Other indicators of monetary conditions

8. Inflation: There was another unexpectedly large rise in retail price inflation in April taking the twelve-month growth rate up to 6.9 per cent. Movements in the RPI are being exaggerated by changes in mortgage rates. The annual rate of growth to April in the RPI excluding the mortgage interest payments element was 5.3 per cent. The twelve-month increase to May in the all items RPI may well go a little above 7 per cent and in the following months the twelve-month increase may reach a peak of 7½ per cent. The underlying annual growth rate of average earnings continues to run at 7½ per cent. Private sector wage settlements in the current pay round covering about one-half of employees are ½ per cent higher than at the same point last year. Recent unit wage cost figures are always difficult to interpret because they are likely to be revised downwards when better information on manufacturing output becomes available. Nonetheless the figures for the first quarter of 1985 suggest an increase in the growth of unit wage costs compared with the

first quarter of 1984. In contrast, the forward indicators of prices suggest a slowing of the rate of increase. Input prices fell in April and are expected to have fallen again in May. Commodity prices in SDRs have been increasing slowly in the last few months but are still about 2½ per cent lower than in last May.

9. Asset prices: The DOE monthly house price data, which are not mix-adjusted, suggest that house price inflation may be increasing a little. In the twelve months to April prices at the mortgage approval stage increased by 9 per cent and prices at the mortgage completion stage increased by 7½ per cent.

10. Real interest rates: The incrase in real short term interest rates in May shown in Annex Table 8 is due to an apparent fall in inflation expectations. This is directly attributable to the latest forecast by NIESR, which included a downward revision of their inflation forecast. In practice, with nominal rates slightly lower and the RPI increasing by unexpectedly large amounts, real short rates may be little changed or even lower than in recent months.

11. Exchange rate: The exchange rate improved modestly against most currencies during May. The sterling index is about 8% higher than it was in March, and the £/DM rate about 5% higher.

Three month forecast

12. As usual no change in the interest rates is assumed over the forecast period. MO is forecast to rise by 0,7 per cent in banking June. This high figure reflects information already available on the first three weeks of banking June. For July (0.3 per cent) and August (0.4 per cent) more moderate growth is projected, reflecting the high level of interest rates. It is still assumed that the continued increase in the £1 coin issue will be broadly offset by slower growth in the note issue. Annual growth in MO is projected to fall to 5.1 per cent at the end of June, but to rise again to 5.8 per cent by the end of the forecast period.

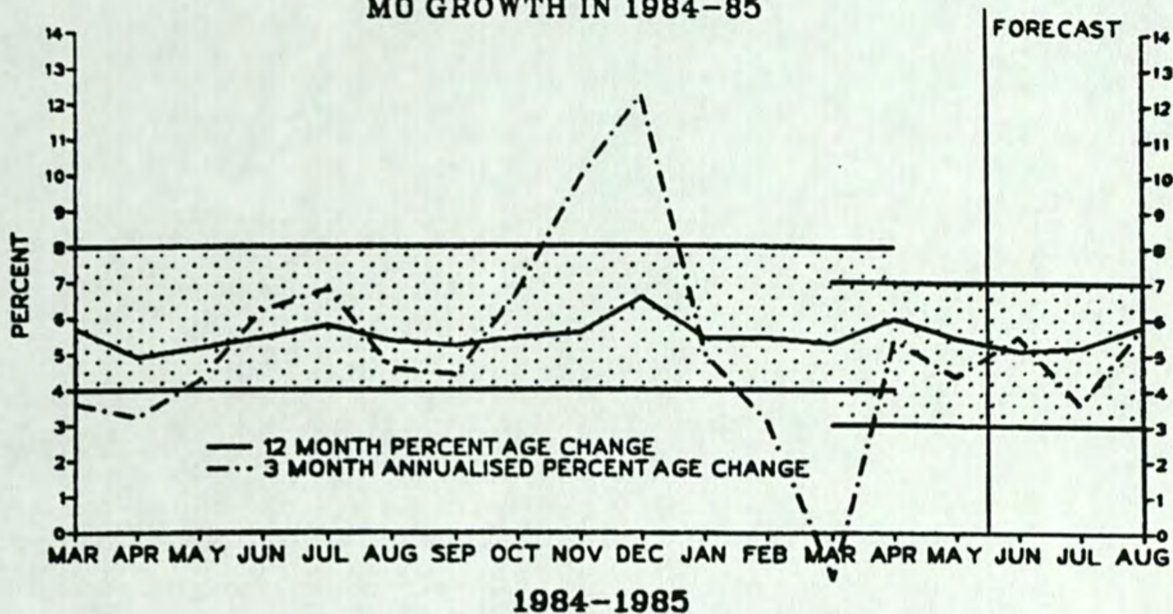
13. A part (0.1 per cent) of the MO growth forecast in August relates to the ending of the deferred payment scheme for £1 coins on 31 July. As a transitional measure £1 coins held by banks at cash centres were counted as holdings by the Bank of England, rather than the banks concerned. From 31st July they will be counted as belonging to the banks concerned, and will thus be included in MO. Over time the extra cost of holding these coins might be expected to encourage the banks to reduce their holdings at cash centres.

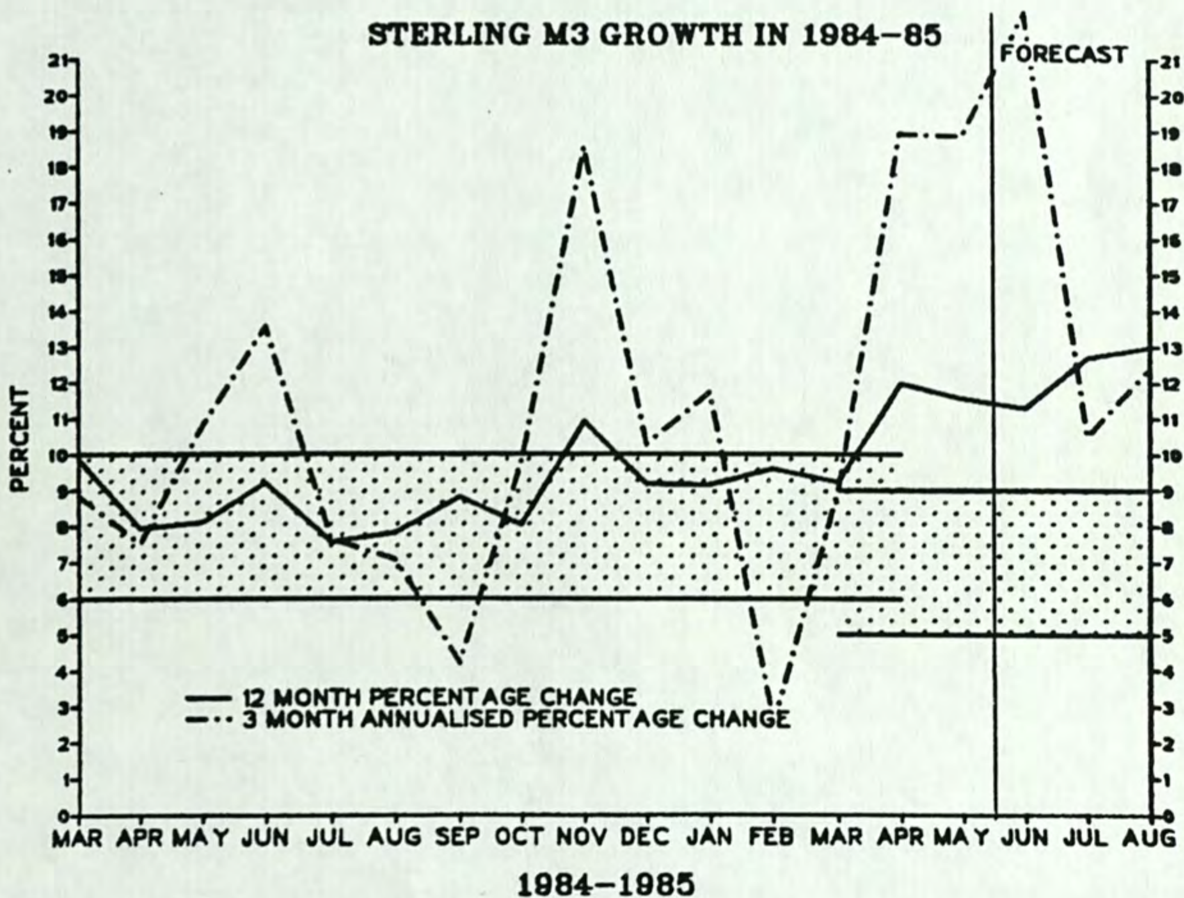
14. June is still expected to be a month of particularly high growth in £M3. But our forecast of 1.7 per cent growth in the month is below last June's figure of 2 per cent - so the 12 month growth rate is nevertheless projected to fall - to 11¼ per cent. We have revised upwards our estimates of both underlying bank lending (see paragraph 5 above and gross gilt sales (because of the level of sales already achieved since last month's forecast.

15. The picture over the forecast period as a whole is once again very uneven, attributable mainly to an uneven "PSBR" profile (partly due to the BT call in July). June's large increase is followed by a small rise in July, and a fairly high figure for August. On the basis of gross sales of almost £2 billion already in June, we have pushed up expected gilt sales in June to £2¼ billion but have retained the stylised assumption of £1¼ billion gross sales in July and August. Funding therefore exerts only a slightly contractionary influence in July, when there is another large redemption. Annual growth for £M3 on this projection would rise again to 12.7 per cent at the end of July, (as the negative figure for last July drops out) and reach 13 per cent by the end of the forecast period.

16. Table 2 summarises the forecast for the target aggregates, and Chart II shows past and projected movements in the 12 and 3 month growth rates for MO and £M3. If £M3 growth is as expected

CHART II





over the next 3 months, the monthly increase from then on would have to be less than 0.4% for £M3 is to be within its target range by the end of 1985-86. (To get to the centre of its range monthly growth would have to be no more than 0.1%.)

Table 2 Target aggregates: Summary of forecast

per cent, s.a.

	MO	£M3
Monthly change		
June	0.7	1.7
July	0.3	0.3
August	0.4	0.9
Growth to mid-May at an annual rate over past:-		
3 months	4.4	19.0
6 months	3.7	10.6
12 months	5.5	11.6
Growth to mid-August at an annual rate over past:-		
3 months	5.8	12.4
6 months	5.1	15.6
12 months	5.8	13.0

Public Sector Borrowing

17. In banking May the PSBR of £0.7 billion was very close to forecast. However there were offsetting errors with the CGBR £0.2 billion below forecast and the OPS £0.3 billion above forecast.

18. The outlook for the CGBR, based on calendar month profiles, is uneven over the forecast period in both seasonally adjusted and unadjusted terms. In particular there are large CGBR's of around £1½ billion in June and August and a £¾ billion surplus in July. The reasons for this are complex but there are two main factors. First, June and August are five week banking months whereas July is a four week month. Although adjusted for known tax payments, it seems that the seasonals do not fully offset

the extra supply expenditure in five week months, so a longer month means a larger CGBR. Secondly in July there is the BT second call (£1.2 billion), particularly heavy tax receipts and low debt interest payments. Again the seasonals do not it seems fully pick up the latter, which reflects the timing of gilt dividend dates. Indeed in the same period a year ago the CGBR displayed a similar monthly pattern seasonally adjusted and allowing for BT.

Table 3 Public Sector Borrowing

£ million monthly average

	mid May 1984 -mid May 1985	mid May 85 -mid Aug 85	mid May 84 -mid Aug 84
CGBR (0)	457	588	752
'LABR'	255	210	110
PCBR	120	40	-43
'PSBR'*	832	838	819

* PSBR less non-bank private sector transactions in other public sector debt

19. In the forecast period the CGBR(0) adjusted for asset sales is running about £200 million a month higher than a year ago. Similarly the LABR is higher. The latter reflects in a small way extra borrowing by those local authorities who have not set a rate but the main cause of the higher projected borrowing is the new arrangement which allows large corporate rate payers to pay monthly rather than semi-annually. This smooths rate income but means that at this time of year when large rate bills are usually paid, income is less then 'normal'. There are no special factors affecting the PCBR.

Debt Sales

(a) Gilts

20. Gross gilt sales in the 4 weeks of banking May totalled £1,029 million, compared to a target of £1¼ billion. Net official sales were £990 million. The remainder of the 9½% conversion

2004 was sold out and, together with the £650 million of tranchettes issued on 19 April, raised almost £800 million. Indexed gilts raised £150 million. With minimal buying in of next maturities, net sales were close to £990 million, but larger than usual purchases by the overseas sector meant sales to the nbps were under £600 million.

21. Table 4 compares the May outturn with performance in the previous year and projections for the forecast period. With gilt sales close to £2 billion already achieved, and 10 days of the banking month still to go, the forecast assumes gross gilt sales of £2¼ billion in June. This means that despite the £1.2 billion redemption of the 3% Treasury 1985, and high forecast overseas sales, gilt sales are now expected to exert a contractionary influence on £M3 of almost £½ billion in June.

Table 4 Gilts Sales

Banking monthly averages £mn

	Actual		Forecast		
	June 84-May 85	May	June	July	August
Gross Sales	1299	1029	2250	1250	1250
Redemptions	-247	-1	-1177	-979	-
Next maturities	-86	-42	-50	-30	-100
Net Sales	966	986	1025	240	1150
of which					
Monetary Sector*	70	53	100	-40	50
Public Corporations	3	-	-20	-	-
Overseas	120	347	450	-50	175
Non-bank private sector	774	586	495	330	925

* excluding repos.

22. The stylised assumption of £1¼ billion gilt sales has been retained for July and August. A further redemption in July produces a minimal contribution to funding from gilts in that month. On these assumptions both net gilt sales, and net sales to the nbps, would in June-August be substantially below last year's monthly average. They would also be lower than in the same three months last year.

(b) CTDs

23. Both purchases and surrenders of CTDS were higher than forecast in banking May, and the net result was an expansionary influence on £M3 of around £100 m. We expect CTDs to continue to have a midly expansionary impact over the forecast months. Purchases are expected to pick up from their May level, in preparation for the heavy tax payments in the Autumn. On average, surrenders are likely to outstrip purchases, in part reflecting heavy surrenders in banking August when an unusually large amount of ACT falls due, in addition to the normal PRT payment.

National Savings

24. National Savings contributed £215m (unadjusted, £234m seasonally adjusted) to funding in banking May, some £50m below forecast. Unusually sales all but dried up in the last week of the month, since when they have improved. We have assumed that the dip may to some extent have reflected personal sector bidding for shares in British Aerospace. The effects of the BAe flotation and the call for BT shares on National Savings and other retail savings are discussed in more detail below in the section on retail inflows.

25. On the assumption of no change in interest rates we expect National Savings' inflows to be about £300m per month (seasonally adjusted) over the forecast period. The income bond and accrued interest are expected to be the main contributors. We have assumed that the 3rd issue of index-linked certificates is introduced on 1st July and that the 2nd Issue is withdrawn simultaneously. We do not expect that this development will alter the prospects for index linked certificate sales substantially.

26. The forecast suggests that by the end of banking August the total inflow to National Savings will be only a little below the monthly striking rate required to attain the £3 billion target.

The PSBR and Funding

27. Table 5 summarises net funding over the last 12 months and that implied by the forecast. In May there was a full fund on a seasonally adjusted conventional basis (sacb) but over the last year there has been overfunding of £3.3 billion (sacb). In the forecast period there is expected to be a full fund (sacb) but a modest underfund in unadjusted terms.

28. In May there was again some contribution to funding from the overseas sector. Indeed with the forecast projecting continued strong gilt sales to overseas the total for external finance in the first 8 months of calendar 1985 is expected to reach over £2 billion compared with £0.8 billion for the same period in 1984.

Money Market Influences

29. In May there was a small (£0.3 billion) increase in the need for assistance. This was met by purchasing £0.8 billion of commercial bills and reducing market advances by £0.4 billion. In the forecast period the outstanding level of assistance remains high. In June the large unadjusted CGBR ensures a surplus but heavy gilt sales mean that the surplus, at £1¾ billion, is around £1¼ billion less than thought a month ago. With a large shortage in July and a neutral outlook for August, total assistance is projected to be £17.5 billion at the end of banking August compared with the last end banking month peak of £17.6 billion in March.

Table 5: The PSBR and funding

£ billion, seasonally adjusted

	Actual mid May 1984- mid May 1985	Forecast mid May 1985- mid August 85	mid August 1984- mid August 1985
'PSBR'	10.0	2.5	10.1
Debt sales to nbps	-13.3	-2.3	-12.2
of which:-			
Gilts	-9.3	-1.8	-8.5
National Savings	-3.1	-0.9	-3.4
CTDs	-1.0	0.4	-0.5
Over(-)/Under Funding(+)	-3.3	0.2	-2.1
(Unadjusted)	(-3.4)	(0.7)	(-2.3)
External finance of the public sector	-1.8	-0.6	-2.5
Over(-)/Under funding(+) alternative definition	-5.1	-0.4	-4.6
(Unadjusted)	(-5.2)	(0.1)	(-4.8)

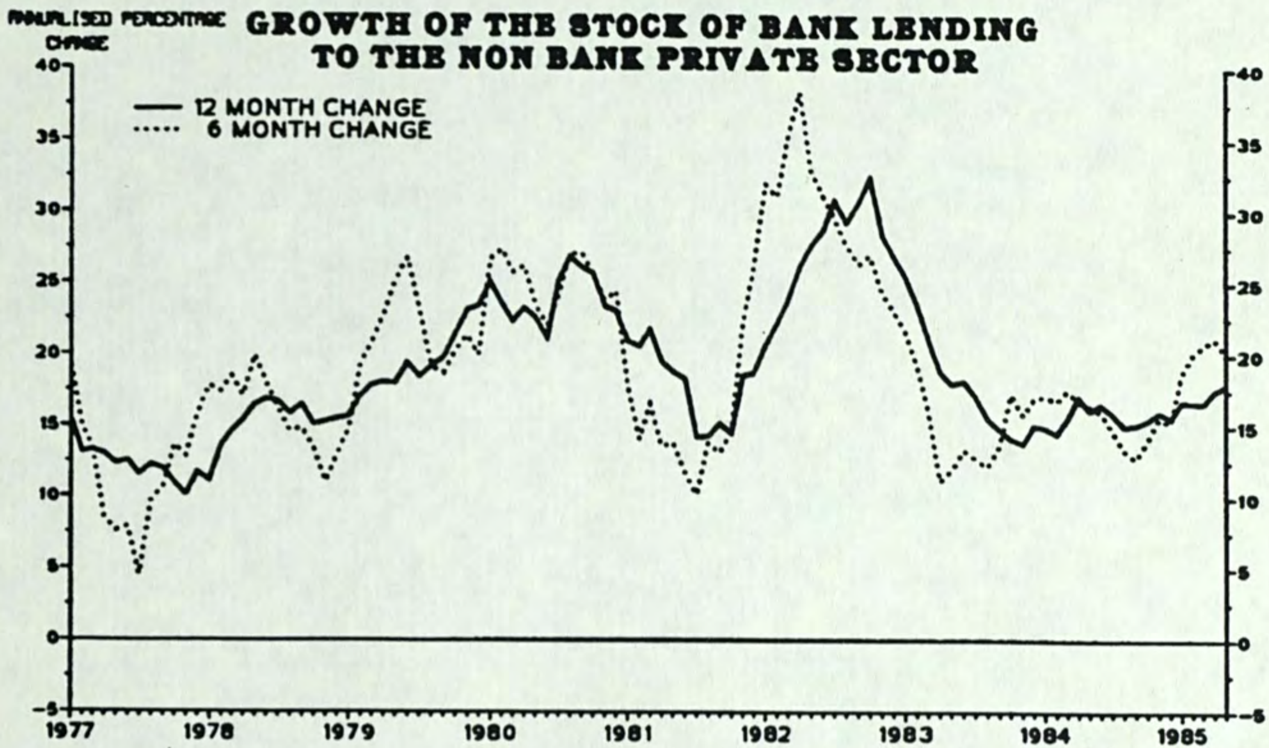
Sterling lending to the private sector

30. Sterling lending increased by £1½ billion in May taking the 3 and 6 month growth rates over 20%. The 12 month rate, at around 18%, is only a little lower and has been increasing fairly steadily since the Autumn of 1983. The May figure may have been boosted a little by borrowing to finance BAe share applications.

31. We had expected lending to be around £¼ billion lower due to some unwinding of last month's £1 billion surge to finance investment at the 1984-5 level of capital allowances and also because extensive round tripping in one month bills issued in April should have unwound in May. It seems likely, therefore, that underlying lending is running somewhat above our previous estimate, perhaps reflecting a lower or slower response to the continuing high level of base rates. For the forecast period we have increased our estimate of the underlying rate of monthly lending by £100 million. We have also included a more modest decline than assumed hitherto as a response to the high level of interest rates. We have also taken the view that the large

CHART III : BANK LENDING AND FT INDEX

GROWTH OF THE STOCK OF BANK LENDING TO THE NON BANK PRIVATE SECTOR



REAL FT ALL SHARE INDEX

predicted swings in the PSBR, will not offset changes in bank lending in the usual way. In banking June and August the PSBR is forecast to be about £¾ billion above trend while in July it may be £½ billion below trend. The forecast assumes that, as usual, only around 40% of the changes in the PSBR will feed through to £M3 but we have allocated only half of the offset onto bank lending and the other half has been divided equally between the externals and net non deposit liabilities (NNDL's).

32. So far in banking June there have been a few opportunities for bill arbitrage but the level of profits attainable has been negligible. No extra lending is therefore included for this or other types of arbitrage over the next 3 months. In theory, bill arbitrage opportunities are most likely to occur when the authorities are attempting to resist a rise in interest rates. However, if participants in the bill market are - as it often said - more optimistic about the prospects for falls in rates then those operating in the interbank market, arbitrage opportunities would tend to open up when base rate cuts were expected. This hypothesis is supported by the evidence for the period 21st March-9th April 1985 when profitable one month bill arbitrage opportunities existed continuously and base rates were widely expected to fall. (In fact some base rates were cut by ½% on 29th March and thre was a further ¼% cut on 2nd April. On the other hand, the evidence from last July, when base rates peaked at 12% and thereafter cuts were generally expected is not consistent with this theory, as there were very few profitable arbitrage opportunities in subsequent weeks).

33. The provisional Q1 sectoral breakdown of bank lending, analysed in last month's report, showed that most of the extra borrowing was being undertaken by OFI's and companies, both incorporated and unincorporated. The CBI's April survey suggested that both new orders and investment are expected to rise so that gives little reason for believing that companies' demand for finance will fall. But net new issues continue to provide much of the required finance. In the first five months of 1985 listed

TABLE 6 **STERLING LENDING TO PRIVATE SECTOR**

Seasonally adjusted

		Moving Averages of Underlying Lending						Moving Averages of Recorded Lending					
		3 months		6 months		12 months		3 months		6 months		12 months	
		£m	%*	£m	%*	£m	%*	£m	%	3m	%	£m	%
1984	Jan	1116	15.1	1117	14.9	1157	15.9	1195	15.6	1271	17.1	1084	14.9
	Feb	1076	13.7	1171	15.3	1158	15.6	1283	16.5	1278	16.7	1076	14.5
	Mar	1095	13.7	1303	17.0	1200	16.1	1283	16.2	1340	17.5	1161	15.5
	Apr	1627	20.9	1396	17.9	1268	17.0	1445	18.4	1320	16.9	1273	17.0
	May	1424	17.7	1250	15.7	1240	16.2	1322	16.4	1302	16.4	1230	16.1
	June	1563	19.2	1329	16.5	1262	16.5	1297	15.8	1290	16.0	1267	16.5
	July	882	10.4	1255	15.5	1186	15.3	936	11.1	1190	14.7	1231	15.9
	Aug	1098	12.9	1261	15.3	1216	15.3	887	10.3	1104	13.3	1191	15.0
	Sept	1028	11.9	1295	15.4	1299	16.3	850	9.81	1074	12.7	1207	15.1
	Oct	1637	19.4	1260	14.8	1328	16.3	1452	17.1	1194	14.0	1257	15.4
	Nov	1831	21.6	1464	17.1	1357	16.4	1785	21.0	1336	15.6	1319	16.0
	Dec	1788	20.8	1408	16.3	1368	16.3	1793	20.9	1321	15.2	1305	15.6
1985	Jan	1684	19.3	1660	19.3	1457	17.4	1748	20.1	1600	18.6	1395	16.7
	Feb	1614	18.1	1722	19.8	1492	17.5	1715	19.3	1750	20.1	1427	16.7
	Mar	1599	17.7	1693	19.3	1494	17.2	1835	20.5	1814	20.7	1444	16.6
	Apr	1668	18.2	1676	18.7	1468	16.7	2021	22.3	1884	21.2	1539	17.5
	May	1635	17.5	1624	17.9	1544	17.4	1959	21.3	1837	20.3	1586	17.9
Forecast													
	June	1640	17.3	1619	17.6	1513	16.9	1817	19.3	1826	19.9	1573	17.5
	Jul	1550	16.8	1648	17.5	1654	18.4	1507	15.5	1764	18.8	1682	18.7
	Aug	1620	16.5	1628	17.1	1675	18.3	1435	14.5	1697	17.8	1723	18.9

* Based on stock of recorded lending

UK companies have raised over £2.8 billion, more than in the whole of 1983, which was itself a record year. But as yet there are no signs of such finance substituting for bank borrowing.

Table 7: Issues by Listed UK Companies

Calendar month averages, £m

		Net Issues	Gross Issues Queue* (Equities)
1982		97	-
1983		234	-
1984		143	-
1984	Q1	51	850
	Q2	199	1510
	Q3	218	1030
	Q4	106	1215
1985	Q1	400	
1985	Jan	275	1610
	Feb	201	2943
	Mar	723	4100
	Apr	989	4332
	May	620	4350**

* Excluding privatisations, currently consisting of British Airways and Britoil/

** As of 3 June 1985.

Externals and net non-deposit liabilities (NNDL's)

34. After the very large positive externals in banking April there was no noticeable unwinding in May. Even allowing for foreign currency issues, externals were again positive. However, nndls and externals together had a negative influence on money of £0.8 billion compared with a positive influence of a similar amount in April and a £0.4 billion average contradiction in the year to banking March.

35. In the forecast period both nndls' and externals are dominated by foreign currency issues. All the major clearing banks have now either made or announced issues in the market,

totalling around £3 billion. These issues affect both nndls and externals in equal and offsetting amounts. The Bank are considering redefining these counterparts to remove foreign currency issues as these tend to swamp underlying changes in externals and nndls. This new definition, which if agreed would be incorporated in the published figures from June onwards, has been used in Annex table 3 (the full counterparts table).

Building Societies and Broad Liquidity

36. At £1025m, seasonally adjusted retail inflows in banking May (including interest credited) were in line with last month's forecast. We estimate that the underlying level of inflows in May was nearer £1100m, with the BAE flotation and preparation for the BT second call reducing actual inflows slightly.

37. Our retail savings model suggests that, with no change in interest rates, retail inflows will continue at about £1100m per month over the next 3 months. With little change in net mortgage advances and only moderate wholesale funding we expect a continued, though gradual, fall in the liquidity ratio. Table 8 attached shows the impact of these projections on the building societies balance sheet (unadjusted).

38. The table shows inflows of principal (column 5) somewhat below the striking rate necessary to maintain a constant liquidity ratio. The unadjusted liquidity ratio is projected to fall to about 16¼ per cent by the end of banking August. The fall is not as steep as we projected last month, principally because we now forecast inflows of principal to be slightly higher than last month.

39. An interesting development has been the renewed interest in building society term shares. Revised data for calendar April and May have shown a very large movement of savings into term shares - to the tune of over £1½ billion. The substantial movement in savings undoubtedly reflects a campaign by the major societies to revitalise term shares. It should be noted that total retail

TABLE 8 BUILDING SOCIETIES BALANCE SHEET FLOWS [UNADJUSTED]

£ million

	Total Flow	Assets			Liabilities			
		Mortgages	Liquid assets	Other (fixed investment)	Retail Inflows principal	interest credited	Wholesale	Other (mainly additic to reserves)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Calendar years*								
1983	1059	911	142 (19.9)[1]	6	570	310	136	42
1984	1277	1189	72 (18.3)	16	710	387	136	51
Calendar quarters*								
1984 Q1	896	977	-83 (19.2)	1	870	302	33	-308
Q2	1145	1326	-201 (18.1)	21	598	414	99	34 } +37
Q3	1476	1345	114 (17.6)	17	543	272	278	384
Q4	1592	1109	459 (18.3)	24	831	560	133	96
Calendar months								
Jan	-39	942	-999 (17.3)	18	823	726	-102	-1486
Feb	452	967	-533 (16.7)	18	474	64	-138	52
March	1116	1181	-83 (16.4)	18	214	272	151	479
April	1469	1149	302 (16.5)	18	507	417	149	396
May[2]	1694	+1335	+341 (16.5)	+18	598	430	270	396 } +58
Banking Mth forecast								
June	1335	+1457	+178 (16.5)	18	531	+1020	+222	-123
July	1491	+1181	+162 (16.4)	18	578	+720	+100	-37
August	1256	+1547	+128 (16.3)	18	613	+163	+131	+786

* monthly average in the period

Note 1. figures in () show liquidity ratio.

2. Calendar May figures are provisional.

inflows have not been revised; the figures reflect a move out of 90 day accounts. The term shares have identical characteristics to 90 day accounts except that they guarantee a fixed differential over the ordinary share rate for two years.

40. For the forecast months we have assumed that new inflows to term shares exactly offset redemptions of existing term shares, and as a result the building societies' contributions to PSL2 and PSL2A are equal.

41. Given the similarity between the latest generation of term shares (which are excluded from PSL2) and 90-day accounts (which are inside PSL2) these developments tend to emphasise the merits of PSL2A (PSL2 plus term shares) as a better indicator than PSL2.

42. Table 9 below compares recent 12 month growth rates of £M3, PSL2 and PSL2A. Several interesting points emerge:

(i) The growth rate of PSL2A has been more stable than for £M3 or PSL2 over the last year (see standard deviations)

(ii) The diffence between the growth rates of PSL2A and £M3 has narrowed substantially in recent months, reflecting the fact that bank deposit interest rates have improved relative to building society rates. (The degree of convergence of the two series may be overstated by the raw figures in banking April and May because of the effect of the BAe issue and BT call).

(iii) The growth rate of PSL2 has been distorted by movements in and out of term shares. In September 1984 there was a one-off increase in the growth rate of PSL2 relative to PSL2A as the first batch

of term shares, issued 5 years earlier, began to mature. Similarly in the last two months the growth rate of PSL2 has declined relative to PSL2A with the substantial movement of funds into the new breed of term shares.

Table 9 Growth rates of monetary aggregates

(12 month growth rates, %)

	£M3	PSL2	PSL2A	PSL2A-£M3
1984				
Banking:				
May	8.1	11.6	11.9	3.8
June	9.2	13.0	13.1	3.9
July	7.6	12.0	12.2	4.6
Aug	7.8	12.1	12.2	4.4
Sept	8.8	13.1	12.6	3.8
Oct	8.0	13.4	12.5	4.5
Nov	10.9	15.6	14.1	3.2
Dec	9.1	14.5	12.8	3.7
1985				
Jan	9.2	14.9	12.9	3.7
Feb	9.7	15.3	13.1	3.4
Mar	9.3	14.7	12.5	3.2
April	12.0	15.5	13.6	1.6
May	11.6	14.4	13.1	1.5
Standard Deviations	1.4	1.4	0.6	-
Mean	9.3	13.8	12.8	

Retail Inflows

43. Table [10] brings together our forecast for retail inflows to National Savings, building societies and banks. In banking May retail bank deposits were some £250m higher than forecast, building societies and national savings inflows a little below forecast, and total savings almost £200m above forecast. The error undoubtedly reflects, in part at least, a build up of bank deposits in preparation for the flotation of BAe, and perhaps in preparation for the second payment for BT shares.

44. In interpretting the banking April and May outturns we have assumed that building society inflows were below their

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TABLE 10

RETAIL INFLOWS

	Ave. monthly inc. mid May 1984 to mid May 1985	OUTTURN		FORECAST		
		APRIL	MAY	JUNE	JULY	AUGUST
RETAIL BANK DEPOSITS						
NIB Sight	+56	+186	+195	)		
IB Chequable	+195	+536	+529	) +420	+100	+400
IB Other	+72	-96	-211	)		
Total Bank	+323	+626 (+526)	+733 [+470] (+400)	+190 (+430)	+100 (+400)	+400 (+400)
Building Societies	+1030	+791 (+891)	+1026 [+1065] (+1076)	+1090 (+1100)	+1100 (+1100)	+1180 (+1100)
National Savings	+261	+218	+234 [+265] (+274)	+345 (+265)	+280 (+280)	+305 (+305)
TOTAL RETAIL	+1614	+1635	+1993 [+1800] (+1750)	+1625 (+1795)	+1480 (+1780)	+1885 (+1805)

[ ] = last month's forecast

( ) = underlying inflows

underlying level (also National Savings in May) as money was transferred to bank accounts in preparation for share purchases. As a result bank deposits were above their underlying level in both months. In particular in banking May, bank deposit inflows were, we have assumed, £330 million above their underlying level reflecting money submitted unsuccessfully for BAe shares.

45. In banking June we forecast that bank inflows will be £240m below their underlying level. This reflects an assumed unwinding of unsuccessful money subscribed for BAe shares (£330m) offset in part by a further transfer of money from building societies to bank accounts (£90m) in preparation for the BT second call.

46. By banking July, bank accounts are assumed to have benefitted from a cumulative £200m transferred over previous months from building societies in preparation for BT share payments. This, with a further £100m from bank accounts, is used to pay for the BT shares in banking July. Hence bank deposits are £300m below trend in that month. We have assumed that the other £100m needed to finance the personal sector's payment for BT shares (assumed to total £400m) is financed from bank borrowing. By banking August all these various distortions are assumed to have unwound, and inflows to the three groups of savings institutions (banks, building societies and national savings) return to their underlying levels.

Wholesale Deposits

47. As last month, we have looked at the prospects for wholesale deposits within £M3. Forecasting wholesale flows is not easy. Chart (iv) plots the movement of these deposits since 1982. There does at least seem to be a clear negative correlation between the flow of wholesale deposits in one month and the next. Taking forecast growth of £M3 over the next 3 months, together with our forecast for notes and coin and retail bank deposits, implies a pattern of wholesale flows very similar (with a similar month by month fluctuation) to the past.

CHART IV

MONTHLY CHANGE IN NBPS WHOLESALE BANK DEPOSITS

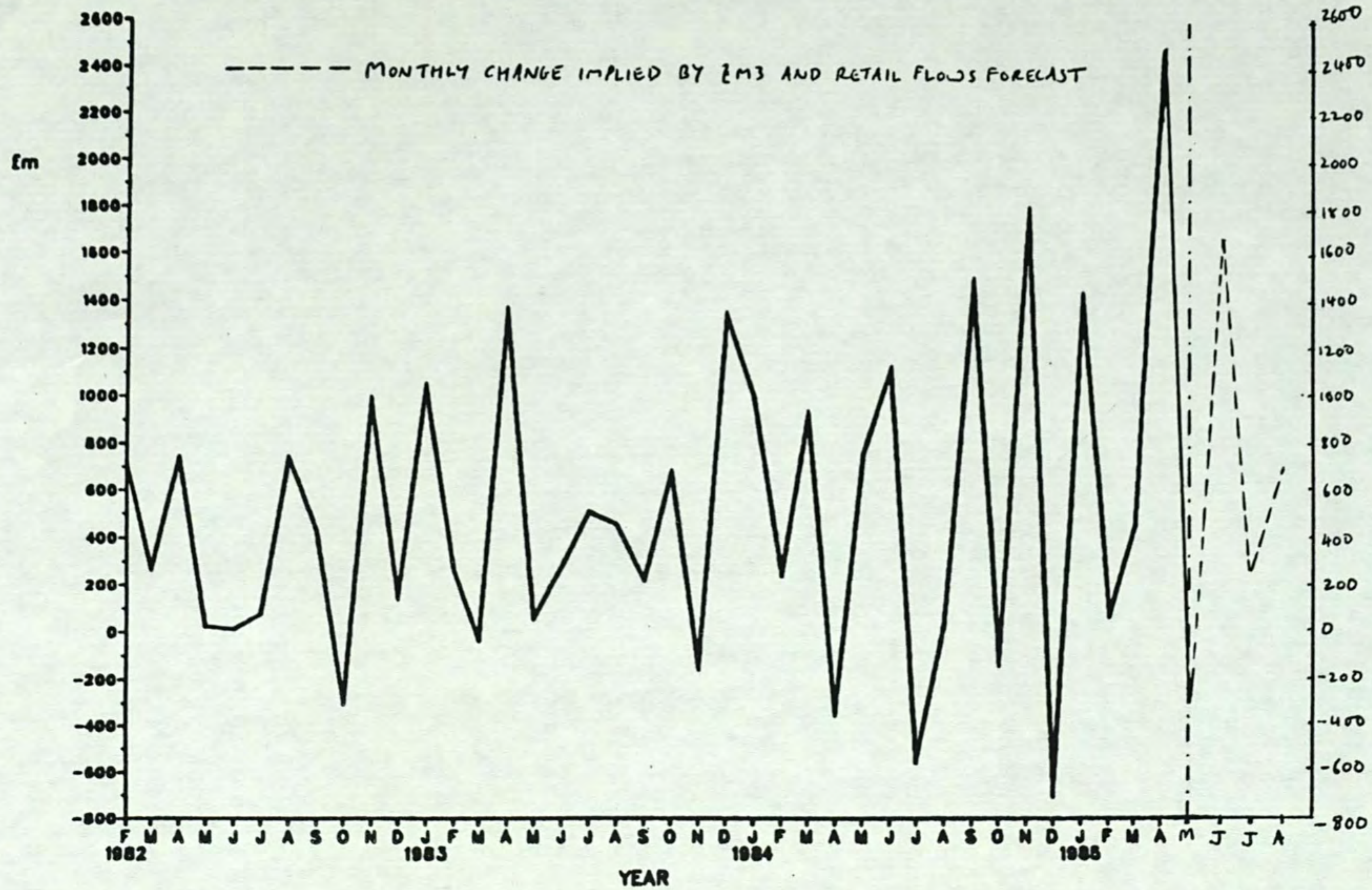
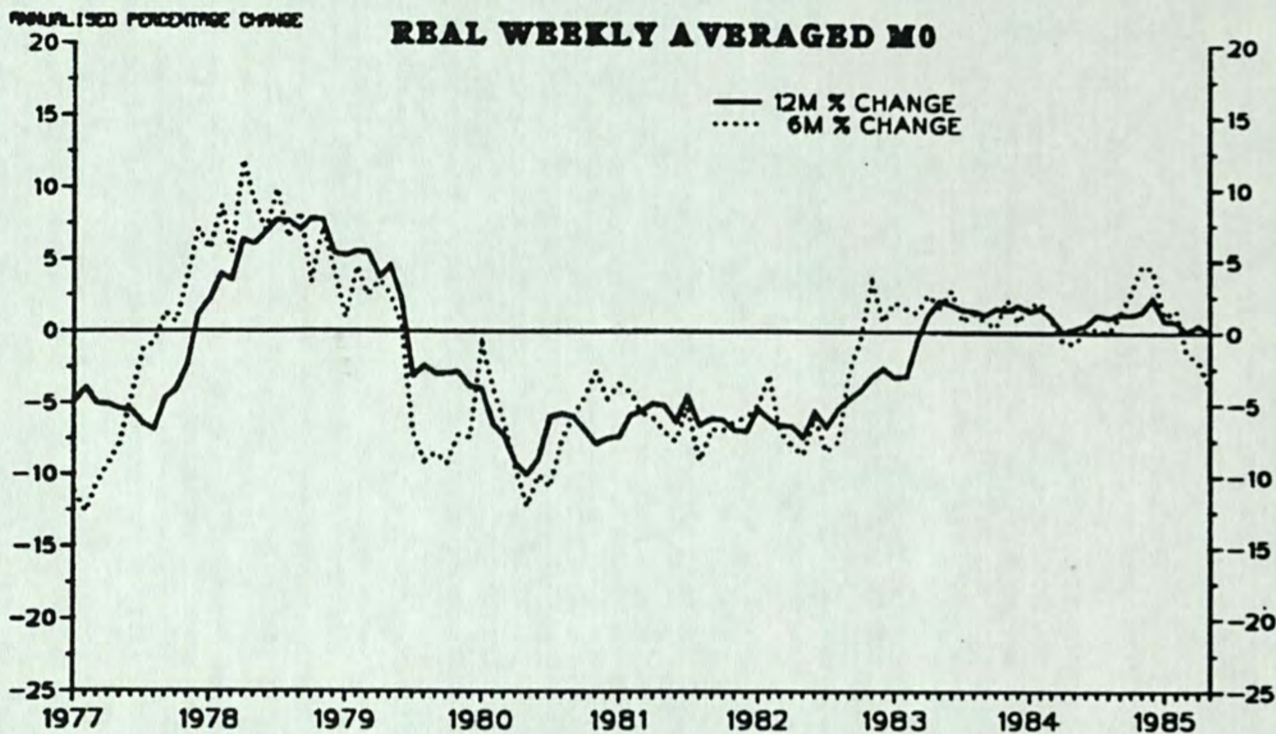
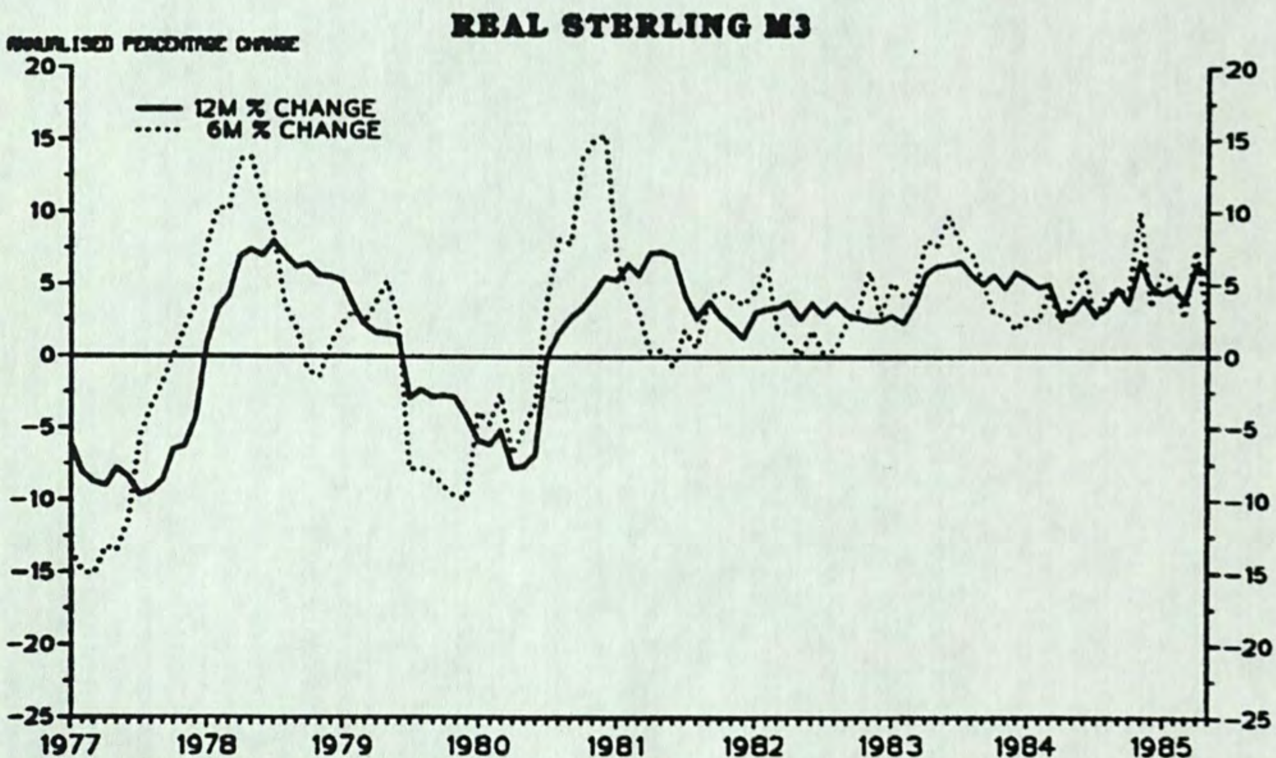


CHART V: GROWTH RATES OF REAL MONETARY AGGREGATES





REAL GROWTH RATES ARE CALCULATED BY DEFLATING BY THE GROWTH OF THE RPI EXCLUDING THE MORTGAGE ELEMENT

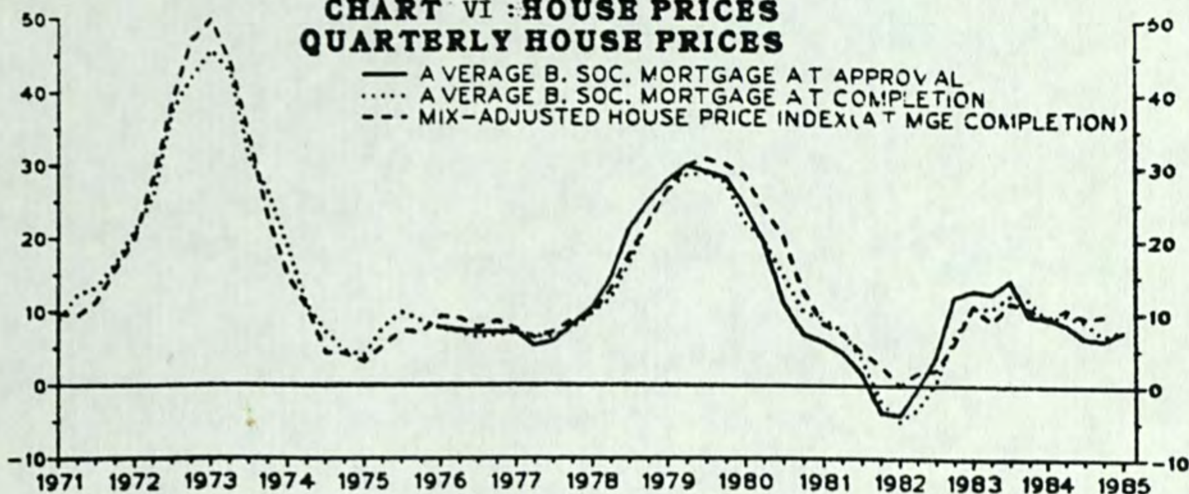
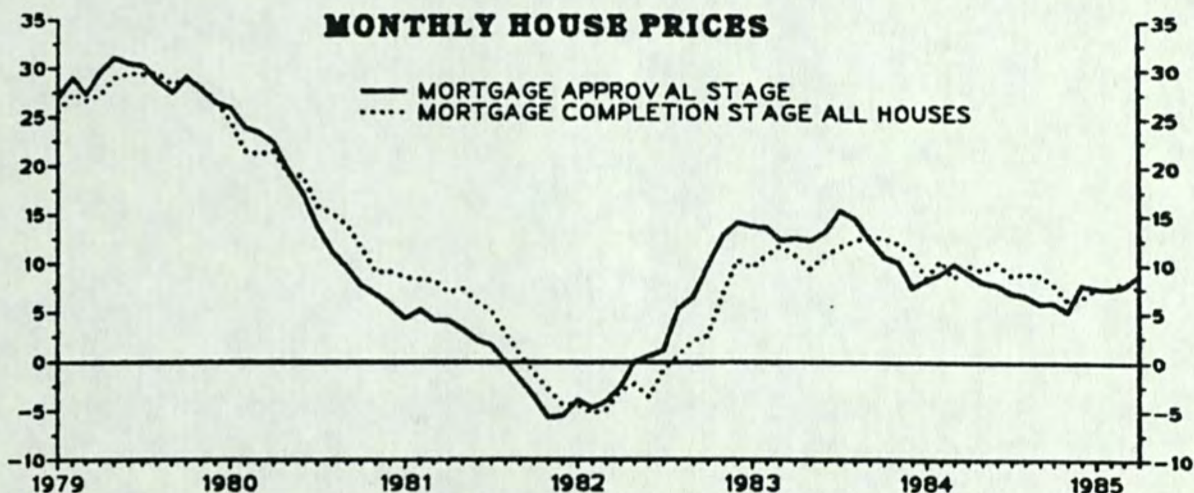


CHART VI : HOUSE PRICES
QUARTERLY HOUSE PRICES
AVERAGE B. SOC. MORTGAGE AT APPROVAL
AVERAGE B. SOC. MORTGAGE AT COMPLETION
MIX-ADJUSTED HOUSE PRICE INDEX(AT MGE COMPLETION)
50
40
30
20
10
0
-10
1971 1972 1973 1974 1975 1976 1977 1978 1979 1980 1981 1982 1983 1984 1985


MONTHLY HOUSE PRICES
MORTGAGE APPROVAL STAGE
MORTGAGE COMPLETION STAGE ALL HOUSES
35
30
25
20
15
10
5
0
-5
-10
1979 1980 1981 1982 1983 1984 1985

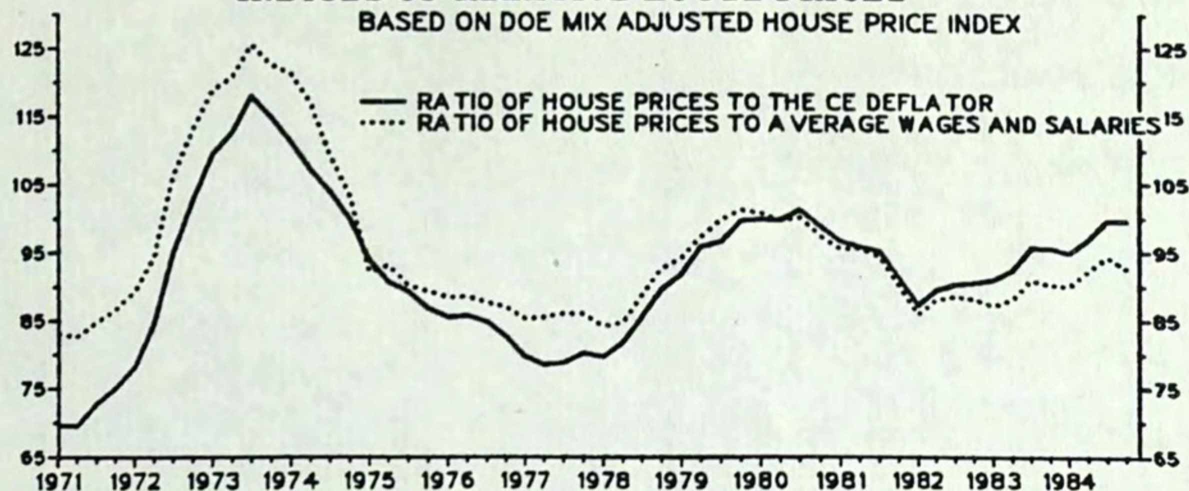
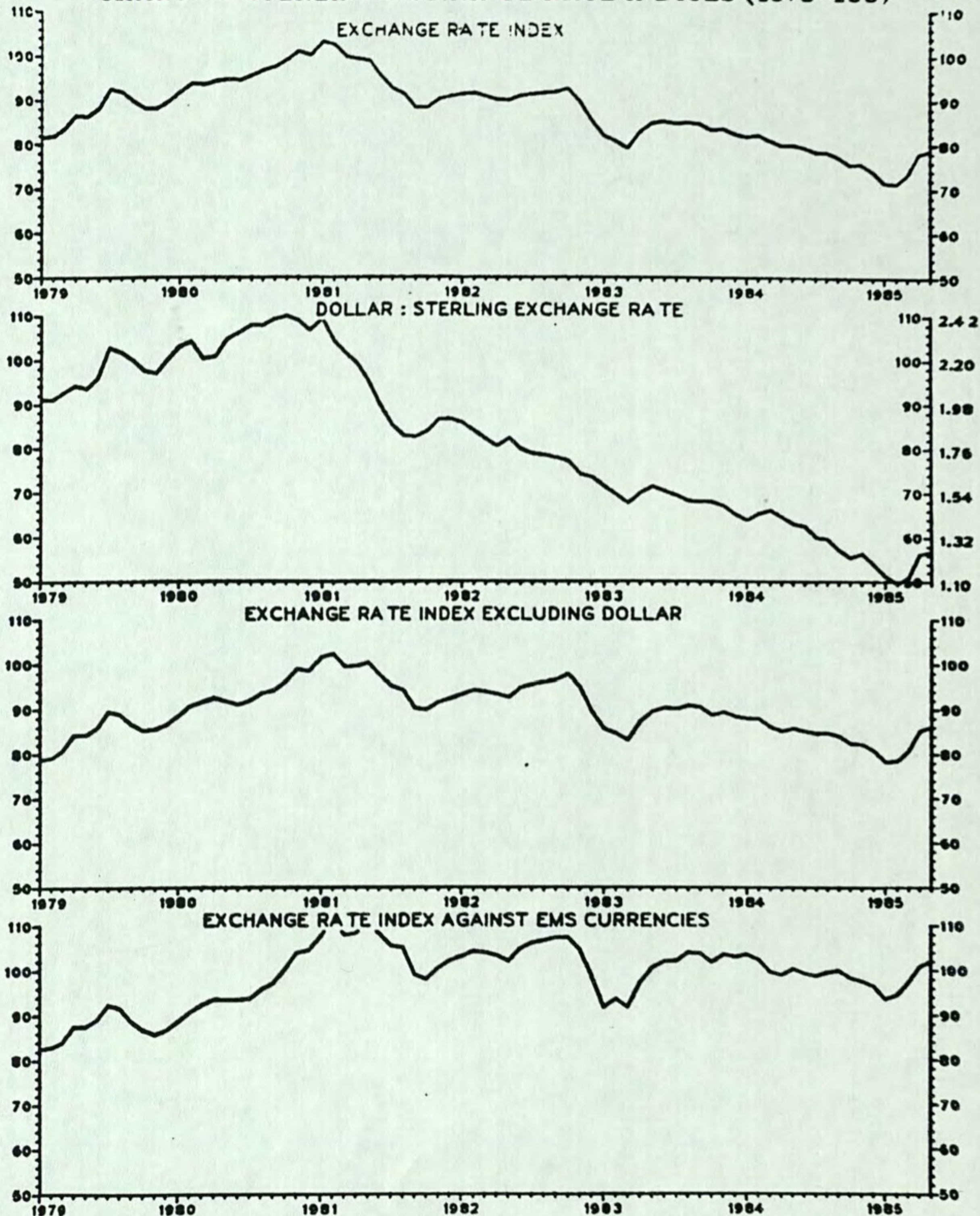

INDICES OF RELATIVE HOUSE PRICES
BASED ON DOE MIX ADJUSTED HOUSE PRICE INDEX
RATIO OF HOUSE PRICES TO THE CE DEFLATOR
RATIO OF HOUSE PRICES TO AVERAGE WAGES AND SALARIES
125
115
105
95
85
75
65
1971 1972 1973 1974 1975 1976 1977 1978 1979 1980 1981 1982 1983 1984

CHART VII: STERLING EXCHANGE RATE INDICES (1975=100)



NOTE : ALL SCALES ARE EQUIVALENT

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SRWACL

SUBJECT
c. Master set
File
bcc Mr David Willetts

4

10 DOWNING STREET

From the Private Secretary

12 June 1985

THE REVIEW OF BANKING SUPERVISION AND JOHNSON MATTHEY BANKERS

The Prime Minister discussed with the Chancellor his minute of 7 June and the terms of his draft statement. She was generally content that the right balance had been struck between acknowledging faults and not undermining the position of the Bank. The Chancellor explained that para 19 of the draft statement was intended to demonstrate his view that the Bank had been in part to blame, but without weakening the Bank's case against the auditors.

The Prime Minister asked whether the Chancellor thought the Bank had been wrong to rescue JMB. The Chancellor said the Bank had put forward two defences - the need to protect the banking system as a whole and the need to protect the London Gold Market. He did not accept the first argument but did not feel in a position to reach a conclusive judgment on the second. The Prime Minister added that, at the point of decision, the Bank had very little time in which to consider its course of action.

The Prime Minister suggested amendments to the drafting of the statement at three points. Para 20 implied that the Chancellor was sure that the Bank's supervision of the remaining 600 banks was sound. This seemed to be a hostage to fortune. The statement in para 21 that the manager directly responsible had been moved to another part of the Bank might sound trivial. Finally, she thought the statement should end on a stronger note. As drafted the statement appeared almost to be looking for the next collapse.

(ANDREW TURNBULL)

Mrs. Rachel Lomax,
HM Treasury.

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9.50

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FROM: M T FOLGER

DATE: 11 June 1985

cc Ms Holding - CSO
Mr Walton
Mr Davies
HE/11

MISS O'MARA

INTERNATIONAL COMPARISONS OF OWNERSHIP OF CONSUMER DURABLES

The Chancellor asked last night for some quick figures on this, in the content of a recent article in Barclays Bank Review. I attach some "league tables", which I have put together from Eurostat material kindly supplied by CSO. The data cover telephones, TV and cars and relate to the US, Japan and most European countries (not all the Scandinavian countries are included, nor is Switzerland).

2. The tables do not suggest any particularly startling points to make about the UK. Certainly we are well up the league for TV (third in Europe) and on telephones are roughly level-pegging with the French and German. But for cars - a "bigger ticket" item - we are tenth and behind all the major European countries.

MOM

for M T FOLGER

Consumer durables per 1000 population

Private cars

		number	per cent of average for EC10
1.	USA	538	160
2.	W. Germany	391	116
3.	Luxemburg	377	112
4.	France	356	106
5.	Sweden	353	105
6.	Italy	346	103
	EC10	337	100
7.	Belgium	328	97
8.	Netherlands	326	97
9.	UK	311	92
	(Japan etc	217	64)

TV sets (league table for EC only)

1.	Denmark	366	128
2.	W. Germany	329	115
3.	UK	327	114
4.	Netherlands	305	106
5.	Belgium	302	105
6.	France	298	104
	EC10 etc	287	100

Telephones

1.	Sweden	857	182
2.	USA	768	163
3.	Denmark	702	149
4.	Luxemburg	587	124
5.	France	542	115
6.	UK	513	109
7.	W. Germany	509	108
8.	Japan etc	499	106
	(EC10	472	100)

Source: Eurostat

10 DOWNING STREET

Prime Minister (2)

see Ch/EX meeting record 7.6

Treasury and Bank are working on papers to answer the points you have raised. These are expected next week for discussion the week after. Alan is being consulted throughout.

The Bank are closer to your view on ~~Mandatory~~ conditions than Treasury or Alan, but they are more wedded to £M3 and hence to the overfunding which control of £M3 dictates.

AT

11/6

M

PRIME MINISTER 11 June 1985

JOHNSON MATTHEY

The Bank of England's supervision of JMB was clearly inadequate. And after JMB had got into difficulties the Bank was wrong to rescue them. The Chancellor knows this. It was the Governor's responsibility - not his. But it is difficult for him to comment in public as it damages relations with the Governor and exposes the Bank of England to the charge of incompetence. That is why the draft statement just says 'In mounting the rescue I am satisfied that the Governor was acting properly within his discretion'. But can the Chancellor sustain his Pontius Pilate position in the House when David Owen and Dennis Skinner ask:

- Why did it take the Bank six months to grasp a problem which first emerged in March 1984?

- Does the Chancellor believe that it was right to rescue JMB?

- Is the Chancellor satisfied with the Bank's supervision of JMB?

You may want to discuss the handling of these questions.

Politically, the best bit of his statement is the announcement that Arthur Young will be sued for their incompetence in auditing JMB. This is good but there is a risk that Arthur Young might join the Bank of England in the suit. What is the Chancellor's assessment?

At no point do the papers discuss the criteria which the Bank of England apply in deciding whether to rescue a bank. Our impression (and the City's) is that they are committed to sustaining any institution called a bank but not all licensed deposit-takers (LDTs). Yet because "banks" are

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thought to be so reliable and trustworthy they are supervised more loosely than LDTs. So the least work is done where the risk to public funds is greatest. It is right to eliminate the LDT/Bank distinction. But it must be made very clear that financial institutions will only be rescued in the most extreme circumstances and that whether they are called "banks" is irrelevant. It would be wrong to widen the number of institutions the Bank may be forced to take over. And they must be better supervised.

We endorse the detailed proposals for improved supervisory arrangements. In particular, improved communications between auditors and supervisors are sensible. But we have three questions:

i. UK banks are expected to stand behind their foreign subsidiaries. Isn't this an important gap in our supervisory arrangements (eg Midland/Crocker)?

ii. What about requiring more detailed disclosure in banks' accounts. JMB clearly made inadequate provision. Proper reporting of non-performing loans as in the US might be an improvement.

ii. Limiting a bank's exposure to any one borrower to 25% of its capital base could significantly affect its lending activities. A major bank's exposure to a major multinational or indeed HMG could be larger. Do we need to specify a figure?

Whatever the supervisory arrangements, financial institutions will carry on failing just like other commercial firms. We should not take responsibility away from management and take risks away from shareholders. We can't be responsible for failed banks and must not find ourselves morally obliged to bale them all out. There is already a comprehensive Deposit Protection Scheme.

David Willetts
DAVID WILLETTS

R21A

SECRET Mr A-Turnbull

3

NOTE OF A MEETING AT No.11 DOWNING STREET ON FRIDAY 7 JUNE 1985 AT 11.45am

Present: Chancellor
Economic Secretary
Sir P Middleton

Mr E George - Bank of England
Professor Sir Alan Walters

MONETARY POLICY

The Chancellor said the Prime Minister had a number of concerns, some of which he shared. While he did not accept that monetary conditions were out of control, he did have some worries about the system of monetary control. He hoped it would be possible to define some practical options for improving the situation.

2. Sir Alan Walters agreed that monetary conditions were not too loose. His concern stemmed from the way in which the 1981 arrangements had been amended both deliberately and under force of circumstance:-

(i) in 1981 the Bank had originally intended to operate only at the short end of the money market, keeping the seven day rate within an undisclosed band. Since 1983 the band had disappeared, and the Bank had been forced by the growth of the bill mountain to operate all along the yield curve. A bill mountain of the present proportions had certainly not been envisaged in 1981 and while it was not a major economic problem, it did have damaging effects on credibility;

(ii) the size of the Bank's daily operations in the money market had frustrated the aim of achieving greater automaticity in interest rate movements, and allowing

more market influence on the structure of interest rates. Political anxiety about base rate movements had also played a part;

(iii) since 1981 more attention had been paid to the exchange rate in determining interest rates;

(iv) sales of long term conventional gilts had been resumed;

(v) contrary to his understanding in 1982, there had been continued over-funding.

3. A more welcome shift of emphasis had been the prominent role assigned to M0, always his preferred monetary indicator. The 1981 arrangements had been intended as an interim step on the way to monetary base control. Targetting MO was a step in that direction. But there had been no progress towards introducing a quantitive element into money market operations.

4. His judgment was that the monetary stance had been broadly correct since about 1980; this was borne out by the success in bringing inflation down to around 5 per cent, which he guessed was still the current underlying rate. But he was concerned that the system of monetary control contained no automatic mechanism to prevent a switch from broad money into cash. This was a potential danger.

5. The Chancellor noted that the 1981 arrangements had never worked as envisaged almost from the start. He shared Sir Alan Walters concern about over-funding and this had been reflected in his Mansion House speech in November 1983. There was nothing new about over-funding; what had happened in the last few years was that it had cumulatively reached absurd proportions and this was reflected in the present size of the bill mountain.

But we had been driven into over-funding as a result of our attempts to control sterling M3. As it had become apparent that sterling M3 was a highly imperfect measure of monetary conditions, so the justification for over-funding had become weaker. Conversely, de-emphasising sterling M3 was a necessary condition for ending the over-funding/bill mountain "merry-go-round".

6. Mr George was more concerned about current monetary conditions. He doubted whether policy was on track for re-establishing a downward trend in inflation (to around 3 per cent in 1988). The slowdown in wage settlements had come to an end and the prospect was for an increase in unit labour costs of around 5 per cent or more. This concern underlay his worries about the behaviour of broad money. While he could accept the idea that there had been some upward shift in the demand for sterling M3 as a result of financial innovation, the buoyancy of the economy and the behaviour of unit labour costs suggested that the performance of sterling M3 was less misleading than it had been in 1980.

7. The monetary policy instruments available to control sterling M3 were short term interest rates and over-funding. He would be happier with more emphasis on higher short term interest rates since these would help to control demand for credit. But over funding was a perfectly rational second best approach. It helped to restrain the aggregate demand for credit from both public and private sectors. The objections to it were presentational. The bill mountain was an even more severe presentational problem. In economic terms it was not important; it was a technical inconvenience, the scale of which had been much exaggerated by commentators like Gordon Pepper.

8. The ways of reducing reliance on over funding and checking the rise in the bill mountain had been much discussed in recent

years. They included steps to improve PWLB facilities to reduce bank lending by local authorities and changes to encourage companies to borrow from the capital markets rather than the banks. The impact of the bill mountain on money market operations could be sharply reduced by lengthening the maturity of "hard core" assistance, either by placing long term deposits with the banking system or buying-in fixed rate export credit paper currently held by commercial banks.

9. Sir Peter Middleton felt that inflation would come down further. His principal worry concerned public expenditure and the fiscal side. This underlined the need for a credible monetary policy. The present policy lacked clarity; the time might have come to make a decisive move to restore credibility. His own preference would be to drop sterling M3 as a target and rely on M0 and the PSBR. Practical and political realities meant that the exchange rate also had to be taken into account.

10. Sir Alan Walters supported Sir Peter Middleton's proposal. He saw it as the sine qua non for getting rid of over funding and the logical next step in the evolution of policy.

11. The Economic Secretary thought that overfunding was less worrying than the reason for it: the rapid growth in bank lending. No change in the emphasis of policy could afford to leave this problem to one side.

12. Mr George commented that the merits of Sir Peter Middleton's proposal clearly hinged on the importance attached to bank credit and broad money. He would be uncomfortable with any set of monetary indicators that left them out of account. Nor would the credibility of policy be improved by going in this direction.

13. The Chancellor took the view that Sir Peter's suggestion was less radical than it sounded; policy had been moving in

this direction for some time. The time might have come for more clarity. He would not propose disregarding sterling M3 entirely, but there could be a case for dropping it as a target. But any such step depended critically on the performance of other indicators: it would probably require a continuation of current levels of interest rates, some further deceleration in the growth of M0 and, above all, a firm exchange rate. Such a combination of circumstances, in his judgment, would be sufficient to put downward pressure on inflation.

14. Sir Alan Walters agreed that if interest rates remained at current levels, it was reasonable to expect some deceleration in both M0 and inflation. Any worries he might have voiced about monetary conditions had been based on the implicit assumption that the present level of interest rates was likely to prove temporary. Mr George was sceptical whether the current level of interest rates would produce a deceleration in both M0 and sterling M3 growth; a further rise might be necessary. He would not be convinced that monetary conditions were consistent with falling inflation if the only indicator pointing in that direction was M0. He accepted, however, that high interest rates could have the temporary effect of raising sterling M3 growth; and that financial innovation had complicated the task of interpreting the behaviour of broad money. Sir Alan Walters added that the restructuring of the economy could have inflated broad money by increasing the need for bank intermediation. This had certainly been an important influence in 1980 and 1981 and, in his view, was still significant.

Policy options

15. The Chancellor identified two options to deal with the related problems of sterling M3 and over funding:-

(i) to drop sterling M3 as a target altogether, and aim at a "full fund" of the PSBR (or, more

precisely, the PSBR less the desired growth in M0);

(ii) to keep sterling M3 as a target, but to raise the range (probably in conjunction with a reduction in the target range for M0).

16. It was also worth looking at changes in money market arrangements that might inhibit the growth of bank lending. Sir Alan Walters suggested that this might be achieved by supplying cash to the banking system at penal rates, at least at the margin. He saw this as a logical step in the direction of monetary base control. This would inevitably mean more volatile base rates, which would be politically sensitive. But less predictability in the terms on which the Bank was prepared to supply cash to the banking system was the only way of influencing behaviour, on both the asset and liability side of the banks' balance sheets. The degree of volatility needed to induce such a change in behaviour was of course inherently unpredictable.

17. It was agreed that further work should be done to develop Sir Alan Walters' ideas about money market operations. Both the Treasury and the Bank would contribute to papers for a further meeting with the Prime Minister. These would be sent to Sir Alan Walters in Washington for his comments.

RL.

RACHEL LOMAX

NOTE FOR THE RECORD

Alan Walters spoke to Dr Leutwiler on the 'phone and reported the Prime Minister's concerns about the UK monetary position. He in turn expressed his concerns about international debt. I understand the discussion was fairly brief but Alan did say that the PM would be delighted to see Dr Leutwiler if he were coming through London in the near future.

I have since spoke to Dr Leutwiler who will be in London on Thursday 4 July. I have arranged for him to see the PM at 9.30 am for about 45 minutes.

KT

ANDREW TURNBULL

11 June 1985

10 DOWNING STREET

(1)

Prime Minister

The Chancellor wishes to discuss this on Wednesday. There is a major presentational problem. In seeking to safeguard its position in the legal action against the auditors, the Bank are forced to downplay any weaknesses in its supervision. This will create an impression of whitewash, with the Bank blaming JMB and the auditors but being insufficiently self critical (even if in practice it is taking the criticisms very seriously).

AT
7/6

P.S. You may find it easier to look at the Annexes in the order C, B, A.

R16

SECRET

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

REVIEW OF BANKING SUPERVISION AND JOHNSON MATTHEY BANKERS

In my minute of 10 December 1984, I told you that I intended to set up a Review Committee to look at our system of banking supervision in the light of the Johnson Matthey Bankers (JMB) affair. I announced the review in a statement to the House on 17 December. I asked the Governor to chair the Committee and its members included Peter Middleton and an experienced banker, Derek Van der Weyer.

2. The Committee has now submitted its report, which I attach as Annex A. Its recommendations are summarised on pages 25-30. The Report is a competent and authoritative piece of work, with which I largely agree. While I do not feel committed to every detail of its recommendations, I propose to publish the report as a Command Paper. It will be used as a basis for early consultation with interested parties, supplemented as necessary by consultative papers on particular topics. I would then hope to publish a White Paper on Banking Supervision towards the end of the year, and to prepare legislation for introduction in the 1986-87 session. You will recall that QL Committee has already provisionally allocated a firm place in the legislative programme for a Banking Bill.

SECRET

3. I also enclose at Annex B an account by the Bank of England of events leading to the collapse of JMB and the subsequent rescue operation by the Bank. This will be published with the Bank of England's Annual Report and accounts.

4. I intend to lay both these documents before the House and to make a statement on 18 June. I attach a rough draft of the statement at Annex C. I should like to discuss this with you when I see you next Wednesday. It is clearly too long but I have not yet decided how much I can leave out. I would propose to circulate a final version to interested colleagues.

5. I apologise for the length of these papers. The background to the Committee's recommendations is fully covered in its report and more summarily in the draft statement, and I shall not go over it again in this minute. There are, however, several important points which I should add:-

(i) The terms of reference of the Review Committee were confined to reviewing the supervisory system. The Committee were not asked to conduct a post-mortem into JMB.

(ii) The account at Annex B has been prepared by the Bank, who are solely responsible for it. It omits any suggestion that the Bank of England supervisors were in any way to blame for the scale of the collapse. I am clear that supervisory lapses did occur, and the Governor accepts this. But the Bank of England intend to initiate, through JMB, legal action against JMB's former auditors, Arthur Young. The Governor is therefore unwilling for the Bank to admit any contributory responsibility, since this would

jeopardise their suit. I am advised that anything critical which I say about the supervisors' role in the affair will also carry risks, albeit somewhat less, for the Bank's action. However, I do not believe that my statement will carry credibility unless it includes some mention of the supervisors' mistakes. Paragraph 19 of the statement has been drafted accordingly.

(iii) As you will recall from my earlier minute, I was not wholly convinced that the consequences of allowing JMB to fail would have been as serious as to justify a full scale rescue operation by the Bank of England. These doubts persist, and you will see from paragraph 7 of my draft statement that I have refrained from endorsing the Governor's action.

Rachel Lomax

NIGEL LAWSON

7 June 1985

(approved by the Chancellor and signed in his absence.)

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ANNEX A

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REPORT OF THE COMMITTEE SET UP TO CONSIDER
THE SYSTEM OF BANKING SUPERVISION

Section	Subject	Page
I	Introduction	1
II	The nature of the supervisory process	3
III	The two-tier system of authorisation under the Banking Act	4
IV	The relationships between the managements, supervisors and auditors of banks	7
V	Large exposures	12
VI	Quality of assets and control systems	15
VII	The adequacy, scope and timeliness of data received for supervisory purposes	16
VIII	Parental support	17
IX	Staffing and organisation of the Banking Supervision Division	19
X	Consolidated supervision	21
XI	Matters raised with the Committee by the official group considering the desirability of amendments to the Banking Act	22
XII	Towards implementation of the Committee's proposals	25
XIII	Summary of recommendations	25
Appendix	Terms of Reference	

REPORT OF THE COMMITTEE SET UP TO CONSIDER THE SYSTEM OF BANKING SUPERVISION

I Introduction

1 The Chancellor of the Exchequer and the Governor of the Bank of England agreed in December 1984 that a Committee should be established, under the Chairmanship of the Governor, to consider the present system for supervising banks* and whether any early changes in supervisory procedures were called for in the light of the problems which had arisen in Johnson Matthey Bankers Limited (JMB). The members of the Committee were:

Mr R Leigh-Pemberton	Governor, Bank of England (Chairman)
Mr C W McMahon	Deputy Governor, Bank of England
Mr W P Cooke	Associate Director, Bank of England
Sir Peter Middleton	Permanent Secretary, H M Treasury
Mr F Cassell	Deputy Secretary, H M Treasury
Mr D Vander Weyer	Deputy Chairman, British Telecom plc, Director, Barclays Bank plc

The Secretary was Mr I M Cobbold of the Bank of England.

2 Within the broad terms of reference set out in the previous paragraph, the Committee was asked to give particular attention to the relationship between auditors and supervisors; staff experience and training and the adequacy and deployment of staff resources in the Banking Supervision Division of the Bank of England; the handling of concentrations of risk; the assessment of quality of assets; and notification and collection of statistics. The Committee was asked to draw attention to any areas where, if changes were to be made in supervisory arrangements, these would support the need for the review of

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* In this report the word "banks" is used to include both banks and licensed deposit-takers authorised under the Banking Act 1979, except where recognised banks are specifically referred to.

amendment of the Banking Act 1979. The Committee was asked to produce its report as soon as possible after the end of the year. The full terms of reference, which were published on 17 December, are attached as an appendix.

3 We were not asked to examine the reasons why the particular problems which arose in the case of JMB occurred, nor to consider the reasons for mounting the rescue operation, both of which will be discussed in the Bank of England's Annual Report. Our brief was rather to draw lessons for the system of supervision from the circumstances which gave rise to the decision by the Bank at the beginning of October 1984 to acquire JMB and to consider more widely the Bank's existing supervisory procedures.

4 We have met as a Committee on fifteen occasions and have considered a range of papers produced by the Banking Supervision Division and by an official group drawn from the Treasury and the Bank, set up to consider the desirability of making amendments to the Banking Act. We have also held discussions with senior officials of the Banking Supervision Division and with Mr T P Lankester of the Treasury, the Chairman of the official group.

5 We requested the views of the Institutes of Chartered Accountants in England and Wales and of Scotland on the relationship between banks' auditors and the supervisors. They prepared a memorandum for us, which has been published, and we have held discussions with their representatives. We have also held discussions with a number of senior bankers and received written representations from certain representative bodies and individuals. As indicated in paragraph 79 below, we believe that further consultations will be necessary before a number of our recommendations can be put into practice.

6 We are grateful to all those who have assisted us in our work, and in particular to the Secretary of the Committee.

II The nature of the supervisory process

7 No system of banking supervision has yet been developed which avoids all bank failures. The special characteristics of the system of banking supervision currently in operation in the United Kingdom are its flexible nature and the part played in it by the co-operation of banks secured through regular contacts between the supervisors and banks' managements. The current supervisory regime in this country is widely held to be an important factor in the maintenance of London's role as an international centre.

8 We did not examine in any detail the possibility of changing to a basically different system. We do not believe that the present system is fundamentally flawed but we have identified a number of important improvements which we believe should be made.

9 Continued reliance on a flexible system has three major implications. First, if the Bank is not itself to carry out detailed inspections of banks' books, it must be able to rely on the assistance and co-operation of the professional firms who do carry out this task: the banks' auditors. As will be seen in Section IV below, we believe it is important that co-ordination and contact between supervisors and auditors be improved in a number of ways. Secondly, it requires the continued co-operation of the banks which are supervised. We believe that the existing high level of co-operation between the banks and the supervisors can be maintained and that banks will remain responsive to the concerns of the supervisors. The system cannot, however, rely totally on this responsiveness in all circumstances; the supervisors must have adequate powers to deal with cases where this co-operation is not forthcoming. Thirdly, we believe that for the proper working of the present system, it is essential to improve the capacity of the supervisors to exercise the crucial qualitative judgments on the management, the loan book, the adequacy of capital and other elements of the business of the banks which they are supervising. It will be seen that most of the recommendations made in the rest of this report are directed to that end.

III The two-tier system of authorisation under the Banking Act

10 The Banking Act provides for the authorisation of a deposit-taking institution either as a recognised bank or as a licensed deposit-taker. The relevant criteria are set out in the Banking Act (Schedule 2); the most important differences are that for recognition as a bank the applicant must demonstrate that it provides a wide range of banking services and possesses a high reputation and standing in the financial community.

11 When the Banking Act was introduced, it was the intention that the two-tier system would allow the Bank to continue its traditional style of supervision over the major banks but would give it somewhat greater legal powers over licensed deposit-takers, many of which had not previously been subject to supervision. It was also intended that by broadly restricting the use of banking names and descriptions to recognised banks the system should make the general public aware of the difference of function and/or standing of the institutions within the two tiers.

12 Following from this differentiation in the legal framework, the styles of supervision of the two types of institution have developed somewhat differently. Supervision of recognised banks takes account of the experience and standing of the institutions and relies considerably on mutual trust and the co-operation of management. The smaller licensed institutions accept and generally appreciate a more direct form of supervision with clearer guidance on the standards expected of them. JMB's position as a recognised bank was a factor in the delay in the supervisors becoming aware of, and reacting to, its growing problems.

13 More generally, the two-tier system has not fully achieved its objective of signalling some differentiation between the institutions in the two tiers and has led to confusion in the public mind on the way in which the related criteria of function and status are applied. There is also no clear division in the use of banking names and descriptions between the institutions in the two tiers. Branches of overseas banks which are licensed are allowed to use their names with the qualification "licensed

deposit-taker" shown equally prominently and licensed institutions are able to describe their services as "banking services". Personal depositors also seem to attach more importance to the fact that an institution is officially authorised than to whether or not it is a recognised bank.

14 We were told by the Banking Supervision Division that the administration of the two-tier system has caused considerable difficulties and that a great deal of time and effort has had to be expended in order to apply the criteria fairly and consistently. Moreover the desire to achieve recognised status and meet the services criterion has in some cases encouraged institutions to diversify or expand in ways which are artificial and, at worst, could be counter-prudential. It has also become evident that, in practice, movement between the tiers would normally only be upwards from licensed to recognised status. Revocation of recognition and replacing it with a licence carries some risk. The change in category of authorisation would immediately become public knowledge and could lead to a serious loss of confidence in the bank. The benefit of closely controlling its business by applying stringent conditions to its licence while its problems were being resolved in an orderly manner could be jeopardised and its difficulties intensified.

15 When considering the arguments for and against retaining the two-tier system, we took into account that there were only relatively small differences in the powers of the Bank in respect of recognised banks and licensed deposit-takers. The most important difference in the existing powers is that the Bank is able to obtain information from licensed deposit-takers, but was not given similar powers in respect of recognised banks because it was felt that these banks would always comply voluntarily with requests for information. We noted that the existence of the difference in powers has in one respect proved to be perverse. When requests were made to some banks for information on individual large exposures, where considerations of customer confidentiality were a factor, the lawyers for the banks expressed concern because the absence of a legal requirement to provide the information left the banks at risk if a customer challenged the

disclosure of the information. Although the Bank believes that the banks are already adequately protected at law, we concluded that the Bank's powers to obtain information should be extended to recognised banks.

16 For all these reasons, we recommend that the Banking Act should be amended to replace the two-tier system with a single authorisation to take deposits. All the powers given to the Bank under the Act would then apply equally to all authorised institutions and we accept that all authorised institutions would in consequence be entitled to use banking names and descriptions.

17 We do not intend that the change to a single tier of authorisation should affect to any significant extent the way in which the Bank conducts its supervision of major banks which are soundly run, or its relationship with them. The change will, however, make it easier for the Bank to deal with any problems that may arise in future amongst what are currently recognised banks.

18 We consider that, if the amalgamation of the two tiers takes place, the criteria for authorisation under the Banking Act should remain broadly unchanged - apart from the two major additional requirements for recognition referred to in paragraph 10, which would be removed. There are certain differences between the criteria for recognition and for a licence, however, which will need to be resolved in drawing up a new set of criteria. We noted, in particular, that two of the existing criteria, while having broadly the same meaning, carry slightly different emphases, each of which we believe should be retained. They are the present requirement that all directors, controllers and managers of licensed deposit-takers should be "fit and proper" and the requirement that the business of recognised banks should be carried on with integrity and prudence and those professional skills which are consistent with the range and scale of the bank's business. We recommend that both requirements should be included in the new single set of criteria.

19 The only other significantly different requirement between the two existing sets of criteria is that recognised banks require minimum net assets of £5 million at the time of authorisation (£250,000 if a highly specialised banking service is provided), while licensed deposit-takers require minimum net assets of £250,000. We consider that the move to a single tier and the availability of banking names to all institutions justifies some increase in the minimum net assets requirement from £250,000. Inflation since 1979 would in any case justify an increase to over £400,000. We recommend that the minimum should be set at £1 million.

20 We do not recommend that existing institutions with net assets below £1 million should lose their authorisation as a result of this change. However, we noted that the purchase of such an existing institution would provide a method of obtaining authorisation under the Act without meeting the revised minimum net assets criterion for new applicants (assuming that the institution under its new owner continued to fulfil the other criteria for authorisation). We therefore recommend that an amendment should be made to the Banking Act to require an existing institution to meet the new minimum requirement for net assets on a change of ownership.

IV <u>The relationships between the managements, supervisors and auditors of banks</u>

21 The management of a bank lies in the hands of its directors and executives. It is not the function of either the auditors or the supervisors to take over the role of management; they all have their own discrete functions.

22 In our view, it is most important that all the directors, not only those in executive positions, involve themselves in a bank's affairs. In particular, non-executive directors should ensure that they are given sufficient information to be able to satisfy themselves that the policy guidelines and systems approved by the Board are being followed. We also believe that this is essential in order that the non-executive directors are able to make a constructive contribution to the direction of the bank's business, including forming their own view of the quality of its lending and other risk assets.

23 Audit committees, which are normally composed largely of non-executive directors, can play a particularly useful role in monitoring the operations of a bank. To do so, however, they must not restrict their activities to matters related to the preparation of the annual accounts. They must become involved in assessing and monitoring the bank's control systems and receiving reports from both internal and external auditors.

24 Banks have been relatively slow to follow the example of commercial companies and appoint finance directors to their boards. This may be understandable in the sense that all the executive directors are "financial". We believe, however, that there is an important role to be played by a finance director who, apart from the managing director and the chairman, will be best placed to take an overall view of the business. It is not an easy role, as the finance director must be prepared to question and challenge the decisions of his colleagues, but it can be a most important one. JMB had neither a finance director nor an audit committee.

25 An audit committee and a finance director share many of the concerns of the external auditors and the supervisors and can assist them in carrying out their functions. The auditor is required to make a judgment on the totality of the picture presented by a bank's accounts, drawn up by the management, and to certify that they present a true and fair picture of the affairs of the bank and not a misleading one. The supervisors must satisfy themselves that the business of the bank is being conducted prudently and that depositors' money is not being put at risk to an unacceptable degree. The work carried out by the auditors can greatly assist the supervisors, particularly where the latter do not, as part of their regular supervisory processes, carry out on-site inspections. The auditors will be assisted if they are aware of any concerns or requirements the supervisors may have.

26 If the auditors and the supervisors are to be able to assist each other to carry out their respective functions there must be a dialogue between them. This process is at present hindered by the confidentiality constraints on both parties. The auditors of

a bank have the same duties under the Companies Acts as the auditors of other companies. The auditors are appointed by the shareholders and report to them. Under present conventions and practices, auditors feel constrained by the duty of confidentiality which they owe to their client not to disclose information to third parties, including the supervisors. The supervisors, for their part, are bound by the confidentiality provisions in Section 19 of the Banking Act from disclosing information obtained in the course of supervision to the auditors.

27 Confidentiality constraints on both the supervisors and the auditors can be overcome by obtaining the specific permission of the bank concerned for a dialogue to take place. Such permission has been sought and given in certain cases. It could be withheld, however, in circumstances where such a dialogue was very necessary. We recommend that the Bank should, as an interim measure, seek the agreement of all authorised institutions for such dialogues to take place and should obtain it as a matter of routine from all newly authorised institutions. While a great deal of progress can be made by obtaining the agreement of banks in this way, we believe that provisions should be included in legislation to remove the confidentiality restraints. These would clearly establish the position of both parties and remove the possibility that in certain cases consent might be withheld.

28 We do not wish the arrangements for a dialogue between the supervisors and banks' auditors to upset the basic relationship between the auditors and their clients, the banks. The lines of communication should normally be between the supervisors and a bank and between a bank and its auditors. The bank would commission from the auditors any information required by the supervisors and its representatives would normally be able to attend any meetings between the two. Although direct communication between the supervisors and the auditors is only likely to be necessary in exceptional circumstances, it should be possible for this to take place.

29 We believe, following our discussions with bankers and the representatives of the Institutes, that the auditors can provide valuable assistance to the supervisors, in particular with their

assessment of the design and operation of a bank's control systems. It will also be helpful for the supervisors to be aware of the discussions which have taken place between the management and the auditors on the need for provisions against bad and doubtful debts. In particular the supervisors will want to know whether the auditors feel that the bank is being cautious or whether they have only reluctantly been convinced that the provisions made are adequate. It will be helpful to the auditors, in their turn, to know of the supervisors' requirements for a bank and to be aware of any areas which are causing them concern.

30 We envisage that the dialogue between supervisors and auditors will take place partly through meetings and partly through written material. Auditors frequently send their clients a "management letter" at the end of an audit, commenting on various matters which have come to their attention. We consider that this letter should be made available as a matter of course to the supervisors. The supervisors will, however, also wish to receive some further information from the auditors, for example, on provisions and the adequacy of control systems which may not always be covered in an appropriate way in the management letter. It should be possible to adapt the management letter to meet the supervisors' requirements but this will need to be discussed between the supervisors, the banks and the accountancy profession. The supervisors may also wish a bank to commission special reports from its auditors from time to time. A bank would be expected to make available to its auditors copies of letters from the supervisors setting out any requirements for that bank or raising points of concern.

31 The supervisors rely to a large extent for information on the returns submitted to them by banks, mainly on a quarterly basis. The principal return used for supervisory purposes is certified by a director or senior manager of the bank and the accuracy of the data provided has not been a major cause for concern. We nevertheless consider that improvements in the standards of reporting could be effected if the supervisors were given powers to require these returns to be audited. It is not proposed that

these powers should be used as a matter of routine; but they should be available for carrying out spot checks and for following up any inaccuracies which are detected.

32 The supervisors are rightly concerned that they should be able to rely on the work done by the auditors since this work can give them much of the assurance about the health and general soundness of a bank which would otherwise have to be obtained through inspections by the supervisors themselves. The dialogue proposed between auditors and supervisors in the previous paragraphs will greatly assist in this respect. It is obviously necessary, however, that the supervisors should have full confidence in the competence of the auditors themselves; in particular that they are properly qualified in terms of training and experience for the rather specialised business of auditing banks. The Institutes of Chartered Accountants already provide guidance to auditors operating in specialised fields such as banking, and offer training courses. This advice is very valuable and we hope that the Institutes will consider ways of extending the assistance which they offer.

33 In some countries, the supervisors have to approve a bank's auditors before they can take up their appointment. We considered whether to recommend this procedure but decided against it on the grounds that it could conflict with the right of shareholders to appoint the auditor and would make it more difficult for firms which had not previously done so to begin to audit banks. We also considered but rejected a proposal that the supervisors should have powers to require the dismissal of auditors because this would again conflict with the position under the Companies Acts. Occasional cases may arise where the supervisors consider that the auditors are not competent to audit a bank or have been negligent. We propose that, in order that the supervisors may have a report on which they can rely, the Bank should be given powers to require a bank to appoint a second firm of accountants to make a report, covering similar ground to a statutory audit, and at the bank's expense. The Bank already has some powers under Sections 16 and 17 of the Banking Act to obtain information from licensed deposit-takers and to commission

investigations into all authorised institutions, but we believe that these powers will need some amendment in order to implement this proposal.

34 If the performance of the auditors, or of other professional advisers to a bank, is found to be seriously deficient by the supervisors, we recommend that the Bank should be given powers to pass information to the relevant professional body so that the possibility of disciplinary proceedings can be considered. This proposal would require an amendment to Section 19 of the Banking Act.

35 We have been greatly assisted in our consideration of the relationship between the supervisors and banks' auditors by our discussions with representatives of the Institutes of Chartered Accountants. We believe that the proposals outlined in this Section are generally acceptable to the accountancy profession.

V Large exposures

36 Concentrations of lending and other exposures to individual borrowers or economic sectors have recently been the most important cause of difficulties in banks. This was true, not only in the case of JMB but also in the failures of certain small licensed deposit taking companies in this country. Abroad, the recent problems in Continental Illinois and Penn Square in the United States, Schroeder, Munchmeyer, Hengst & Co in Germany and Kronebanken in Denmark have had similar roots.

37 Many countries have imposed limits in terms of some measurement of capital on large exposures to individual borrowers or groups of related borrowers.* The United Kingdom does not have such legal limits.

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* For example, in the following countries the basic limits, which are subject to various qualifications, are:

United States	15% unsecured
	25% secured by fully marketable securities
Japan	20%-30%
Switzerland	20% unsecured
	40% secured
France	50%
Germany	50%

38 In April 1983, the Bank issued guidance to all authorised institutions stating that "Experience suggests that exposures (loans, acceptances, guarantees etc) to one customer or group of customers should not normally exceed around 10% of an institution's capital base". The notice went on to say that the more an exposure exceeded 10%, the more rigorous the Bank would be in requiring justification for the exposure and that where such loans had been made, the institution would normally be requested to maintain a significantly higher level of capital resources than would otherwise be required.

39 We considered the case for imposing specific limits on large exposures in legislation but concluded that this was not desirable. Other countries' experience has shown that to do so encourages banks to find ways around the requirements and may encourage them to trade up to the specified limit. For some institutions an exposure of even as much as 10% of capital may be excessive and the supervisors need flexibility to agree appropriate policies with individual institutions within overall guidelines.

40 A policy on large exposures has to start from an "at worst" position. The judgment on the acceptable level of exposure is in part a question of the balance of the bank's portfolio and in part a view of the damage which could be suffered if a particular exposure or exposures were to go bad. It is not a judgment on the likelihood of the exposure going bad. Nor is it simply a question of whether the loan is secured or unsecured as this does not necessarily determine the real exposure to risk.

41 A limit placed on large exposures should not be too restrictive. Major corporate borrowers expect to be able to deal in large amounts; too low a limit may force banks to forego good business and make instead smaller, perhaps less good quality, loans. This is particularly a problem for smaller but growing banks which need to take on what are for them relatively large exposures if they are to obtain the business of larger companies. It is much less of a problem for the larger banks.

42 We agree with proposals put forward by the Banking Supervision Division that each bank should be asked to set out in writing its policy on large exposures and that this policy should be formally adopted by its Board. All exposures (including undrawn commitments and contingent liabilities) above 10% of capital would be reported to the Bank and closely examined by the supervisors. No exposure to a single borrower, or to a group of closely related borrowers taken together, should exceed 25% of capital except in the most exceptional circumstances. The existence of exposures over 10% of capital would normally require a bank to maintain greater capital resources than would otherwise be required. Factors such as a long-standing relationship with the borrower, particular expertise in the type of lending, the overall financial standing of the borrower and the security for the loan would be factors to be taken into account when considering different levels of exposure up to 25% of capital, but would not justify an increase beyond that level. Large exposures to borrowers connected with the bank through membership of the same group of companies, by common directors or in other ways, would continue to be particularly closely scrutinised by the Bank and should generally be strongly discouraged.

43 Legitimate concern about political sensitivities makes it undesirable for the Bank to publish general guidelines on the appropriate level of exposures to particular countries. However, control of country exposures is as important as control of exposures to individual customers. We endorse the Banking Supervision Division's present policy of monitoring country risk exposures over 10% of capital and discussing them in detail with banks, except in the cases of lending to the most creditworthy countries.

44 The Bank also needs to monitor banks' exposures to economic sectors both within the United Kingdom and worldwide. The particular monitoring system used will have to have regard to the nature of the individual bank's business. While a broad industrial classification may be appropriate for a large bank, and statistics are already obtained on this basis for exposures within the United Kingdom, a small institution needs to adopt a more closely defined and detailed approach more appropriate to the

scale and range of its activities. We believe banks which do not already have such internal monitoring systems should develop them and that the supervisors should obtain this information from them.

45 While no direct legal penalties are proposed for exceeding the 25% of capital level, breaches should lead to a bank being required to maintain significantly greater capital resources and would reflect on the prudence of its management. Sustained breaches of the 25% ceiling should lead the Bank to consider revoking the bank's deposit-taking authority.

VI Quality of assets and control systems

46 Sustaining the quality of a bank's assets is one of the essential factors in ensuring its continued health. Although it is not the supervisors' role to take individual lending decisions in place of management, the supervisors must always be alert for signs of a deterioration in the quality of a bank's loan book. To complement the information already available to them on banks' loan portfolios, we believe that there are further steps which the supervisors should take to satisfy themselves that banks' control systems, particularly for lending, liquidity and other exposures to risk, are appropriate and are being properly applied in practice. Poor controls were one of the roots of the problems which arose at JMB. The size of the bank's loan book had grown very rapidly since 1981 and the systems in place and their operation in practice proved to be completely inadequate to approve and monitor the volume of lending undertaken. In addition, the administrative processes for taking security against loans were often not properly carried out and the need for provisions not properly identified.

47 We recommend that in addition to the regular meetings which the managements of all banks attend at the Bank, the supervisors should from time to time visit each bank. Some visits already take place, more particularly in the licensed sector, but we believe they should be extended to cover all authorised institutions. The frequency and length of these visits would vary with circumstances. The objective of these visits would not

be to carry out a detailed examination of the bank's books but to assess a wider range of the bank's management team and to consider in greater detail the design of the bank's control systems. The information on control systems obtained through these visits will complement that obtained through the dialogues with banks' auditors, recommended in Section IV.

48 The Banking Supervision Division has developed over the years a capability to carry out investigations where problems arise in a bank or are suspected. We recommend that the Division should be more ready to carry out such detailed investigations at an early stage when there are suspicions that problems are developing. One concern which has arisen in the past has been that knowledge of such an investigation might leak out and cause a loss of confidence in the bank. The visits to banks proposed in the previous paragraph will make it less likely that a special investigation will appear to be an exceptional event.

49 As part of our review, we considered the grading systems used, particularly in the United States, by both banks and supervisors to classify loans. Such systems rely in part on objective criteria and in part on subjective judgments. We believe that these systems can provide useful information to management, auditors and supervisors and that banks which do not already have them should consider introducing them. The systems need to be designed to take account of the particular features of an individual bank's types of lending and do not appear to be easily adaptable to a system-wide reporting mechanism, which would become excessively complex. The supervisors would therefore need to obtain information from individual banks' systems.

VII The adequacy, scope and timeliness of data received for supervisory purposes

50 The Bank has for a number of years collected statistics from the banking system for the purposes of monetary policy and economic and financial analysis. When the system of supervision was extended and enhanced in the mid-1970s, the information required for prudential purposes was to a large extent integrated into the existing returns. Only one of the returns completed by each institution is used exclusively by the supervisors.

51 While there are certain drawbacks in the need to co-ordinate the requirements of all the users of the statistics, we concluded that the present integrated system should be continued. To collect a separate set of data for prudential purposes would overlap to a large extent with the data required by other users, and would place a considerable burden on the banking system and the Bank, which would not be justified by the benefits obtained.

52 We did not identify any major deficiencies in the data received by the supervisors. Minor improvements can always be made and these will doubtless continue to be pursued with the banking system in the normal way. In particular, some additional statistics will be required following the Banking Supervision Division's review of its approach to consolidated supervision which is referred to in Section X. Certain other statistics on exposures to economic sectors and the grading of loans would be obtained outside the integrated reporting system.

53 A substantial delay in providing a return at a crucial time was a factor in delaying the supervisors' identification of the acute problems emerging in JMB. Late reporting may be a sign of problems in an institution. We therefore recommend that the Bank should tighten its procedures for ensuring that all returns used for supervisory purposes are submitted promptly and should consider carrying out an investigation into any bank which fails to provide information within the time allowed.

54 Inaccuracy in the information provided has not proved to be a major problem for the supervisors (although in the case of JMB some of the information given to the Bank on large exposures was significantly misleading). Our recommendation in Section IV that the Bank should be empowered to require banks' auditors to certify their statistical returns will provide an independent check from time to time on the accuracy of the data.

VIII <u>Parental support</u>

55 We were advised that the Bank has always believed that a bank should stand behind its subsidiaries and other related companies,

especially if those companies themselves take deposits. Its view is based on the premise that failure to rescue a subsidiary which got into difficulties would quickly cause a loss of confidence in the parent bank itself. This view is acknowledged and accepted by British banks.

56 The Bank also believes that owners of banks have an additional responsibility not present in the ownership of most other commercial or industrial undertakings, because of the special fiduciary responsibilities on those who run businesses which take deposits from the public. In the mid-1970s, the Bank began to seek letters of comfort from overseas banks with shareholdings in United Kingdom banks which recognised their moral responsibility to stand behind the bank should the need arise. Since then, this practice has been extended to a wider range of non-bank shareholders from both the United Kingdom and overseas. Johnson Matthey plc, the parent company of JMB, had not been asked to provide a comfort letter but had demonstrated its willingness to support the bank in the past. It acknowledged its responsibility to do so when the crisis arose. The problem was its lack of resources to discharge this responsibility.

57 We considered proposals from the Banking Supervision Division to extend its requests for comfort letters to all significant shareholders in United Kingdom banks. These would broadly entail comfort letters being sought from all shareholders who control 15% or more of the voting power, and in some cases shareholders who control 10% or more. The Bank believes that in most cases it is not necessary to formalise the position in respect of shareholdings by United Kingdom banks because of their agreement that they must stand behind their subsidiaries and other related companies in all but the most exceptional circumstances.

58 Having obtained letters of comfort, it is obviously necessary that the Banking Supervision Division should monitor the ability of the givers of those letters to honour their responsibilities should the need arise. We noted that the Division intends to take a closer interest in the position of parent companies and

other large shareholders than it has done previously. We therefore endorse the proposals which are now being implemented. The related question of the consolidated supervision of groups containing a bank is discussed briefly in Section X.

IX Staffing and organisation of the Banking Supervision Division

59 The staff of the Banking Supervision Division totals 94, of whom 23 are senior officials and managers. In addition, there are 36 support staff. The staff are very largely career Bank staff, most of whom have had experience in other parts of the Bank before joining the Banking Supervision Division. The size of the banking supervisory function has grown very substantially since the system of supervision was revised and enhanced in the mid-1970s. However, with growing domestic and international pressures on the banking system, so has the burden of work. An increase in staff numbers is justified to meet the existing level of work and we recognise that certain of our proposals will give rise to the need for some further expansion.

60 We consider that the quality and commitment of the existing staff are high. But we believe that they need to be able to draw on a wider commercial experience in order to improve their ability to make judgments about the quality of lending, liquidity and other risk exposures. This experience can best be obtained by a period working in a commercial bank. A few of the existing staff have already had periods on secondment with commercial banks and there have been some inward secondments from commercial banks. We recommend that this programme of secondments in both directions should be significantly increased. In the short term, commercial experience can only be brought into the Division by inward secondments from commercial banks or the recruitment of staff with banking experience. In the longer term, the staffing policies followed should allow for all managers and senior analysts to have spent a period with a commercial bank; some permanent recruitment of experienced commercial bankers should also be considered.

61 The staff of the Division are subject to the Bank's normal policies on recruitment, promotion and staff development. Members of staff normally spend from three to four years in the

Division, although some have been there for much longer. Supervision is essentially a job which can only be learnt through its practice, although commercial experience and training, for example in accountancy, are also very important. It is essential that the managers and analysts responsible for a group of banks get to know them thoroughly and this cannot be done quickly. The banks also appreciate continuity in their contacts with the Division. For these reasons we believe that the Banking Supervision Division should take steps to develop a significant cadre of long-term banking supervisors.

62 The Banking Supervision Division at present has two qualified accountants whose role is primarily to give advice on any accountancy matters which arise. We recommend that some increase in the number of qualified accountants should be made, particularly taking account of our recommendation in Section IV that a dialogue should take place between the supervisors and banks' auditors.

63 The working practices and systems of communication within the Division have needed to develop to take account of the growth in staff numbers, the larger number of institutions supervised and the greater complexity of the work. We have considered, and approved, plans for a number of improvements in the system presented to us by the Division. These plans, which are now being implemented, define more clearly the scope of the responsibilities of senior officials and managers in the Division, clarify the lines of responsibility and control and improve the flows of information. In addition, senior management within the Division has been strengthened. As a result of these changes, the Division should be better able to identify problems and, equally important, to react quickly and decisively by bringing together the necessary staff and expertise when problems do arise.

64 One of the practical difficulties faced by the Division is the need to deal quickly with large volumes of statistics each quarter when they are first received, in order to identify any significant changes in the circumstances of particular banks. We believe that it is important that the returns of all institutions are examined as soon as they are received and that

any questions raised are followed up without delay. Greater use of desk-top computer facilities would assist in this respect, and we welcome the Bank's intention to introduce more terminals in the near future. Greater selectivity in the use of the very large information base will help the senior supervisors to concentrate on the essential problems in a bank and reduce their considerable workload. Our proposals on the staffing of the Division and for improving the supervisors' knowledge of a bank and its management, for example through the contacts with auditors and visits to the bank, will also improve the supervisors' ability to assess the nature of changes identified from the returns.

65 We considered work done by the Banking Supervision Division into the use of computerised early warning systems as a means of identifying the banks which are most at risk. This work concluded that these systems do not, at present, provide a sufficiently reliable means of detecting such banks. However, the subject merits some continued study and experience gained in other countries might usefully be further investigated.

X Consolidated supervision

66 The matters discussed in the previous Sections of the report all derive from particular issues which arose in the case of JMB. Our terms of reference were not, however, confined to such questions and we have also considered certain other issues related to the system of supervision. These are discussed in this Section and the next.

67 In the light of both recent moves towards the formation of financial conglomerates, and the European Communities' Directive on Consolidated Supervision, the Bank has been reviewing its approach to the consolidated supervision of groups containing a bank or banks. We considered a paper setting out the issues raised by the Bank's proposals and accepted its approach. Consultations have subsequently been started with the banks. In due course a paper setting out the approach to be adopted, agreed by the Treasury, will be sent to the EC Commission in order to demonstrate that the United Kingdom is complying with the Directive.

68 We also considered the problems raised by the supervision of conglomerate financial groups where different parts of the group are the responsibility of different supervisory authorities and no one supervisor has the responsibility for the group as a whole. Close co-operation between the various supervisory authorities will obviously be required: in particular, and subject to appropriate safeguards, barriers to the exchange of information between them will need to be removed. Section 19 of the Banking Act provides such a barrier at present. The need to remove these barriers has already been referred to in the White Paper on Financial Services (Cmnd 9432).

69 The supervision of conglomerate groups raises a number of difficult questions which range beyond our terms of reference and which we have not discussed in any detail. We noted, however, that they will need careful consideration by the relevant government departments and supervisory authorities.

XI Matters raised with the Committee by the official group considering the desirability of amendments to the Banking Act

70 The official group, under the chairmanship of Mr Lankester, has assisted us in our study of the various matters covered by our review of the system of supervision. Additionally, as part of its own work into the desirability of amending the Banking Act, the official group has sought our views on certain issues.

(a) Confidentiality of information provided to the Bank

71 Section 19 of the Banking Act provides that information obtained by the Bank under the Act may only be disclosed to other persons in certain specified circumstances. We have already proposed that the Bank should, in certain circumstances, be able to disclose information to a bank's auditors; to the professional body of a bank's advisers where the possibility of disciplinary action being taken against the adviser exists; and to other supervisory bodies.

72 The Bank is at present able to disclose information to the Treasury where it believes this to be in the interests of depositors or in the public interest. Neither the Bank nor the Treasury is permitted to disclose information on these grounds to other government departments. A number of cases have arisen where the Bank and the Treasury have felt the need to have such a power. Examples include disclosure to the Northern Ireland Office, where local knowledge could have assisted in resolving problems in a licensed deposit-taker based in the province; and to the Foreign Office where action to be taken under the Act against overseas institutions could have been diplomatically sensitive.

73 We endorse a proposal by the official group that the Bank should be given power to disclose information to other government departments, with the consent of the Treasury, where the Bank considers this to be in the interests of depositors or in the public interest. We believe however that disclosure to the Revenue departments of information provided for supervisory purposes should continue to be prohibited.

(b) The Bank's enforcement powers in relation to unauthorised institutions

74 The Bank is one of the prosecuting authorities under the Banking Act. In practice, it is likely to be responsible for pursuing most of the cases which arise in England and Wales, except for those which involve other criminal offences, particularly fraud. The more serious offences occurring under the Act are likely to involve institutions which are not authorised to take deposits; indeed, the most common is taking deposits without authorisation. Ironically, however, the Bank has no powers to obtain books and papers from unauthorised institutions in order to provide the evidence for a prosecution.

75 The official group, after preliminary consultations with other interested Departments, has recommended that the Bank should be given powers similar to those enjoyed by the Department of Trade and Industry under Sections 447 and 448 of the Companies Act 1985. Such powers would enable the Bank to require books and papers from any person who appears to be in breach of the Act and

to apply to a magistrate for a warrant to enter premises, accompanied by the police, and seize books and papers. We support this recommendation.

(c) Deposit Protection Scheme

76 The official group has put certain proposals to us for changes to the Deposit Protection Scheme contained in Part II of the Banking Act. We endorse these proposals:

(i) to increase the amount of a protected deposit from £10,000 to £20,000. Inflation since the Banking Act was passed would justify an increase to £16,500. We also favour some closer alignment between the scheme for depositors with banks and that for depositors and investors with building societies who are at present covered up to £30,000 under the societies' voluntary scheme.

(ii) to increase the minimum initial contribution to the Fund from £2,500 to £10,000. This increase would recognise in part that failures are more likely to occur among the smaller institutions and would be in line with the proposed increase (recommended in Section III) in the minimum net assets criterion for authorisation from £250,000 to £1 million.

(iii) to revoke the provisions which enable H M Treasury to exempt from contributing to the Deposit Protection Scheme, overseas banks whose sterling deposits with their United Kingdom offices are as well protected by arrangements in their home countries as they would be under the Scheme. We consider that the Scheme is intended to protect all depositors with sterling deposits placed with banks in the United Kingdom and that all banks authorised under the Banking Act should share the cost of providing that protection. We are also conscious that the existing provisions have proved extremely difficult and time-consuming to apply in practice.

77 The first two proposals set out in the previous paragraph can be effected by Statutory Instrument, subject to affirmative resolution by Parliament. We believe that it is not necessary to change the other monetary amounts specified in the Scheme; in particular that the cash fund does not need to be raised to accommodate the increase in the limit on a protected deposit. The third proposal would require an amendment to the Banking Act.

XII Towards implementation of the Committee's proposals

78 If adopted, some of our proposals can be implemented by the Bank administratively; some can be implemented by statutory instrument; while others will require amendments to the Banking Act. Most will require prior consultation with the banking system and other interested parties.

79 We urge the Government to allocate time for a Banking Bill in the 1986/87 Parliamentary session. If this is agreed, drafting instructions would need to be prepared for Parliamentary Counsel by the beginning of next year. That would suggest that a White Paper should be published in the Autumn. Some of the proposals for amendments to the Banking Act are covered in this report; others will be considered further by the official group. Many of our proposals deal with complex matters and will require detailed consultations before they could be implemented. If the proposed timetable is to be met, informal consultations should be started with the Banking Associations and other interested parties as early as possible in the Summer.

XIII Summary of recommendations

80 The following is a summary of our recommendations:-

The two-tier system of authorisation under the Banking Act

i) The present two-tier system of authorisation should be replaced by a single authorisation to take deposits under the Act. All the powers given to the Bank under the Act should apply to all authorised institutions and all authorised institutions should be entitled to use banking names (paragraph 16).

ii) The new criteria for authorisation should include both a requirement that all directors, controllers and managers are "fit and proper" and a requirement that the business of the bank should be carried on with integrity, prudence and appropriate professional skills (paragraph 18).

iii) The minimum net assets criterion for authorisation should be increased from £250,000 to £1 million (paragraph 19).

iv) Banks already authorised should be required to meet the £1 million minimum net assets criterion on a change of ownership (paragraph 20).

v) If a two-tier system were to be retained, the Bank's powers to obtain information from licensed deposit-takers should be extended to recognised banks (paragraph 15).

<u>The relationships between the managements, supervisors and auditors of banks</u>

vi) Banks should consider the appointment of an audit committee and a finance director where they do not already have them (paragraphs 23, 24).

vii) A mechanism should be established to enable a regular dialogue to take place between the supervisors and banks' auditors. Existing confidentiality restraints on both parties should be removed, initially by obtaining the agreement of each bank to a dialogue taking place and, as soon as possible, through legislation (paragraph 27).

viii) The dialogue between the supervisors and banks' auditors should not interfere with the present relationship between a bank and its auditors. The bank should commission from the auditors information required by the supervisors and should normally attend meetings between the two (pargraph 28).

ix) Powers should be taken to permit direct communication between the supervisors and the auditors in exceptional circumstances (paragraph 28).

x) The Bank should be given powers to require that statistical returns used for supervisory purposes are examined by the auditors. This should not become a matter of routine but the powers should be used to carry out spot checks and to follow up any inaccuracies which are detected (paragraph 31).

xi) The Bank should have powers to require a bank to commission a report covering similar ground to a statutory audit from a second firm of accountants where the Banking Supervision Division considers that the bank's auditors are not competent or have been negligent (paragraph 33).

xii) The Bank should be empowered to pass information to the appropriate professional body about a bank's auditors or other advisers to assist that body to consider whether disciplinary action should be taken against the advisers (paragraph 34).

<u>Large exposures</u>

xiii) No exposure to an individual borrower, or to a group of closely related borrowers taken together, should exceed 25% of a bank's capital base, except in the most exceptional circumstances (paragraph 42).

xiv) The Bank should continue to monitor and investigate all exposures in excess of 10% of a bank's capital base (paragraphs 42, 43).

<u>Quality of assets and control systems</u>

xv) The Bank should take further steps to ensure that effective procedures are in place to check that banks' control systems, particularly for lending, are adequate and are being properly applied in practice (paragraph 46).

xvi) To broaden their knowledge of banks' managements and to help in the assessment of their control systems, the supervisors should increase the number of visits paid to banks. The frequency and length of the visits would vary from case to case (paragraph 47).

xvii) Where suspicions of problems arise, a detailed investigation of a bank should be undertaken more readily than has been the case in the past. The increased number of visits recommended above should reduce the risk that such an investigation might itself cause a loss of confidence in the bank (paragraph 48).

xviii) Banks should consider introducing loan grading systems if they do not already have them. The Banking Supervision Division should make use of the information provided by such systems to monitor changes in the quality of a bank's assets (paragraph 49).

<u>The adequacy, scope and timeliness of data received for supervisory purposes</u>

xix) The present integrated system for collecting statistical data for various uses, including supervision, should be retained (paragraph 51).

xx) The Bank should tighten its procedures for ensuring that all returns used for supervisory purposes are submitted promptly and should consider carrying out an investigation into any bank which fails to provide information within the time allowed (paragraph 53).

<u>Parental support</u>

xxi) We endorse the Banking Supervision Division's proposals on comfort letters (paragraphs 57, 58).

<u>Staffing and organisation of the Banking Supervision Division</u>

xxii) Some further increase in staff numbers is justified to meet the existing workload and to carry out certain of our other recommendations (paragraph 59).

xxiii) The staff of the Banking Supervision Division would benefit from wider commercial experience to assist them in their work as supervisors (paragraph 60).

xxiv) The programme of secondments in both directions between the Division and commercial banks should be expanded (paragraph 60).

xxv) A significant cadre of experienced, long-term banking supervisors needs to be built up (paragraph 61).

xxvi) Some increase should be made in the number of professionally qualified accountants working in the Division (paragraph 62).

xxvii) We endorse the proposals produced by the Banking Supervision Division for clarifying the lines of communication within the Division, defining more clearly responsibilities and work practices and improving information flows (paragraph 63).

Consolidated supervision

xxviii) Barriers to the exchange of information between supervisory authorities should be removed (paragraph 68).

xxix) The relevant government departments and supervisory authorities should consider carefully the issues raised by the supervision of financial conglomerates, parts of which are supervised by different supervisory authorities (paragraph 69).

Matters raised with the Committee by the official group considering the desirability of amendments to the Banking Act

xxx) The Bank, with the consent of the Treasury, should be able to disclose information to other government departments (except the Revenue departments) where it considers this to be in the interests of depositors or in the public interest (paragraph 73).

xxxi) The Bank should be given powers in respect of unauthorised institutions similar to those enjoyed by the Department of Trade and Industry under Sections 447 and 448 of the Companies Act 1985 in order to facilitate investigation of offences under the Banking Act (paragraph 75).

xxxii) The amount of a protected deposit under the Deposit Protection Scheme should be increased from £10,000 to £20,000 (paragraph 76).

xxxiii) The amount of the minimum initial contribution to the Deposit Protection Fund should be increased from £2,500 to £10,000 (paragraph 76).

xxxiv) The provisions of the Deposit Protection Scheme which allow the exemption of certain overseas banks should be repealed (paragraph 76).

R. Leigh-Pemberton

C W McMahon

W.P. Cooke

P E Middleton

[illegible]

[illegible]

31 May 1985

APPENDIX

TERMS OF REFERENCE

1 A Committee shall be established under the chairmanship of the Governor and with the participation of the Permanent Secretary to the Treasury consisting of representatives of H M Treasury and the Bank. It is intended to appoint a senior outside expert experienced in commercial banking to enquire and report to the Committee. The Secretary shall be provided by the Bank.

2 The Committee shall consider the present supervisory system and whether any early changes in supervisory procedures are called for in the light of the problems which have arisen in Johnson Matthey Bankers.

3 Issues to which particular attention should be given are the relationship between auditors and supervisors; staff experience and training; the handling of concentrations of risk and the assessment of quality of assets; notification and collection of statistics; and the adequacy and deployment of staff resources in the Banking Supervision Division.

4 The Committee should also draw attention to any areas where, if changes are to be made in supervisory arrangements, these may support the need for review or amendment of the provisions of the 1979 Banking Act.

5 A report should be prepared setting out the Committee's views as soon as possible after the end of the year.

6 Detailed consideration of the desirability for legislative changes will be undertaken by an official group under the Chairmanship of the Treasury with the object of making recommendations in the spring in 1985.

CPL

Annex B

The Bank of England and Johnson Matthey Bankers Limited

The Bank of England and Johnson Matthey Bankers Limited

This note is divided into five sections. First, the developments in Johnson Matthey Bankers Limited (JMB) up to September 1984 and the reasons for its failure; second, the Bank's supervision of JMB; third, the rescue operation which was mounted at the end of September 1984; fourth, the reasons for rescuing JMB; while the final section outlines the developments which have taken place since the Bank acquired JMB.

I The development of the business of JMB

JMB was established in 1965 to conduct the banking and bullion business of Johnson Matthey & Co.Ltd (now Johnson Matthey p.l.c.). It became an authorised bank under the Exchange Control Act in 1967 and obtained exemption under the Protection of Depositors Act in 1970. JMB was already being supervised by the Bank before the Banking Act came into effect. After the Banking Act came into effect, JMB was granted authorisation as a recognised bank in April 1980. As one of the five members of the London gold fixing, its business at that time was mainly concentrated on bullion and foreign exchange dealing, with the commercial banking side of the business specialising in trade finance. This spread of business was sufficient to enable JMB to obtain recognition under the normal criteria for a bank providing a wide range of banking services. (The provision of foreign exchange services and trade finance are two of the services required to be provided under the Act for authorisation as a recognised bank.)

Growth of the balance sheet

Total assets of the bank and its subsidiaries in 1980 were £874 million, of which bullion stocks and customers' dealing and metal accounts amounted to £678 million and commercial loans and overdrafts only £34 million. In 1981, the bank began to expand and diversify its loan portfolio. JMB's traditional trade finance business had tended to be based on connections with Pakistan, the Middle East and Nigeria and these areas provided a number of the customers for its expanding lending operations.

The balance sheet of the bank and its subsidiaries, set out in its annual accounts, more than doubled between March 1980 and March 1984 (broadly in line with those of other banks, in aggregate) by which time total assets stood at £2.1 billion (Table 1).

Table 1
£ millions

At end-March	1980	1981	1982	1983	1984
Loans and overdrafts	34	78	135	184	309
Holdings of bullion and customers' bullion-related accounts	678	786	804	1,226	1,359
Total assets	874	1,040	1,183	1,735	2,089

Commercial lending, in the form of loans and overdrafts, grew during the four years much faster than the overall balance sheet. Letters of credit, guarantees and acceptances outstanding also increased rapidly from £18 million in 1980 to £65 million in 1984. Nevertheless, JMB remained very much a specialised bullion trading bank: holdings of bullion and customers' bullion-related accounts, which had amounted to around three quarters of the bank's assets in 1980, still amounted to around two thirds of them at end-March 1984. Although the lending book had been increased markedly, no serious attempt was made to broaden the base of the banking services into, for example, corporate finance or investment management. The JMB group did however diversify to some extent into other financial services by purchasing subsidiaries engaged in soft commodities broking (in the United Kingdom, the United States and Singapore), insurance broking (United Kingdom and the United States) and asset management (United States). The bank did not become involved in large scale financing of sovereign borrowers from developing countries.

Profits and provisions

According to its audited annual accounts, the JMB group's return on shareholders' funds was well over 20% between 1980 and 1983, and the return on total assets varied between 1.1% and 1.6%. This performance compared favourably with that of other banks. During the period between 1980 and 1984 well over three quarters of its profits came from bullion dealing and from sterling and foreign exchange operations partly connected with such dealing (Table 2). In the year to 31 March 1984 total profits fell, with the return on shareholders' funds declining to 9% and on total assets to 0.4%. The fall was attributed in the bank's annual report to 'flat conditions in world bullion markets, intense commission-reducing competition for base metal and commodity futures business, and growing trading problems for our banking customers at home and abroad'.

Table 2

£ millions

Year to end-March	1980	1981	1982	1983	1984
Pre-tax profits	14.4	11.6	16.6	24.3	9.4
of which:					
Dealing (including bullion operations)	13.4	10.0	14.7	20.8	8.9
Banking	1.0	1.6	1.9	3.5	0.5

It was the policy of the JMB board not to make specific bad debt provisions, but rather to write off directly any bad debts. A general provision of £8.0 million was maintained from May 1981 until March 1984. In JMB's quarterly return for June 1984, the Bank was informed that the general provision had been increased to £12.0 million, as from March 1984. After the Bank acquired JMB, it discovered that the general provision had in fact been increased to some £16 million[1] and that part of the general provision was in fact earmarked against a long-standing claim related to an earlier bullion trading transaction. As such this part was more in the nature of a specific than a general provision.

(1) The figure of £20 million for general provisions as at March 1984 given in a press release issued by the Bank of England on 13 May 1985 includes certain debts which had previously been written off in accordance with JMB's normal policy but which have been written back into the accounts and provided against for the purposes of the indemnity arrangements referred to on page 00.

The causes of the failure

JMB entered into several large exposures, each of them equivalent to over 10% of the bank's capital base, as part of its banking operations. The two largest commercial debtors which eventually precipitated the crisis had been customers of JMB for several years; both were loosely associated groups of companies run by businessmen from Pakistan. By June 1983 the sizes of the exposures to these debtors were equivalent to 26% and 17% of JMB's capital base respectively. They had grown to 51% and 25% of capital base by December 1983. They continued to grow rapidly during the first half of 1984, reaching some 76% and 39% of JMB's capital base, respectively, in June 1984. The differences between the actual exposures and the levels reported to the Bank are set out on page 00. The total loan book also grew very rapidly in 1984 increasing by over a third, in sterling terms, in the six months between end-March 1984 and the time of the rescue. (The larger part of this rise reflected an increase in JMB's lending but since much of this was in US dollars, the total was also affected by the downward movement in the sterling/US dollar exchange rate in this period.) Many of JMB's other debts have since proved to be bad or doubtful, including some other large exposures.

In 1984 problems began to arise with the two large exposures. JMB was faced with a familiar banker's dilemma of deciding whether to lend more to help the customer trade out of its problems or to refuse further credit and bring about the customer's failure. JMB chose the former course.

The roots of JMB's problems were, however, more deep-seated. The loan book had grown very rapidly since 1981 and it has become clear since JMB's acquisition by the Bank that the controls and systems were inadequate; that the organisation and management of the commercial banking and credit monitoring activities had serious shortcomings; and that insufficient attention had been given to the concentration of risks involved. Security was not required from borrowers when this might have been expected under normal banking practice; and even when security was required the steps necessary to

give the bank title to the security were not always taken properly. The need for provisions against bad and doubtful debts was not assessed with the proper degree of caution. The judgement of management in approving so many loans which have required substantial provisions was clearly defective. However, no evidence of fraud by the directors or staff of JMB has been discovered, except in one case dealt with before, and immaterial to, the collapse. Lending against bullion was not a factor in the loan losses. (Further references to the problems and shortcomings which the new, post-September 1984, management discovered in JMB will be found in the last section of this note.)

II The Bank's supervision of JMB

In 1981 and the first half of 1982 JMB's capital ratios were more than adequate and, even allowing for the nature of its business, left room on the Bank's normal criteria for an appreciable expansion of the balance sheet. The ratios weakened during late 1982 and the first half of 1983 before stabilising at the level which prevailed until the late summer of 1984. At that level they were still in line with those of many other banks.

Until the year ending on 31 March 1984, JMB's profit performance had been good and the Bank's knowledge of their bad debt experience, up to and including that year, gave no indication of any sizable problems. The annual accounts carried unqualified audit reports and included a note that 'Provision is made for all known doubtful debts'.

Particular attention was devoted at regular prudential interviews to discussing bullion trading, which was the dominant part of JMB's business. The Bank drew JMB's attention, in the course of 1983, to some concerns it had about the adequacy of its liquidity position. Management responded positively and the position was improved over the following months. Inadequate liquidity was not a serious problem at the time of the crisis. Also during 1983, there was a rapid increase in lending to JMB's commodity subsidiaries. The Bank took up with JMB's management the scale of the exposures, which suggested weak controls in the bank, and the exposures were substantially reduced after the Bank had made clear its concern about them. In the five months, October 1983 to February 1984, the Bank held three meetings with JMB's management at which the two concerns described in this paragraph were particularly discussed.

The Bank's identification of the problems building up in the commercial loan book was seriously hindered by misreporting of the large exposures (which were significantly understated in the returns), and by late reporting, particularly for the March 1984 quarter. Table 3 shows the exposures to the two largest borrowers as they have subsequently been discovered to be and as they were reported to the Bank from June 1983 to June 1984.

Table 3
Percentage of capital base

	Reported		Actual	
Customer:	A	B	A	B
1983				
June	15	12	26	17
September	18	—	45	21
December	27	18	51	25
1984				
March	42	30	65	34
June	38	34	76	39

In December 1983 these exposures, reported at 27% and 18% of capital, were not significantly out of line with the size of exposures carried by many other banks (though JMB's exposures were not to first-class names). One other large commercial exposure, which is now considered doubtful, was reported in the March 1984 return as equivalent to 14% of capital; this was about half the true exposure. A further doubtful exposure equivalent to 27% of capital was omitted altogether. The levels of the largest exposures at the end of March, even as reported, would have caused the Bank to request an early meeting with JMB's management. But the report for March, which was due in the middle of April, was not received until June in spite of JMB being pressed to provide it on several occasions.

After the March return was received, the Bank asked for a meeting with JMB in July; but this was delayed at the request of JMB's management and a

meeting was arranged early in August. This meeting was held on JMB's premises and lasted for most of the day. By the time of this meeting the end-June returns had also been received. Although the two exposures then stood at some 76% and 39% of capital respectively, the returns showed that the larger of the two exposures had been reduced from 42% to 38% of capital, while the smaller had increased from 30% to 34%. A new exposure equivalent to 17% of capital was reported for the first time. It was not until just before the August meeting that the Bank discovered that the new exposure was to a company related to the larger of the two other borrowers, bringing that exposure apparently to 55% of JMB's capital, still an understatement. It was following the August meeting, at which the Bank expressed serious concern about these loans that JMB requested its auditors to examine the loans in greater depth. As a result of this examination, the extent of the provisions required began to become clear to the management of JMB. The management then advised the Bank on 25 September that provisions were required against these loans which would substantially reduce the bank's net worth. The development of the rescue operation is covered in Section III.

Lessons for the future

The problems which arose at JMB give rise to a number of questions about ways in which the present system of supervision should be improved. Two features of the existing system of supervision, which were highlighted by the problems which arose at JMB, are the Bank's lack of any detailed analysis of the quality of the loans in a large part of a bank's loan book and the difficulties for the supervisors of assessing the quality and effectiveness of control procedures. The Bank relies heavily on a bank's external auditors to cover these subjects during the course of their work. The auditors need to satisfy themselves as to the basis on which the directors arrive at their valuation of a bank's assets if they are to give a clean audit report. They can also be expected to review the adequacy of a bank's controls and systems during the course of an audit and to make comments to management on any aspects they consider to be less than satisfactory.

Other features of the Bank's supervision are the practice of relying on the accuracy of banks' returns and the encouragement given to banks' managements to bring their concerns to the Bank at an early stage. The Bank's reliance on these features has, on the whole, been justified; but it proved not to have been justified in the case of JMB. One of the problems may have been that management and the parent company did not themselves realise the extent to which JMB was building up problems and subsequently did not appreciate their seriousness. In addition, reporting was inaccurate and misleading and at a critical point was late—and significantly later than the Bank stipulates. It appears that most of the misreporting was due to the deficient systems in JMB, a lack of understanding of the Bank's reporting requirements and lack of co-ordination between different departments, rather than to a deliberate attempt to mislead the Bank.

Some of the problems which arose in JMB in 1983 such as weak liquidity and excessive lending to the commodity subsidiaries, were addressed by the management but only after these shortcomings had been raised with JMB's management by the Bank. In late 1983, the attention accorded to the adequacy of the liquidity of the bullion business and the control systems associated with intra-group lending reflected the importance given to these factors by the Bank at that time. Both were features which, had they not been rectified, could have led to serious difficulties for the bank. In this connection, it should be emphasised that the critical problem which surfaced in September 1984 was in no way connected with the bullion business, which was generally well managed and profitable. The problems related exclusively to JMB's commercial lending business.

In the commercial lending part of the business, the problems of deficient systems, poor lending judgements and inadequate monitoring and control were not identified or pursued by the board or the

parent company of JMB. The information in the regular returns made to the Bank gave some clues to possible problems in these areas—for example, the rapid growth of the commercial loan book, the large exposures to less than first class names and the declining risk asset ratio. But, as has been seen, much of the information was seriously deficient and for the period between December 1983 and June 1984 not available. Had accurate end-March figures been received on time and the August meeting, at which the Bank's concerns about the loans were made clear to management, been held earlier, it should have been possible to prevent some of the late rapid growth of the loan book as a whole, and in particular of the major problem loans. This might have made it possible to contain the bank's difficulties. Even then, however, JMB's ultimate losses would have been very substantial.

The issues raised in this section about the system of supervision are covered in the Report of the Committee set up by the Chancellor of the Exchequer, to consider changes to the system. The Committee comprised the Governor (Chairman), the Deputy Governor, Mr W P Cooke (Associate Director with responsibility for banking supervision), Sir Peter Middleton (the Permanent Secretary to H M Treasury), Mr Frank Cassell (Deputy Secretary, H M Treasury) and Mr Deryk Vander Weyer (Deputy Chairman of British Telecommunications p.l.c., and a director of Barclays Bank p.l.c.).

The Committee was asked by the Chancellor to consider in particular: the relationship between auditors and supervisors; the handling of concentrations of risk and the assessment of the quality of assets; the notification and collection of statistics; the adequacy and deployment of staff resources and the experience and training of staff in the Banking Supervision Division of the Bank; and whether any changes were needed to the Banking Act.

III The rescue operation

The Bank was advised by JMB on Tuesday, 25 September 1984, after its auditors, Arthur Young, had examined the two largest loans, that the directors considered that substantial provisions were required against these loans to an extent which drastically reduced JMB's net worth but did not make it insolvent. At the Bank's urging, the auditors during the next two days carried out a review of a wider cross-section of the loan book. Meanwhile the Bank discussed with the clearing banks the provision of liquidity support for JMB to deal with any withdrawal of deposits when the need for large scale provisions was announced. The further work by the auditors identified the need for other provisions which effectively exhausted the capital of the JMB group. It was then evident that liquidity support for the bank would not be sufficient on its own and that if JMB could not be recapitalised, or its losses underwritten by a third party, it would have to cease trading. An investigation of the loan book was undertaken by a team from the clearing banks, which worked through the Thursday night, 27/28 September and identified the probable need for substantially greater provisions, although the amount could not be accurately assessed in the time available. Their findings were confirmed by a separate examination of the loan book by Price Waterhouse, commissioned by the Bank.

As soon as the need for large scale provisions against the two large loans was known, the Bank discussed with JMB and other parties the ways in which support could be provided. The parent company of JMB, Johnson Matthey p.l.c., was approached first. While acknowledging its responsibility to stand behind the bank, Johnson Matthey p.l.c. indicated that it would be unable to provide from its own resources all the support which would be required.

Certain possible purchasers of the bank, including a clearing bank, a major overseas bank and the members of the London gold market collectively, were approached. However, none of them felt able to commit themselves in the time available, given the considerable uncertainties over the level of the provisions required. Other solutions, such as the sale of the loan book and the introduction of new

minority, shareholders, were being explored simultaneously but had to be abandoned for the same reason.

The final potential purchaser withdrew during the late evening of Sunday, 30 September. The early stages of the negotiations for a rescue had been conducted with complete secrecy but questions had started to be raised in the domestic and international markets on Friday 28 September. By the Sunday night, news agency tapes were reporting that a London bullion house was in difficulties. It was clear to all those present in the Bank that night, including representatives of Johnson Matthey p.l.c., the clearing banks and the other members of the gold market, that without a solution being agreed, JMB would be unable to open for business on the Monday morning. If this was to be avoided, the only possible solution in the time available was for the Bank itself to take responsibility for providing the support required.

Once the decision to rescue JMB had been taken in principle, for the reasons described in the next section, the Bank sought the co-operation of Johnson Matthey p.l.c., of other members of the gold market and of major commercial banks in meeting the cost of the operation. The parent company agreed to sell JMB to the Bank for a nominal £1 and to inject £50 million into the bank before it was sold. This sum was judged by all concerned in the rescue operation to be the maximum that Johnson Matthey p.l.c. could contribute without seriously impairing its own creditworthiness. Undertakings to contribute support were secured from the banks and other members of the gold market. This support was later embodied in an agreement under which the Bank provided JMB with an indemnity of up to £150 million to meet losses in the commercial loan book, while the banks and the other members of the gold market agreed to counter-indemnify the Bank for half of any such losses. The counter-indemnitors have agreed to share any calls on them in the following proportions. The clearing banks have agreed to divide £35 million between them, the members of the gold market £3O million and the other Accepting Houses £10 million.

IV The reasons for the rescue operation

The Bank's fundamental reason for rescuing JMB was a deep concern for the systemic consequences if it was allowed to fail. The Bank, the commercial banks and the other members of the gold market involved on the night of 30 September 1984 were convinced that, had JMB not been rescued, there would have been unacceptable consequences for the banking system as a whole. This belief the Bank still holds.

At first sight, it might seem implausible that the failure of a relatively small bank like JMB, not widely known outside the bullion markets, could have such consequences. Certainly there should be no presumption that the failure of any bank would be thought to carry such risk for the system that it would be rescued. But, in the particular circumstances of JMB last September, several special factors were present which were judged to be conclusive. They are as follows.

JMB is a member of the London gold market. This is not simply a market in a sense analagous to, say, the copper market. It comprises a group of banks and members of banking groups, a substantial proportion of whose liabilities are in the form of deposits of gold, traditionally withdrawable at short notice. London is probably the most important international gold market and is involved in placing and taking gold deposits with a large number of institutions all over the world. The members of the market also do a substantial amount of business with each other. The failure of one of the five main participants would therefore have created a situation of extreme uncertainty.

The other members of the gold market would, because of their presumed exposure to JMB, have come under immediate suspicion and there would probably have been a very rapid withdrawal of liquid funds from all of them. The pressure that this would have been likely to put on the other four members could quite quickly have been translated, in the classical manner of confidence crises, to other banks, in Britain and, perhaps, because of the international nature of the market, to banks

abroad. The Bank believed, and still believes, that it would not have been possible to have convinced the markets in the first few days after the crisis that the problems did not derive from JMB's bullion business. Equally, no statements or promises of liquidity support could have been relied on to contain an ensuing loss of confidence in other members of the gold market and other banks. The possibility of allowing JMB to fail and seeking to contain the consequences of its failure was considered during the week of the rescue operation, but was rejected. This was partly for the reason just given and partly because providing the necessary liquidity in gold would have been beyond the Bank's own resources. It would have necessitated recourse either to the gold owned by the Government in the Exchange Equalisation Account or to a Government guarantee for the borrowing of gold from other sources. It was quite impractical, certainly in the time available, to have set up what would have been an open-ended and possibly very large commitment of this kind.

At the time the rescue occurred, confidence in financial markets generally was fragile in the wake of the continuing international debt problems and particularly of the crisis at Continental Illinois National Bank where, despite the action taken by the US authorities to rescue that bank, US banks suffered some loss of confidence for some time afterwards. The speed and magnitude of the problems that could have developed in the wake of the failure of JMB were demonstrated to the Bank in the early hours of Monday, 1 October. While the form of the rescue operation was still being discussed, and there had been no announcement made about the difficulties in JMB, it was reported from the Far East that some major foreign banks were refusing to deal with first-class British banks (including some not belonging to the gold market) with whom they had very long-standing connections. This strongly underlined the need for speedy and decisive action.

During the Continental Illinois crisis large amounts of money had moved from US banks into UK, other European and Japanese banks. The failure of JMB, because of its prominence as a member of the gold market, risked provoking a similar movement away from British banks. Much of the funds which moved out of the US banks remained in dollars, but sterling lacks the dollar's pre-eminent position and it was clearly a possibility that the move would have been out of sterling as well as out of British banks.

In addition to the foregoing general concerns, there were two other important, if subsidiary, factors which related to JMB itself. Although JMB is only one of the five members of the daily gold fixing, it is the only one which is part of a group which has refining capacity. This refinery constitutes for two reasons an important encouragement to overseas traders to use the London market. It possesses the facility to break down standard bars into smaller bars for which there is an increasing demand; and it has a capacity to refine gold in other forms into standard bars. This refining capacity was a major part of the Johnson Matthey group outside JMB. The failure of JMB would have virtually certainly brought down the whole of the group and could thereby have damaged the position of the gold market.

The second factor was a consideration of a rather different kind. As part of its bullion operations JMB received substantial deposits of gold from a number of foreign governments and central banks. Losses on these official deposits could have had particularly serious implications for the standing of and confidence in British banks generally.

V Developments since the Bank acquired JMB

Immediately following the acquisition of JMB by the Bank steps were taken to reorganise the board: Mr R D Galpin, an Executive Director of the Bank, was appointed Chairman and the resignations were accepted of six members of the previous board. Two of the former directors, Mr J J Shaw and Mr P J K Smith, were confirmed in their appointments and five new directors appointed. These were: Mr P Brenan as Finance Director, Mr G R A Copus and Mr M J Harper as Banking Directors, Mr P W Moss to oversee JMB's commodity subsidiaries and Mr L T G Preston who, with Mr

Smith, has responsibility for the bullion and markets area. Mr Shaw is also Chairman of JMB's insurance broking subsidiary.

Mr Brenan, a member of the Council of the Institute of Chartered Accountants, was at one time the Finance Director of Hambros Bank Ltd; Mr Copus was previously Senior Director of Standard Chartered Merchant Bank Ltd and Mr Harper a Managing Director of Charterhouse Japhet p.l.c. Mr Moss had been Finance Director of Czarnikow Ltd and Mr Preston a Director of Standard Chartered Bank and previously in charge of the foreign exchange operations of the Bank.

Price Waterhouse were appointed as investigating accountants to review and report on the financial condition of the JMB Group as at 30 September 1984. They were asked to cover all aspects of JMB's business. Their report has confirmed the belief held by the Bank when JMB was acquired that its problems were confined to its commercial lending activities.

An important task for the new board of JMB, in consultation with Price Waterhouse, has been to establish the level of provisions required by a review in detail of each of its loan facilities. The detailed review of the loan portfolio is largely complete. In the light of then current circumstances the level of provisions deemed appropriate by the new board of JMB as at 31 March 1985 was £245 million, of which only £20 million had been provided by the previous management.

Price Waterhouse have reported that the capital, reserves and bad debt provisions of the JMB group stood at some £130 million as at 30 September 1984 before the additional provisions required for loan losses had been made. This amount, together with the £50 million injected by Johnson Matthey p.l.c., has been absorbed in meeting these provisions; consequently approximately £180 million of the identified £245 million of provisions has been met from JMB's own resources. To meet the balance of the provisions against JMB's commercial loan book, together with a contribution towards funding costs, the Bank has provided JMB with an indemnity of up to a maximum of £150 million. The Bank's liability is offset by counter-indemnities of up to £75 million from a number of banks and members of the London gold market. The indemnity agreement, signed on 29 March, after lengthy and complex negotiations, provides for calls to be made as at 31 March, with subsequent adjustments, upwards or downwards, on a quarterly basis until 31 March 1986. The total amount for which the Bank and the counter-indemnitors are liable as at 31 March this year is likely to be of the order of £65 million. By 30 April the directors of JMB had identified the need to increase provisions by £3 million. This, and any subsequent adjustment, upwards or downwards, found necessary before the end of June, will be reflected in the indemnitors' liability to be calculated at that date. The Bank has thought it right, however, to provide in its own accounts for half of the adjustment identified at the end of April.

In its efforts to recover as much as possible of the expected losses, the board of JMB is intent to pursue all the legal and other remedies open to it.

An immediate step taken on acquisition was to halt the outward flow of lending where lending limits had been breached or were not properly established. Most of the authorities granted to individuals to commit JMB were temporarily withdrawn and an Executive Committee established, meeting on a daily basis, to control JMB's activities. Control of JMB's operations by the new management was thus quickly established, and as the new directors joined the board the process of appraising its activities was put in train. Immediate action was required in handling, with the help of merchant bank advisers appointed for this purpose, the two largest exposures which had precipitated the crisis. Shortly afterwards, in one case, suits were instituted in the US Courts by the debtor against JMB and the Bank, each for an amount of $300 million. Both actions lapsed on 24 May.

Much of JMB's lending had been in US dollars and

where provisions against such loans have had to be made, it has been necessary to purchase currency to cover these potential losses. Such cover has been effected using a deposit of £100 million placed with JMB by the Bank in November. This deposit has also enabled JMB to make two-way business in the money markets.

A comprehensive review of JMB's lending operations was started in early October. This revealed deficiencies in JMB's records, and it soon became clear that the work involved in reordering the loan portfolio and records was too large and too complicated to be undertaken under the direction of the new board by the existing staff. Accordingly, approaches were made to a number of clearing and other banks for secondees to assist in this process. There was an immediate and helpful response and within a matter of days seconded staff with the necessary skills and experience had arrived. There are currently some 35 such staff working in the banking area of JMB.

With their assistance, significant repayments and reductions in JMB's commitments totalling some £65 million have been achieved. Facilities and credit files are now in better order. A complete reorganisation of the trade finance and bill department has taken place with fundamental improvements being made in its systems, records and controls. In this area there has been a need to reconstruct over a period of some years the facts surrounding over 1,500 separate accounts.

The structure of JMB's banking department has been reorganised and a number of banking review teams established with particular responsibilities. Such teams are led by secondees who have brought to the task skills, such as experience in realisations and credit assessment, which have been essential in dealing with the complicated lending situations which have been discovered.

The operations of the banking division have been the subject of a review by outside consultants and a team of secondees selected for that purpose. The manner in which funds were allocated in support of the banking operations of JMB has also been subject to close examination, following which a number of necessary changes were made. Management below director level has been strengthened through the use of senior secondees from other banks or by direct recruitment of individuals with the requisite experience.

All these developments have increased the demand for space and in the interests of efficiency, considerable relocation of functions and staff has been necessary.

In addition to the Executive Committee already mentioned, which now meets weekly, a new Credit Committee has been formed; its responsibilities have been closely defined and the procedures which existed before have been reorganised and tightened. An Audit Committee of the board and an internal audit function have been established; neither existed before. Arthur Young agreed to resign as JMB's auditors and Price Waterhouse have been appointed in their place. Freshfields have been appointed JMB's legal advisers, Deloitte, Haskins and Sells its tax consultants and R Watson & Sons have been appointed actuaries to the new Pension Fund which has been established by transfer of the actuarially calculated proportion of Johnson Matthey p.l.c.'s Pension Fund. A Staff Committee of the board has also been set up. The former parent company provided a variety of management services, including payroll, security and insurance, to JMB. These have all been subject to review and have been taken over by JMB; and a security manager has been appointed.

Arrangements have been entered into with each member of staff for JMB to take over his or her contract of employment which had been with Johnson Matthey p.l.c.; and steps taken to inculcate within the banking area a more thorough understanding of banking procedures.

Under the direction of the Finance Director, new budgeting and financial reporting methods have been introduced; and management information improved. The implementation of a new computer

system has been put in hand with significant enhancements to remedy serious deficiencies and replace inadequate manual records. The Chief Accountant of JMB has been given a more active role in the executive of the Bank; his function had previously been more one of book-keeping than of monitoring and reporting on financial performance and risk. The working capital requirements of the JMB Group's overseas subsidiaries have been examined; some repatriation of funds has already taken place and more is in prospect. The boards of the subsidiary companies have been reconstructed and in the currently quiet conditions of the commodity futures markets, a reduction of some 40 staff in total has been made in JMB's broking subsidiaries in London and New York. The activities of two further subsidiaries, Johnson Matthey and Wallace Singapore Pte Ltd and Johnson Matthey Asset Management Inc., neither of which had been making profits, have been brought to a close.

Overall control of JMB's lending operations was found to be generally deficient both in its nature and extent. This was not true of the dealing areas where a review of the operating systems and procedures revealed no serious weaknesses—and none which could not be quickly addressed. Steps have been taken to ensure the continued smooth operation of the bullion business in international markets. Various visits to dealing counterparties abroad have been undertaken and JMB, which continues to participate in the London gold fixing, continues to trade profitably overall in the bullion markets and elsewhere outside the banking area.

The new board recognised that some of its decisions would involve additional overhead costs. However these have been kept to the minimum necessary and are in line with the new board's intention to correct the deficiencies in JMB's organisation and systems which existed at the time of acquisition; and to strengthen the control and supervision of its banking operations. The board is also working to retain and develop sound profitable business within the banking area. All steps being taken should facilitate JMB's return to the private sector.

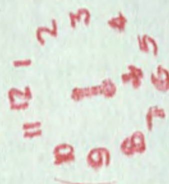
It is the Bank's intention to dispose of JMB at the earliest practicable opportunity. A number of institutions have already expressed interest in acquiring JMB and Barings Brothers & Co Ltd have been appointed by the Bank to advise on the strategy for disposal. With disposal in mind, and to provide JMB with a capital base appropriate to its level of business, the intention to reorganise the capital of JMB has recently been announced in a press release on 13 May. This will involve the cancellation of 59,999,900 issued and 15,000,000 unissued Ordinary Shares of £1 each and the subscription by the Bank of £75 million of fresh equity, of which £25 million will be in redeemable form, together with £25 million of subordinated loan stock with a final maturity date of 1995. The end of JMB's current accounting period has been postponed from 31 March to 30 June to enable the reconstruction to take effect prior to its accounting date. Following the reconstruction, the deposit made by the Bank last autumn, referred to on page 00, will be repaid.

The past six months have created considerable pressure on the staff of JMB who, to their credit, have responded well in difficult circumstances. The Bank is grateful to them and also to those financial institutions who joined in the indemnity arrangements; to the clearing and other banks who so readily seconded experienced staff to JMB to assist in the recovery process; to the secondees themselves; and to the new board.

Economic Policy:

Domestic Monetary Policy

Pt 13



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CONFIDENTIAL

ANNEX C

REVIEW OF BANKING SUPERVISION

In my statement on 17 December 1984, I told the House that the Johnson Matthey Bankers affair raised important issues about our present procedures of banking supervision, and the legislative framework within which it is conducted. I announced a full review, which would consider whether any early changes in present supervisory procedures were called for in the light of the problems which had arisen in Johnson Matthey Bankers, and whether there was a need to review or amend the Banking Act 1979. I placed the terms of reference of the Review Committee in the library of the House.

2. The Review Committee have now presented their report, which I have arranged to be published as a Command Paper and have laid before the House. I shall be considering the Committee's proposals carefully. In the meantime, I have accepted the report as a basis for immediate consultation with the banking associations and other interested parties. Some of the Committee's recommendations would require legislation. The Government propose to publish a White Paper later this year, with the intention of bringing a Banking Bill before the House at the earliest possible opportunity.

3. I am extremely grateful to the Governor of the Bank of England, who has chaired the Review Committee, and to its members, who comprised senior officials of the Bank of England and Treasury, and a distinguished commercial banker, Mr Derek Van der Weyer.

4. I have today also laid before the House, as required by Section 4 of the Banking Act 1979, the Governor's Annual Report under that Act. A note by the Bank of England on events leading to the failure of JMB and the subsequent rescue by the Bank and its conduct of JMB's affairs is annexed to the Annual Report.

5. The Bank's account makes it clear that serious shortcomings in the management of JMB led to its collapse - heavy concentration of exposures, lack of adequate control systems and over-rapid expansion of the loan book.

6. It also reveals lapses on the part of the auditors, Arthur Young McClelland Moores. I understand that the present board of JMB, which of course is a wholly-owned subsidiary of the Bank of England, have today announced their intention of initiating legal action against them.

7. The Bank's account also sets out their reasons for rescuing JMB. In mounting the rescue, I am satisfied that the Governor was acting properly within his discretion.

8. The Review Committee have made 34 specific recommendations. Their implementation will require action by the Bank of England, supervised institutions, their auditors and the Government. The Committee propose two fundamental changes in the present arrangements, and several important modifications. They have taken the view, which I share, that the JMB case exposes shortcomings in the present legislative framework and supervisory techniques employed by the Bank of England. I shall in my statement outline only the Committee's main proposals. A full summary of their recommendations is annexed to their report.

9. The Banking Act 1979 draws a distinction between recognised banks and licensed deposit-takers. JMB was, and still is, a recognised bank.

10. Most of the Act's provisions, and of the Bank's powers set out in it, relate to licensed deposit-takers. A dual system of supervision has resulted. Licensed deposit-takers have been subject to a more rigorous regime of supervision, whereas the supervisors have relied heavily on the integrity and co-operation of the management of recognised banks. With most banks, this confidence has not been misplaced. But the banking industry has expanded rapidly, and its activities have diversified. Recognised bank status - as we have seen with

JMB - cannot be regarded as a guarantee of prudence and responsibility.

11. The committee recommends that the two-tier system be abolished and that the powers given to the Bank under the Act should apply to all authorised institutions. I accept this recommendation. It follows that all institutions authorised under the Banking Act will be entitled to use banking names.

12. I also intend to tighten the criteria for authorisation.

13. The second fundamental change recommended by the Review Committee concerns the role of bank auditors. In this context, I am grateful to the Institutes of Chartered Accountants of England and Wales and of Scotland for the co-operation they have afforded the Committee.

14. The Committee recommend that there should in future be a regular dialogue between the supervisors and banks' auditors. I strongly endorse this proposal.

15. A bank's auditors are uniquely placed to monitor its control systems and assess its financial prudence. At present the accountancy profession considers itself prevented by a duty of confidentiality to the client from passing information to the supervisors. The supervisors are themselves inhibited by the Banking Act from communicating supervisory information to third parties without the institution's consent.

16. It is in precisely those cases where consent is not forthcoming that dialogue might be most necessary. This is why I accept the Committee's recommendation that the constraints on contact between auditors and supervisors be removed.

17. I emphasise, however, that it is the directors and senior managers of banks who are responsible for the conduct of their business. They have duties both to depositors and shareholders.

This responsibility cannot be side-stepped and shifted to auditors or supervisors. If there is one overriding lesson of the JMB collapse, it is that banks must have in place adequate management and control systems. I therefore strongly endorse the Committee's suggestion that banks ought to appoint an audit committee and a finance director where they do not already have one.

18. The Committee has also made important recommendations on the staffing and organisation of the Banking Supervision Division of the Bank of England.

19. JMB's senior managers were clearly gravely at fault. But the supervisors cannot escape blame for failing to pick up the danger signals.

20. This lapse must be seen in perspective. The Bank of England supervises over 600 institutions. It has carried out these duties conscientiously and with considerable success.

21. The Committee have recommended that the staff of the division would benefit from wider commercial experience; that the programme of secondments in both directions between the division and commercial banks should be expanded; that a significant cadre of experienced long-term banking supervisors must be built up; and that there should be more professionally qualified accountants in the division. They have suggested that more staff are needed. The Governor has accepted all the Committee's recommendations, and has begun to implement them. The manager directly responsible for supervising JMB has been moved to another part of the Bank, [and changes have been made in certain senior posts concerned with the banking supervision division.]

22. JMB's failure stemmed directly from a number of large, related exposures. The Committee recommend - and the Bank of England have accepted - that in future no exposure to a

borrower, or to closely related borrowers, should exceed 25 per cent of the lender's capital base, other than in the most exceptional circumstances.

23. Many of the Committee's recommendations do not need legislation. Some are already being implemented. Following further consultation, proposals for changes in the statutory framework will be set out in the White Paper to be published later this year.

24. I do not claim that these recommendations will prevent further bank failures. No system of supervision can guarantee that. It is the responsibility of the management of banks to conduct their business prudently. It would be wrong for the supervisory system to offer them so little scope that they could no longer take the commercial risks inherent in banking.

25. Important lessons have been learnt from JMB's collapse. The Review Committee's report provides the basis for a stronger supervisory system. I commend it to the House.

I think we need a stronger ending. One is almost left looking for the next collapse or collapses.

MT

Nick . Have you notified this to Private Office?

Mr Turnbull: To be aware. NP.

PROFESSOR WALTERS

CC Mr Ingham
Miss Caines

File

INTERVIEW WITH CHANNEL 4 TV

You have tentatively agreed to give an interview in America to Channel 4 TV News, subject to No 10 Press Office advice.

Nick Owen, the journalist concerned, had thought that you had severed all connection with the Prime Minister's Office when he asked you for an interview. He was prompted to ask you by your recent article in the [?] Economist, and says that he would like to film you giving voice to the views in the article, along the following lines:

- what your views were on the needs of the British economy when you were appointed advisor to the Prime Minister
- how your views have changed with experience
- what your views are now

He might also, if you agree, touch on other subjects (a potentially dangerous road!). You already know that Mr Ingham has agreed to your giving an interview - providing you are cautious.

Mr Owen will be in America for two weeks, filming various stories for Channel 4 News and will expect to use your interview as one of these stories.

I understand that his office in America has been in touch with your office there about an appointment early next week in Washington.

Nicolas Towers

Nicolas Towers
Press Office

7 June 1985

10 DOWNING STREET

THE PRIME MINISTER

5 June 1985

Alan,

I am very worried about M3, the Bill mountain, the rate of inflation and rising property prices. I have seen the Greenwell Bulletin, which I believe to be well founded, — and your note. Would you see Eddie George and tell him that the present monetary control arrangements are not working

according to the decision we made in 1987.

They must be put right and under strict control.

Shall I ask Leutwiler over? Will you also see him when you are in Zurich?

Margaret Thatcher

SECRET

File SUBJECT cc Master (SL3AGO) DBG 1.

10 DOWNING STREET

From the Private Secretary

6 June 1985

MONETARY POLICY

When the Chancellor and Sir Terry Burns came to see the Prime Minister yesterday, she expressed her concern about monetary policy. First, she felt that monetary conditions were too lax. £M3 was persistently above the top of the target range; inflation had ceased to decelerate and, even allowing for the distortions caused by mortgage interest rates, might now be accelerating; house prices were rising rapidly.

Secondly, she was concerned that the monetary arrangements introduced in 1981 were not working properly. £M3 was contained only by persistent over-funding, leading to the creation of the bill mountain. The Bank had originally intended to operate only at the short end of the money market, keeping the seven day rate within an undisclosed band. The band had become a point and the Bank operated all along the yield curve. It, rather than the market, was the dominant influence in setting the bill yield curve which was often inconsistent with rates in the inter-bank market, thereby setting up opportunities for arbitrage. The Bank stood ready to relieve cash shortages at a known interest rate without penalty. There was thus no restraint on bank lending. She believed this perpetuated many of the weaknesses which the studies in 1980-81 had sought to eradicate. Whatever view one took of current monetary conditions, these weaknesses of monetary control created the risk of higher inflation in the future.

Thirdly, she queried the wisdom of selling long-dated gilts. She had hoped that this policy had come to an end.

The Chancellor argued that the rapid growth of £M3 did not necessarily point to lax monetary conditions. Real interest rates were undoubtedly very high; the exchange rate had recovered substantially and narrow money was growing satisfactorily. The rise in inflation was more likely to have been due to monetary conditions in 1984 than to current conditions.

On monetary control, the Chancellor said he too regarded heavy reliance on over-funding and an ever-growing bill mountain as unsatisfactory. The problem of the bill mountain was not that it itself represented a threat to inflation, but that it made it impossible to operate the monetary arrangements in the manner originally envisaged. There were two requirements for breaking out of the present bind - a rise in short-term interest rates and a willingness to place less emphasis on £M3 and see it grow more rapidly for a time.

On funding, he said the Government had kept out of the long end of the market in the hope that companies would move in. This had not happened, with companies preferring shorter-term finance. With the present yield curve long-term gilts were not excessively expensive. The yields being demanded on indexed gilts were higher than had been expected.

Summing up the discussion the Prime Minister asked the Chancellor to discuss these issues with Sir Alan Walters and the Bank of England. A paper should be prepared analysing monetary conditions, the problems of monetary control and funding policy, and suggesting what further action might be taken. This would then be discussed with the Treasury and the Bank. I would be grateful if the paper or papers could reach me during the week beginning 17 June. The Prime Minister will also want to know the views of the Bank of England. Could you let me know whether this would be done in a joint paper or whether the Bank would prefer to submit a separate paper of their own.

AT says no need to chase 5/6

I am copying this letter to John Bartlett (Governor of the Bank of England's Office) and to Sir Alan Walters.

Andrew Turnbull

SMH

Mrs. Rachel Lomax,
H.M. Treasury.

Andrew – I must have a discussion with Nigel and if necessary also with Peter Middleton and Terry Burns. It looks as if we must have another Bank seminar. I had no idea we had let things go to such an extent. MT

4 June 1985

PRIME MINISTER

MONETARY CONTROL

1. I entirely agree with John Redwood's judgement that monetary policy is not too loose. The growth of the monetary base is well down in the target range, and is consistent with a long run inflation rate of circa 5%. With the high interest rates prevailing over the past year, it is likely that the growth rate of the monetary base will decline further, subject to the provisos below, and the longer run inflation rate from 1988 onwards may be pressed below the 5% level.

2. Although the general stance of monetary policy is broadly consistent with your objectives, the operations and procedures of monetary policy are quite different from those which we envisaged in 1981. In short, instead of a market-oriented monetary policy, we have a Bank-controlled and administered policy. (So far as I can see, much of this change has taken place over the last year or two.) This system of administerd interest rates with no penalty rates, together with the influence of the exchange rates, generates considerable instability and removes much of the self-regulating mechanism that, in 1981, we saw as the main desiderata of monetary control.

3. In 1981 we agreed that the Bank would control the 7 day rate within an unpublished band, and that intervention would be restricted to this short end. The term structure of all interest rates would then be determined by the market, and would reflect the expectations of future levels and term structures of rates. This would allow the market to absorb, more or less smoothly, external shocks and changes in government policy.

4. Quite soon the Bank had given up the idea of a flexible short (7 day) rate and the de facto band had shrunk to a point. The market managers at the Bank, rightly, pointed out that the intervention rate was well known and expectations constrained them to one point rate. Such a move did little damage to the substance of the system so, with little reluctance, we went along with this arrangement. More ominously, however, the Bank said it found it necessary to intervene in the higher bands up to and including the market in 3 month bills.

5. The main reason for such intervention in the 1 to 3 month market was the scale of the Bank's bill operations which were required in order to supply the market with sufficient liquidity to hold the level of the 7 day interest rate. Daily shortages of £500 million were common, and occasionally £1 billion or more was required.

6. One of the principal causes of these large liquidity requirements was the overfunding of the PSBR in order to control the growth rate of £M3. (You will recall that in 1982 we took the view that we should not overfund the PSBR, but somehow in 1984-5 this has been ignored.) In effect, the Government borrows long and lends short. In the process, we have raised a mountain of bill assets and a swamp of gilt liabilities. This would not matter very much, although it does look absurd, if it were not for the fact that the bill mountain matures and needs to be rolled over very frequently. Thus the Bank dominates the bill market in its roll-over and liquidity operations.

7. In its desire to promote what it regards as orderly markets, the Bank has arranged its intervention so that there is a downward sloping yield curve in the 7 day to 3 month bill market. The yield curve is controlled with this constant downward slope, as illustrated in Gordon Pepper's paper, whatever the conditions in competitive money markets.

But competitive markets, particularly the interbank, show very large deviations from the yield curve for bills. Thus by creating an administered (and constant) structure of interest rates on bills, the Bank has opened up massive opportunities for arbitrage. It is clear that many banks may find it profitable to borrow in the bill market and lend in the interbank market. It is remarkable that the interbank yield curve, which is recorded by Pepper after such arbitrage, is still so far from the bill yield curve. But this is a measure of the opportunities and the problem. The instability and the effects on £M3 must be very large. (Incidentally I have seen somewhat similar effects of structural monetization recently in Brazil - with the same regulated administrative structure of interest rates associated with a free interbank and overnight market. The effects there have been devastating.)

8. The first question to ask is whether the Bank, under broadly existing conditions, could not allow the market freely to settle the term structure, even though the Bank continued to carry out its massive liquidity operations. I would guess that it would be possible for the Bank to buy (and occasionally sell) a fixed menu of bill maturities, so that the market could determine the yield curve. Once it was clear that this was the Bank's policy, the market would adjust rapidly.

9. However this does not deal with the fundamental problem, which is not per se the growth of credit, as exemplified in £M3, but above all the potential for instant and unstable monetization. The real reason for controlling $M3 and bank credit is the fear that this will become 'spending or transactions money' and so add to inflationary pressure. The point is that many credit instruments are accepted by the Bank as eligible for rediscounting and getting instant access to Bank money. There is no penalty rate. Consequently, there is a potential for immediate and

costless monetization. (As we know, the banks hold virtually no non-mandatory balances at the Bank; they do not need to.) While this situation exists, we have to be concerned about the growth of £M3 - not because of its effect on inflation, but because of the potential for trouble in the future. But the real fault lies in the fact that the Bank operates a no-penalty liquidity machine.

10. I believe that it is time to:

a. Review the experience of monetary control from 1981 to the present.

b. Examine the funding record, and particularly the phenomena of overfunding and the recent issues of long conventionals (again, you will recall our 1981 policy precluded such stocks).

c. Consider introducing the next stage of MBC, namely a penalty rate on bank borrowing from the Bank.

d. Review the future of the bill mountain and the effect on policy.

11. It would be best to keep such a review firmly in the hands of people who are knowledgeable of, but not responsible for, the past 4 years. (A team such as Michael Scholar and Brian Griffiths might be appropriate, with perhaps someone like Petherbridge - lately of Union Discount, but now retired - as a sympathetic and wise City participant.) I would be happy to help if you thought it appropriate.

Linda Rust

pp ALAN WALTERS

SIR ALAN WALTERS

The Prime Minister would be grateful for your assessement of the state of monetary policy in Britain. She would be interested to know your views both on the tightness, or otherwise, of monetary policy, and on the difficulties of monetary control including the problem of the bill mountain. I attach copies of the recent Greenwell Bulletin and of a note by the Policy Unit. Could you prepare a short note, to reach me by close on Tuesday, for discussion when you see the Prime Minister on Wednesday.

AT

3 June, 1985.

PRIME MINISTER 30/5 30 May 1985

MONEY POLICY AND THE ECONOMY

Moving Targets

It is an increasingly common view in the City that we are witnessing the death of monetarism (Phillips & Drew, De Zoete & Bevan, Hoare Govett, etc). In March 1980, when the MTFS was launched, we were told strategy relied on one targeted monetary aggregate, Sterling M_3. Its growth would fall to 4-8% in 1983-84. It was not new: Denis Healey's Chancellorship had used Sterling M_3 targets to an increasing extent in his latter years.

In 1981, Sterling M_3 was downgraded a little, as we were told Sterling M_3 had not been a good indicator of monetary conditions. Some slight attention should also be paid to the exchange rate. In 1982, M_1 entered the list of targeted monetary aggregates, and we were told that narrow money was important, as well as wider money. The exchange rate gained a little more prominence. In 1984, M_0 was introduced, M_1 was dropped, and PSL2 had a short life as a monitored variable. In 1985, the exchange rate was seen to have greater priority.

Nigel's announcement that Sterling M_3 no longer has the same importance as it used to, is being taken in the City as evidence that he wishes to relax policy, as he is concerned about jobs and is doing a gentle pirouette. Alan Walters

would see it as the final, sensible transition to Monetary Base.

1982-5 - Is it at all like 1970-73?

De Zoete's point out in their analysis that, between 1970 and 1973, monetary growth rose sharply by 93.4% for Sterling M_3, and 77% for PSL2. M_1 stayed under reasonable control. This led to a subsequent major inflationary surge. Between 1982 and 1985, if we annualise the last 4 months' data to give a figure for 1985 as a whole (a slightly unfavourable way of doing the calculation, but not too important in the total) Sterling M_3 growth is 52.6%, and PSL2 66%; whilst M_0 is under control. They sound some warning notes.

However, there are still encouraging signs on the inflation front:

- there is no inflationary surge in commodity prices, unlike 1974-75;
- there is little sign yet of a major upward movement in pay settlements in the private sector, although drift in the public sector, coupled with considerable earnings growth in the private, is nudging pay upwards again;
- the feed through to inflation so far from the sharp decline in sterling last year has been relatively modest by past experience, and we now have had several

months of rising sterling which should begin to correct the worst of this effect.

Should we worry about the rate of monetary growth?

Against a more deflationary world background, and with an economy which is working much more efficiently than it did in the early 1970s, more of the monetary stimulus may go into output, and less into price inflation. With real interest rates of this level, and with sterling behaving much better, money policy is now tight, as the Chancellor will argue. Round-tripping must be prevalent, and helping to distort the wider money figures.

However, money policy has to be very tight to hit a 3% inflation target. There are things that can be done to strengthen the chances of monetary growth going into output and less into prices. This underlines the need for:

a. A strong competition policy in product and service markets.

b. Continued attempts to free the labour market, and to bring more of the unemployed into the labour market to lower the average cost of labour.

c. The need to run a money policy which hits the middle-of-target ranges, thus keeping sterling's value up.

d. The need to avoid self-inflicted political wounds which also raise the RPI by more than they should - eg water rates, gas prices, rents, etc.

e. The need to free more land to lower land prices, facilitating more house building, and to keep the costs of new housing down - we are already witnessing too rapid an increase in house prices for comfort.

Anyone for a U-Turn?

As commentators begin to argue that the policy - both monetary and fiscal - is somewhat laxer than they thought, there are more dangers of an allegation of a U-turn. I attach a copy of the cover of the latest Phillips & Drew Review, and a copy of De Zoete's recent accusation of a U-turn on some elements of public spending policy. Their view has fed on Nigel Lawson's statement in the Budget that there was no pre-ordained magic in any particular level of PSBR, and that in a future year he might consider a higher one.

The Political Cycle

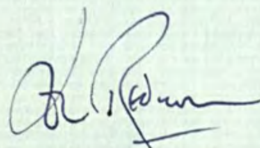
I also attach a copy of a chart which demonstrates that there is nothing unusual in the current profile of support for the Government. De Zoete plot the trend of public confidence in the Government compared with the average of the last 4 electoral cycles (in one of which the Government

went on to win the subsequent Election; in the others, the Government of the day lost, but by a narrow margin). This shows that support is declining as usual, but it would be comforting to see the decline in support bottoming out some time in the autumn or early winter.

Conclusion

You could discuss with Nigel how he sees the MTFS and the general economic strategy evolving. Is he confident that the rapid growth of broad money in the last 2½ years does not matter? Does he feel we have to retain monetary tightness for longer? When he comes to relax in order to stimulate output and jobs in time for the next Election, is his preferred mechanism to do it by monetary relaxation and lower interest rates, and therefore probably lower sterling; or through a continuation of tight money policy, and a raised budget deficit? Is he also aware of the presentational difficulties if the policy is seen to be a U-turn?

Our recommendation is still to concentrate on micro measures, to run a tight money policy for a bit longer, and not to give way on the PSBR next year.



JOHN REDWOOD

Phillips & Drew

MARKET REVIEW

MAY 1985

The death of monetarism

NO REFLATION WITHOUT REPRESENTATION

* A buoyant domestic economy with inflation rising is not the background to stimulate reflationary policies.

* But, as our analysis over previous pages has shown, growth could ease and inflation could remain high.

* Two policy actions therefore seem likely:

  - money policy will remain tight for longer than is still the commonly held view;

  - stimulatory fiscal measures will begin to form as a response to the many representations now being made, but they are unlikely to take effect until fiscal 1986/87.

Thatcher U-turn on export loans

The Prime Minister has privately ordered a tactical U-turn on the Government's policy on "soft" — low interest — loans to win export orders after Britain's failure to secure the Bosporus bridge contract in Turkey.

The Government's policy change is unlikely to be publicly announced but it will be hailed as an important shift in economic strategy by Tory MPs, including many wets seeking to reduce unemployment.

A leading member of Labour's shadow Treasury team said last night that such a U-turn would enable the Government to steal the opposition's clothes — soft loans will be a central plank in its policy for economic revival.

The policy switch has been made with the sanction of a few Cabinet ministers to allow more generous credit to be offered by British Leyland to the Thai government, which is seeking tenders for a contract for 4,000 buses for the Bangkok mass transit authority.

Ministers privately admitted last night that the policy switch was a direct reaction by Mrs Thatcher to the loss of the Bosporus bridge contract, won by the Japanese government by the alleged unfair use of heavy subsidies through soft

Brittan heckled by jail officers

At the end of the speech, during which he announced a crash programme to head off potential trouble in the prison system, there was muted applause and some slow hand clapping.

THE TIMES WEDNESDAY MAY 22 1985

Joseph puts surprise new offer to teachers

ECONOMIC RESEARCH

de Zoete & Bevan

25 Finsbury Circus London EC2M 7EE
Telephone: 01-588 4141
Telex: 888221 and 883179

de Zoete & Bevan (Far East)
81a New Henry House
10 Ice House Street Hong Kong

Weekly Economic Survey

Michael Hughes
David Bowers
Mark Brett
Beatrice Parrish

TOPIC 1060-1084 Daily Economic Bulletin
TOPIC 1085-1094 Exchange Rate Monitor

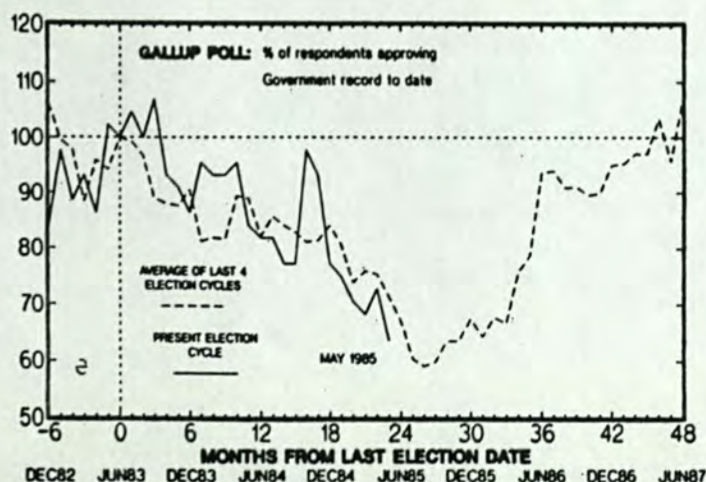
Issue 85/19 16th May 1985

Tories third in opinion poll

* The further deterioration in the Government's support shown by the latest Gallup Poll is not unusual for this stage of the election cycle. It will only become a real market concern if this deterioration continues into the Autumn. This is the stage when these polls traditionally improve in favour of the government ofthe day.

* It is therefore too early to contemplate a response by the Government to its critics. The time is right however to expect them to be rigorous in their control of inflation. Control over the monetary aggregates now is required if a falling consumer goods inflation trend is to be assured in a 1987 election year.

* UK monetary policy is not exceptionally tight at the moment. A continuation of recent monetary growth trends and it will have to be. Our own expectations for RPI growth beyond the next six months are rising. An inflation rate above 6% in 1986 seems to us to be an increasing probability.



Prime Minister (2)

Greenwell's are extremely critical of current system of monetary control but relatively relaxed about rapid growth of £M3. They see much of growth in interest bearing deposits as result of high real interest rates.

AT 27/5.

W. Greenwell & Co.

Bow Bells House, Bread Street, London EC4M 9EL
Telephone : 01-236 2040 Telex : 883006 GRNWLL G
Facsimile (Groups 3, 2 & 1) 01-248 0702

W. Greenwell Inc.
535 Madison Avenue, New York, N.Y. 10022
Telephone : 0101 212 702 5480 Telex : 429654
Facsimile (Groups 3, 2 & 1) 0101 212 702 5490

Monetary Bulletin

No 172 May 1985

Two recent events raise very serious doubts about the efficiency of the present system of monetary control. An efficient system would have prevented a rise in interest rates as sharp as the 4% in January. It would also have prevented the money supply from jumping by 3%, as happened to sterling M3 last month. The one event would certainly not have followed the other.

Monetary control post-August 1981

The mechanism of monetary control was last altered in August 1981, following the publication of the Green Paper on Monetary Control in March 1980 by the Treasury and the Bank of England and three subsequent papers by the Bank. The most important practical change was in the Bank's intervention in the money market. Instead of making regular loans to discount houses, the Bank was to concentrate on open-market operations in bills, which were divided into Bands 1, 2, 3 and 4, according to their length. Instead of "administering" the three month Treasury bill rate, the Bank explained that its operational aim would be to keep very short-term rates within an unpublished band. A clearly stated objective was to allow market factors a greater role in determining the structure of short-term interest rates.

On rereading the stated aims and objectives, it is quite remarkable how few have been achieved. Further, the distortions to the system have been massive, most obviously with the bill mountain and the distortions to the broader money and credit aggregates from arbitrage transactions.

Lender of first resort

In all the discussions which followed the 1980 Green Paper, the one point which the Bank appeared to acknowledge was that it had become far too much a lender of first resort rather than one of last resort - hence the change from loans to discount houses to open-market operations in bills. In practice, the Bank has remained a lender of first resort, supplying every bit of liquidity that the market has wanted.

This can most easily be demonstrated in conjunction with another of the authorities' stated objectives. In his budget speech of March 1981, the Chancellor said that the new system could permit a gradual evolution to monetary base control, the Bank having explained earlier that a necessary preliminary for this was for the authorities to be able to monitor banks' functional demand for balances with the Bank. The new mechanism was designed to do this.

The size of banks' demand for such balances was quickly apparent - it was virtually nil. Previously, the balances maintained by the London Clearing Banks had been mandatory. Under the new regime, the operational balances, maintained by banks as a whole, fell to the

R.H. Lawson, G.T. Pepper, The Lord Annaly, J.A. Rickards, L. Gooderham, T. Quinn, M.T. Higgins, D.G. Thomson, H.N. Seely, T.G. Wakeley, J.F.R. Hammond, J. Wigglesworth, E.J. Fenton, A.J. Bonner, N.S. King, G.P.P. Stewart, K.P. Joseph, A.G.P. Davidson, P.D. Jones, R.L. Thomas, K.C. Brown, J.C. Finch, S.J.D. Posford, R.W. Walker, W.E.A. Bain, R.M. Harvey, R.B. Pomphrett, M.R.F. Wonfor, A.L. Bucknall, M.S. Jaskel, P.B. Lilley M.P., A.J.E. O'Sullivan, G.R. Addison, K.M. Feeny, P.H. Beaufrère, K.A.J. Crawford, J.B. Lake, L. Maddy, R.J.M.L. Ottley, S.H. Wamsley, I.S. White, S.L. Greenwell

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minute level of 1/8% of eligible liabilities. In fact, the most important reason why banks now need balances with the Bank is merely to guard against errors in the Bank's daily predictions of surplus or shortage.

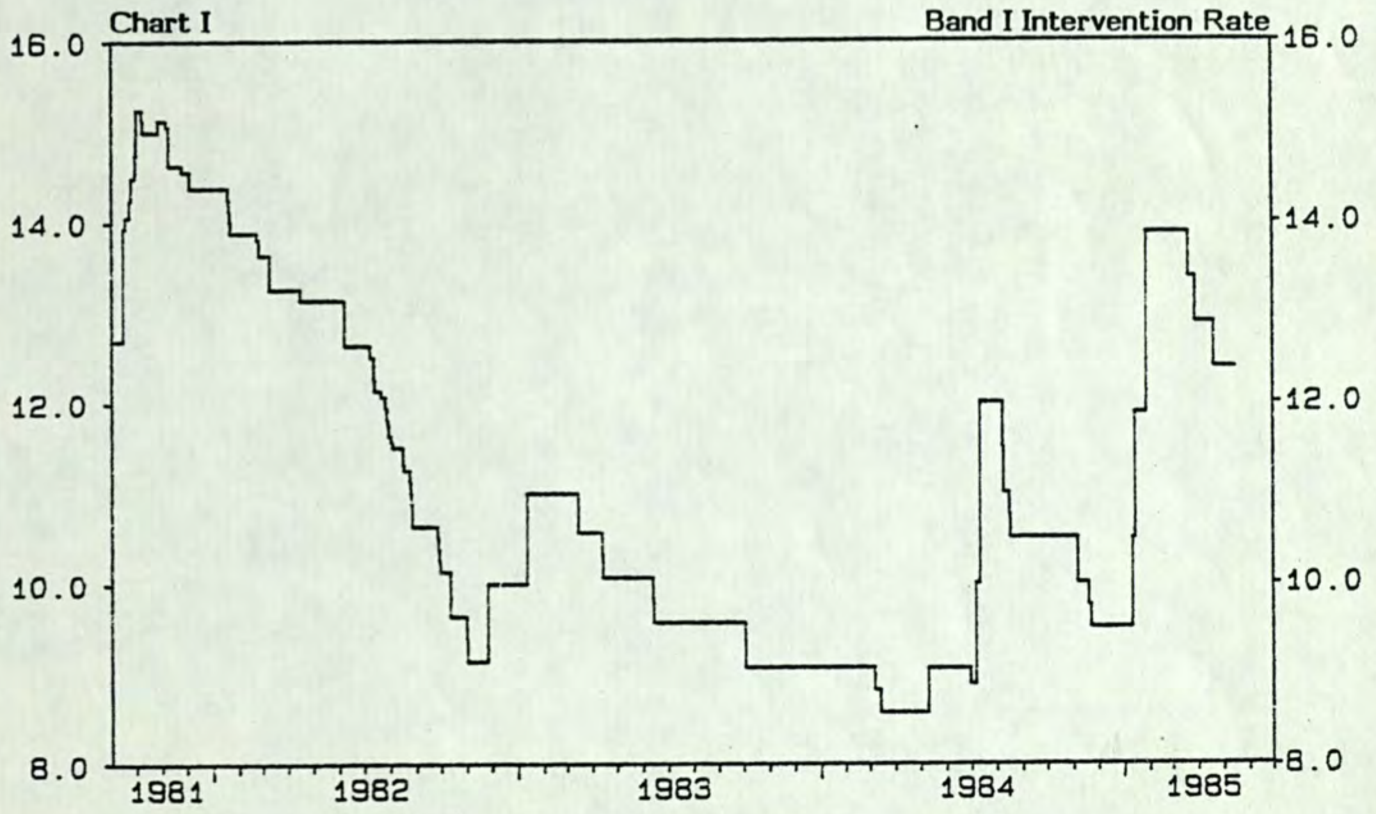
The reason why banks have so minimal a need for operational balances with the Bank is that "primary liquid assets" meet their requirement for reserves. This can readily be seen from the Bank's definition of primary liquid assets - they are assets "which are in all circumstances a ready source of cash, because the authorities stand ready either to purchase them or to accept them as collateral for last resort lending".

With such a definition of a primary liquid asset the Bank is, in effect, stating openly that it will continue to be an unlimited lender of first resort. This in turn means that the present mechanism of monetary control has no secure foundation.

Unpublished bands

As we reported above, the authorities intended to keep very short term rates within an unpublished band. There were two reasons for the unpublished band. First, fluctuations within a band allowed some role for market forces. Secondly, and more importantly, there was an attempt to avoid political resistance to upward changes in rates. It was felt that if changes in the bands were not announced, questions in the House of Commons and elsewhere were less likely.

Chart I, below, illustrates what has happened in practice. It shows the changes in the authorites' rate for Band 1 bills. It will be seen that the rate has not wobbled within a band but that instead there has been a single rate, and that it has been published! Market forces have had no role here.



Structure of interest rates

The outcome for the structure of short term interest rates has also been very different from the authorities' clearly stated intention. The structure of bill rates has been wholly administered. Further, since last July, there has been absolutely no attempt to permit a structure which reflects expectations in the market. As maturity lengthens from Band 1 to Band 4, the rate has always dropped by 1/8% at each step. The term structure was not altered when there were expectations of a rise in rates early in January. Nor was it altered after rates had subsequently risen by more than 4%, when there were expectations of a fall. Market forces have had no role here either.

There is a further point. If market expectations change and the authorities do not allow the term structure of rates to reflect the change, the system is unstable until the authorities concede the expected new level of rates. This argument, which can be proved mathematically, has been set out in previous Bulletins. If the authorities persist with the policy of not allowing the term structure to alter and of resisting a change in the level, as they have since last July, there are bound from time to time to be periods of turmoil in the market, as there was in January.

Exchange rates

The final point to make is that the new mechanism was designed to control the money supply. In practice, the main cause of alterations in interest rates, certainly as far as timing is concerned, has been the behaviour of sterling. It should be noted that the new mechanism is less efficient than the old in this respect. Under the old mechanism, the authorities concentrated on pegging the three month rate, which allowed for short and sharp rises in overnight rates to help squeeze bears of sterling. Under the new mechanism, very short rates are also pegged, and bear squeezes are more difficult to organise.

Excuse for failure

The most important excuse for failing to meet the stated objectives is the existence of the Bank's bill mountain. The huge volume of the consequent transactions in bills has meant that the Bank has dominated the whole spectrum of rates in the bill market.

Leaving aside the very important argument that the bill mountain is a by-product of the lack of secure foundations on which the present system of monetary control is built, inconsistencies between the administered term structure of bill rates and the term structure of interest rates in the inter-bank market have added greatly to the opportunity for arbitrage transactions.

Chart II, on page 4, illustrates the term structure of both sets of rates on four recent occasions. The solid lines show the rates at which the authorities have intervened in the bill market. The dashed lines show the rates in the inter-bank market. The differences in one graph relative to the other on the four occasions speak for themselves. Given the combination of this distortion and the bill mountain, it is no wonder that the broader aggregates are currently riddled with the effects of arbitrage transactions. It might be claimed that these are on a relatively small scale. Our reply is first that market participants gradually but powerfully become more aware of arbitrage possibilities and are likely to take increasing advantage of them. Secondly, everyone greatly underestimated the size of the distortions that had built up before the corset was scrapped in June 1980.

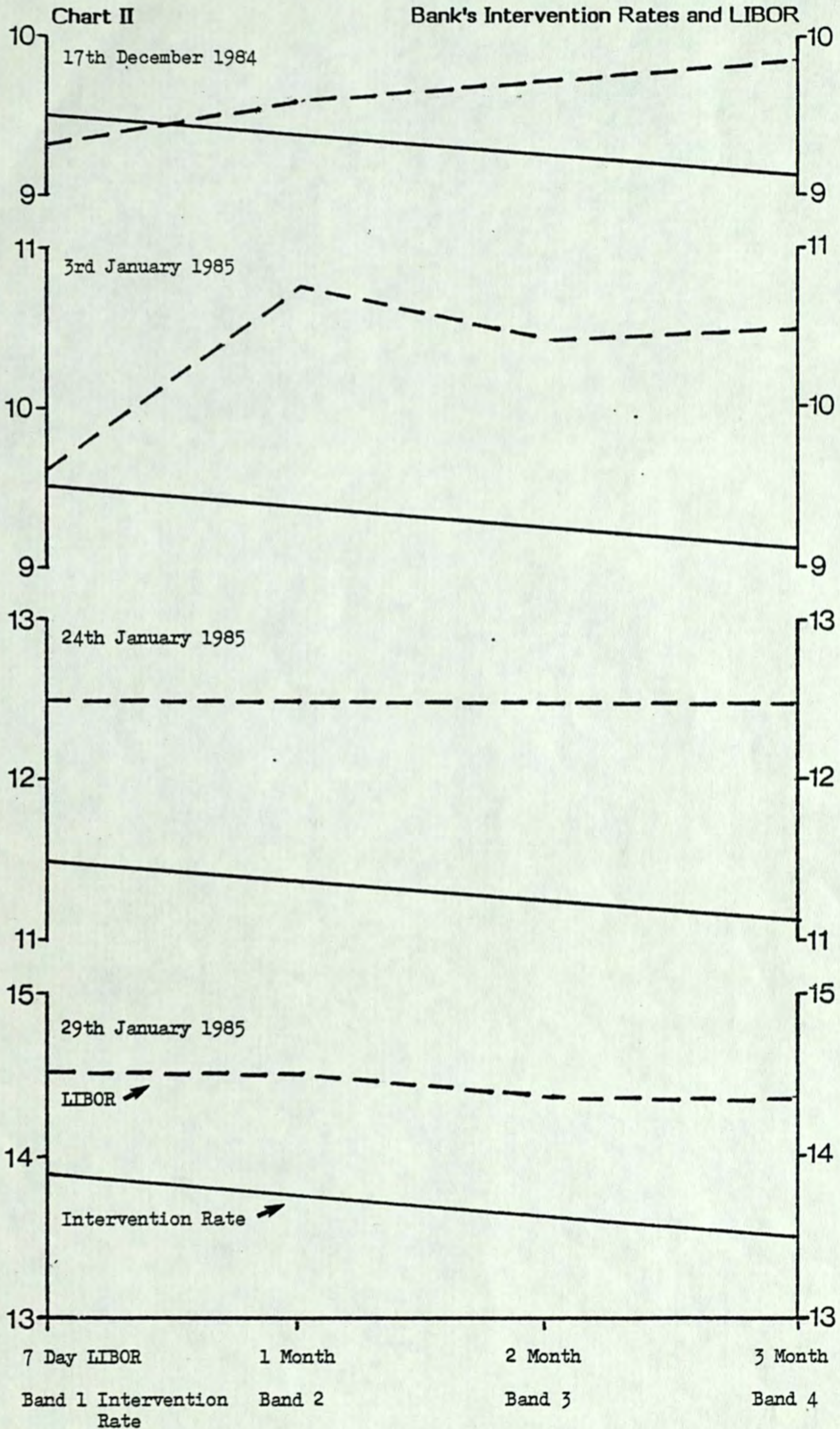


Chart II
Bank's Intervention Rates and LIBOR
17th December 1984
3rd January 1985
24th January 1985
29th January 1985
LIBOR
Intervention Rate
10
9
11
10
9
13
12
11
15
14
13
7 Day LIBOR
1 Month
2 Month
3 Month
Band 1 Intervention Rate
Band 2
Band 3
Band 4

Conclusion

It is quite clear that the mechanism of monetary control which was introduced in August 1981 has not operated in anything like the way which was intended. Does this matter? The question can be answered from the narrow technical point of view or from a wider general perspective.

The Bank's bill mountain is a technical factor which is obviously quite absurd. The Bank has been a massive investor in commercial bills and has financed its investment by huge issues of gilt-edged stock. These issues have been so large that they would have financed almost two years' PSBR. The Bank's need to roll over the daily maturity of bills has reached more than £1,000m on quite a few occasions. Transactions of this size are bound to have caused massive distortions to the market.

A second technical factor is the way in which the term structure of bill rates has been wholly administered and, at times, inconsistent with expectations of rate changes in the market. This has been the cause of large arbitrage transactions and an important reason for turmoil in the market when a change in expectations has persisted, as in January.

The arbitrage transactions have distorted the broader money and credit aggregates. They are contributing significantly to the buoyancy of sterling M3. Even after allowing for this, the broader aggregates are currently expanding rapidly. In our judgement, however, this is substantially due to genuine savers being attracted into interest-bearing deposits by the high level of return, both in real and nominal terms, and by the pattern of relative interest rates. We are therefore more relaxed about the expansion of sterling M3 than many other commentators and see no immediate danger of a significant acceleration of inflation.

There is nevertheless no doubt that liquidity is accumulating in the economy. At some time in the future, people could decide to spend it. The control mechanism to prevent this from happening in the aggregate is not in place. Under the current system, equilibria tend to be unstable rather than stable - like a ball-bearing balanced on top of a large ball rather than in the trough of a saucer.

The fact that sterling M3 is becoming less intelligible is one reason why the authorities are currently focussing more and more attention on Mo. Under the present system of monetary control, however, they have even less ability to control Mo than sterling M3. The Bank's insistence on continuing to be an unlimited lender of first resort means that there is no supply-side control of Mo. Although Mo can be controlled from the demand-side - a change in interest rates will in due course affect Mo - the route is very indirect and there is a long lag before the influence materialises. According to a paper by the Treasury (The Demand for Non-Interest Bearing Money in the United Kingdom, R B Johnston, February 1984) the lag is about a year! We are, therefore, drifting into a situation where there is no short run mechanism for controlling the aggregate to which the authorities are now turning.

What is the solution? Some people will answer that the above analysis confirms their worst fears about monetarism and that the whole thing should be scrapped. Our answer is that we have consistently warned about the progressive build up of undesirable side effects from the demand-side system of monetary control which the authorities adopted ten years ago. This system was not the one that was recommended by the original advocates of monetary control. It was a variation on neo-Keynesian themes.

The events of this year are a clear warning that all is not well with the techniques of monetary policy. The Government would be wise to think it through again.

Monetary Growth in the Month to Mid-April

The seasonally adjusted data for the four weeks to 17th April are shown in Table I.

Table I
Changes in the Month to April

	£m	pa
Mo	103	9%
Currency	17	2%
Retail M1	203	7%
M1	1,622	39%
Sterling M3	3,173	35%
PSL1	3,215	34%
PSL2	4,069	25%
Bank lending in sterling to private sector	2,627	26%

The sharp increase in the broader aggregates is very striking. The position over the longer term now becomes:-

Table II
Published Growth Rates

		3 months	6 months	1 year	14 months*
Narrow money:	Mo	5	5	6	5¾
	Currency	6	4	4	6
	Retail M1	2	3	4	6
	M1	22	15	15	17
	M2	n.a.	n.a.	9	n.a.
Broad money:	Sterling M3	19	15	12	12
	PSL1	19	15	12	12
	PSL2	18	17	16	16

* 1984/5 Target period

Overall our estimate for the underlying growth of the aggregates is given in Table III. The indications shown for the underlying growth of the three broad monetary aggregates are very tentative because of the uncertainty over the extent of the distortions in banking April.

Table III
Underlying Trends

		Six months Published p.a.	Trend %	1985/6 Target Range % p.a.	Notes
Narrow money:	Mo	5.2	5½	3-7	
	Currency	5.8	5½		
	Retail M1	3.2	6		1
	M1	14.9	9		2
	M2	9.2	9		3
Broad money:	Sterling M3	15.5	11?	5-9	4
	PSL1	14.8	11?		4
	PSL2	16.9	14?		5

Notes
1. Revised upwards because of a switch from current accounts to high interest cheque accounts.
2. Revised downwards not only because of roundtripping but also because of the newly available high interest cheque accounts and the greater use of overnight deposits by Other Financial Institutions.
3. The published rate is for the last year rather than the last six months, because the series is too new for seasonal adjustments to be calculated. The downward adjustment is for a reclassification of certain building society deposits as estimated by the Bank.
4. The downward adjustment is to allow for bill arbitraging and roundtripping and for the uncertain upward distortions to the figure for April.
5. The downward adjustment is to allow for bill arbitraging and roundtripping, changes in term shares of building societies and for the uncertain upward distortions to the figure for April.

There is clearly a great divide between those aggregates which do and those which do not include some form of interest bearing deposits. None of the three narrowest aggregates include any interest bearing deposits. They all continue to grow only modestly. Indeed, the provisional indications are that Mo may actually have fallen very slightly in the banking month to mid-May. Its three, six and twelve month growth rates look set to decline to 4% pa, 4% pa and 5½% respectively, as compared to the 5% mid-point of the target range. The lagged effect of the rise in interest rates in January may be starting to materialise.

Turning to the other side of the great divide, the introduction in recent months of new high interest cheque accounts by three clearing banks is probably the major factor behind the £1,419m rise in interest-bearing sight deposits in the month to mid-April. Anecdotal evidence suggests that most of the money in these new deposits came from seven day and other term deposits, ie from deposits not included in M1. Up to a quarter may have come from current accounts. This latter switch has no effect on M1, but reduces retail M1. The underlying trends shown in Table III allow for this.

The very large increase in sterling M3 in the latest month to mid-April, and the sustained rise in bank lending, inevitably raise the question of whether monetary growth has become excessive. In our judgement this is not the case. These Bulletins have frequently argued that the growth of sterling M3, PSL1 and PSL2 have been boosted in the last four years by both the changing shape of the yield curve and the high level of real interest rates.

Chart III, at the top of page 8, shows the difference between three month money rates and yields on twenty year gilt-edged stocks. Since 1979, three month interest rates have been much higher relative to gilt-edged yields than during most of the 1970s; this is consistent with a switch of funds back into money related assets and, therefore, into sterling M3 and the broader aggregates. Chart IV, at the bottom of page 8, shows three month money rates in real terms. They too have been consistently very high over the last four years.

An analysis of the holders of bank deposits, given in Table IV, indicates that it is the deposits held by Other Financial Institutions that have grown most rapidly. During 1984 they accounted for over 40% of the total increase.

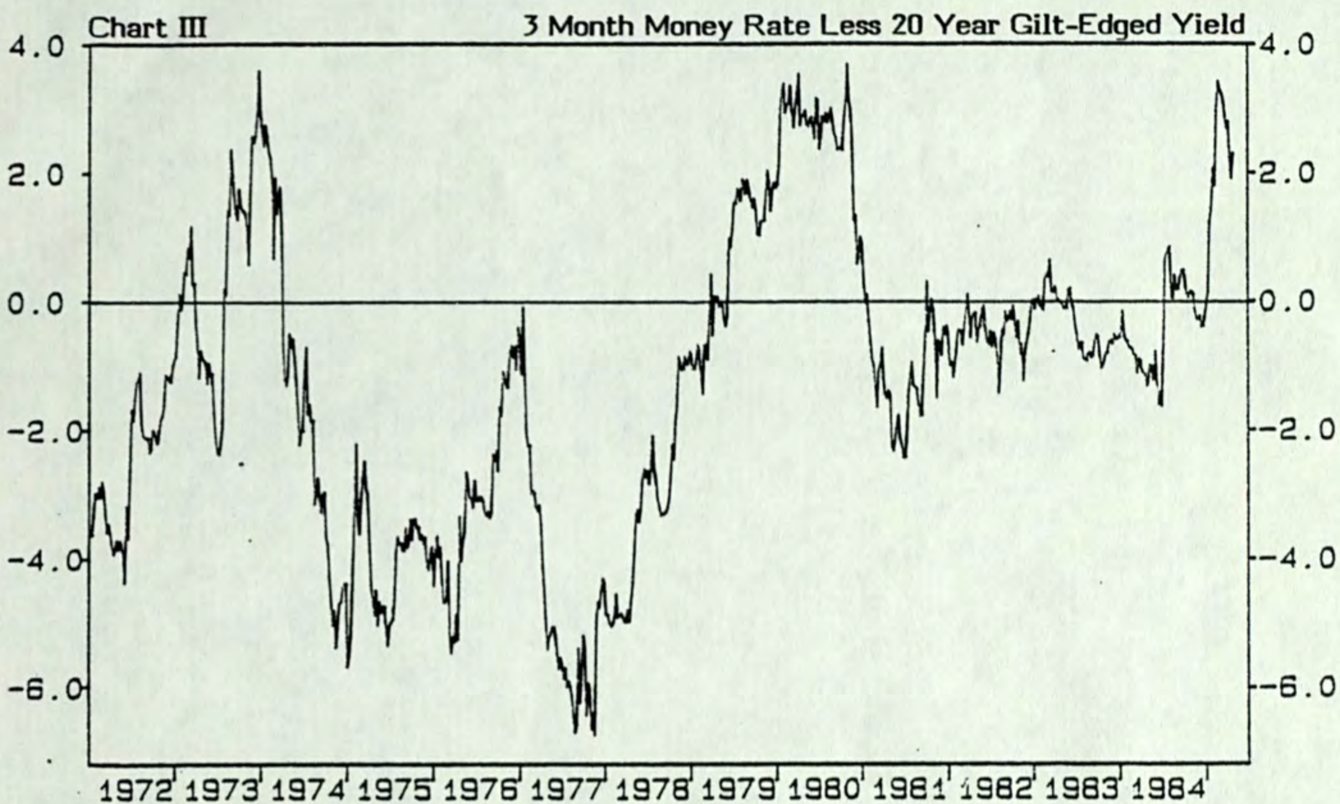


Chart III
3 Month Money Rate Less 20 Year Gilt-Edged Yield
4.0
2.0
0.0
-2.0
-4.0
-6.0
1972 1973 1974 1975 1976 1977 1978 1979 1980 1981 1982 1983 1984

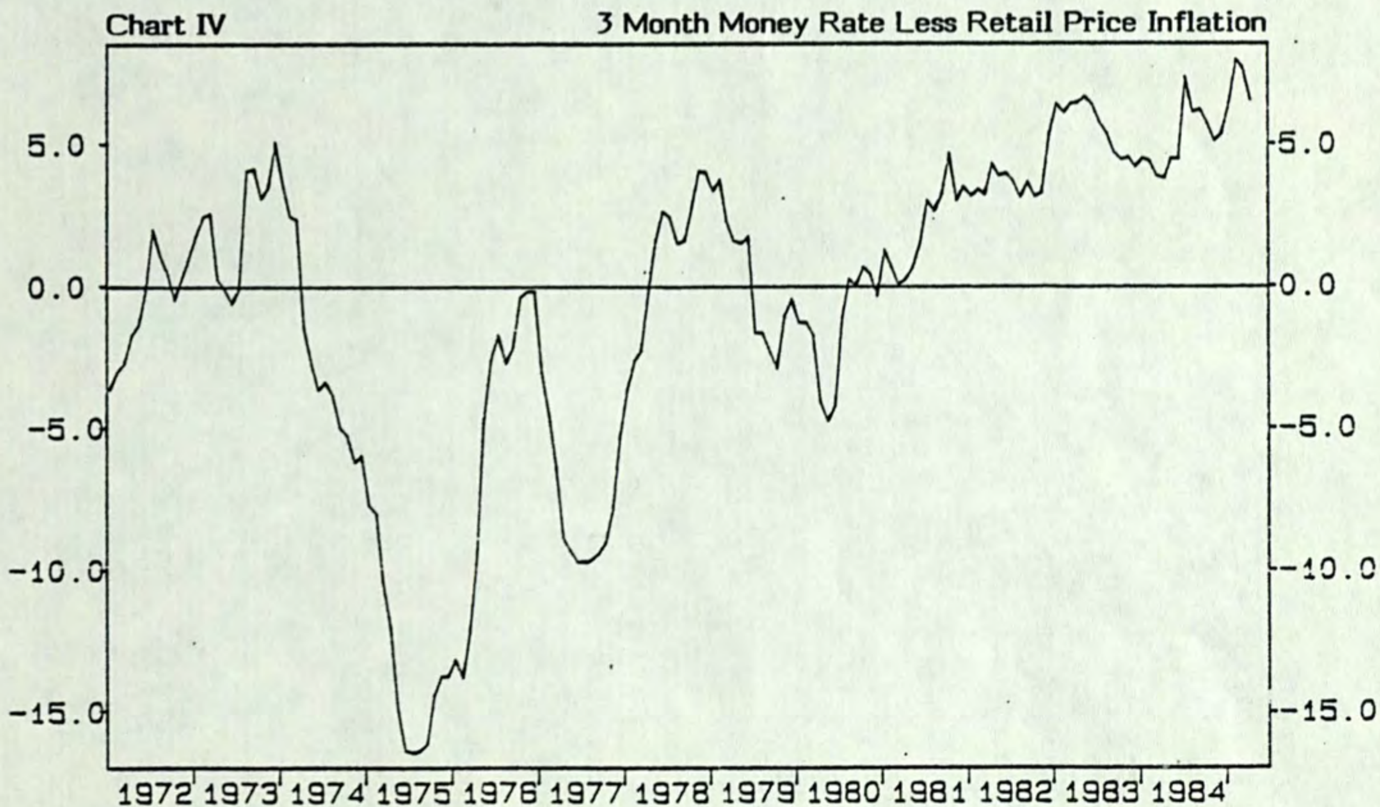


Chart IV
3 Month Money Rate Less Retail Price Inflation
5.0
0.0
-5.0
-10.0
-15.0
1972 1973 1974 1975 1976 1977 1978 1979 1980 1981 1982 1983 1984

Table IV
Components of Growth of Sterling M3

				Bank Deposits				
£m(%)	Sterling M3	Notes & Coin	Bank Deposits	OFI	Ind & Com Cos	Persons	Other Personal Sector*	Residual Error
1981	9296 (13.6)	585	8711	2107 (29)	2966 (22)	2222 (8)	1466 (17)	-50
1982	7522 (9.3)	462	7060	2920 (30)	501 (3)	2409 (7)	1236 (12)	-6
1983	9466 (10.6)	672	8794	2065 (18)	3580 (20)	2199 (6)	1036 (9)	-86
1984	9773 (10.2)	309	9464	4037 (27)	2839 (13)	1939 (5)	1144 (9)	-495

* Mainly unincorporated businesses

Deposits held by Other Financial Institutions are relatively sensitive to the interest rate differential between bank deposits and gilt-edged stock. They are also much less likely to be directly transferred into transaction balances than are other deposits. A nagging worry does remain, however, because of the authorities' current techniques of money market intervention, as explained earlier.

The extent of the distortions to sterling M3 and the other broader aggregates can also be analysed in terms of the counterparts. Bank lending was clearly distorted upwards by a surge of some £1bn in leasing finance ahead of the reduction in capital allowances at the beginning of April. Direct investment by business will also have been accelerated by the change in allowances, and is likely to have contributed at least a further £½bn to bank lending. Once most of the invoices are paid, which may not be for another month, bank lending should be sharply lower for some months.

The other main source of the rapid growth of sterling M3 came from the exceptionally unfavourable impact of the banking sector adjustments. These comprise banks' net foreign currency positions, together with their net sterling transactions with non-residents (whose deposits are excluded from the definition of sterling M3) and the increases in their capital from both issues and retained profits. Together, these elements increased sterling M3 by £940m in banking April, compared with an average reduction of almost £300m in the previous five months. In future months, the net impact of these adjustments should largely reverse. The data for banking May will be favourably affected by the proceeds from Barclay's £500m rights issue. Special factors will also favourably affect the data for banking June and July; will be a benefit from the proceeds received from the dollar perpetual floating rate notes issued recently by Lloyds, Midland, National Westminster and Standard & Chartered. Because of associated changes in the banks' net foreign currency positions, however, the net impact on sterling M3 from these dollar dominated issues, may be no more than a quarter of their total proceeds of $2,900m, say £500m.

GTP
RLT
RR

1. FERB
2. CF

Prime Minister (2)

To note
AT 30/5

H M Treasury
Parliament Street London SW1P 3AG
Switchboard 01-233 3000
Direct Dialling 01-233 3620

MS

Sir Peter Middleton KCB
Permanent Secretary

CONFIDENTIAL

F E R Butler Esq
Principal Private Secretary
10 Downing Street
LONDON
SW1

30 May 1985

Dear Robin,

JOHNSON MATTHEY BANKERS

The Chancellor, who is on leave, is intending to brief the Prime Minister fully on the JMB affair before he makes a statement to Parliament in the early part of June. But there is one matter about which I should warn you in advance. The Bank have come to the conclusion, following Counsel's advice, that they should sue for damages JMB's auditors at the time of its collapse. The auditors are Arthur Young.

It turns out however that the major firms of accountants take out indemnity insurance with Lloyds on an annual basis. The insurance year ends on 31 May. Given the possibility of a suit, the Bank have been advised that Arthur Young's cover may be renewed at a lower level from 1 June. The Bank have accordingly written to Arthur Young putting them on notice so that significant damages can be secured from the action. A final decision will be taken when the Governor returns from overseas next week. But this is virtually certain to confirm that the Bank go ahead with the suit; the Governor has already told the Chancellor, who agreed, that this was his intention.

It is not in anyone's interest to announce this initial step, but it might get out and I should be grateful if you would warn the Prime Minister. Otherwise the intention would be to announce the move at the same time as the Chancellor's statement to the House - along with the publication of the report of the Committee set up to consider the system of banking supervision in the light of JMB. The Governor is also producing a report on the reasons for the JMB collapse and the Bank's subsequent decision to purchase JMB for a nominal sum.

CONFIDENTIAL

I should perhaps add that Tony Wilson has considered the implications for Government departments. As the Crown is not involved the Bank's action clearly does not have the same consequences as the recent decision to sue Arthur Anderson. But we may need to issue some guidance when the decision becomes public.

Northern Ireland Office over De Lorean.

Yours ever,

Peter

P E MIDDLETON

30 MAY 1985

Ats Ai to NSto

H. M. TREASURY

Parliament Street, London SW1P 3AG, Press Office: 01-233 3415
Telex: 262405

29 May 1985

DISCLOSURE OF TAX DECISIONS AFFECTING GOVERNMENT SECURITIES

The Government is in a unique position in that it both has responsibility for the tax system and is a major issuer of securities. From time to time, tax changes are considered that could specifically affect the terms of issue (express or implied) of those securities.

It has always been understood that, for the orderly conduct of fiscal policy, it may on occasion not be possible to disclose decisions on such tax changes as soon as they have been taken, for example if the changes need to be announced together with other decisions in a Budget statement. However, in the course of preparation for this year's Budget, it emerged that there was an element of doubt as to the point at which a decision on the tax treatment of accrued interest on fixed interest securities should be disclosed. Accordingly, immediately after the Government had made its decision, the measure was announced by the Inland Revenue on 28 February, despite the close link between this measure and the proposals for reform of Capital Gains Tax announced later, in the Budget on 19 March.

Although the occasions when tax changes giving rise to such doubts are under consideration are likely to be infrequent, it is desirable to clarify the position for the future. The Government must be able to take its tax decisions in an orderly manner and announce them, with any related policy decisions, at an appropriate time. This means that on occasion some time may elapse between the point when a tax decision that may specifically affect the terms of issue of Government securities is taken and its eventual announcement.

For the avoidance of doubt, therefore, the Treasury wishes to make it clear that in the interest of the orderly conduct of fiscal policy, neither HM Government nor the Bank of England or their respective servants or agents undertake to disclose tax changes decided on but not yet announced, even where they may specifically affect the terms on which, or the conditions under which, Government securities are issued or sold by or on behalf of the Government or the Bank. No responsibility can therefore be accepted for any omission to make such disclosure and such omission shall neither render any transaction liable to be set aside nor give rise to any claim for compensation.

A reference to this statement will henceforth be included in the documentation upon which Government securities are issued or sold by or on behalf of the Government or the Bank.

PRESS OFFICE
H M TREASURY
PARLIAMENT STREET
LONDON SW1P 3AG

80/85

NOTES FOR EDITORS

Today's statement by the Treasury clarifies the position of the Government and the Bank of England in relation to Government securities issued or sold by them or on their behalf.

2. It makes clear that, as has always been understood, in the interest of the orderly conduct of fiscal policy some time may on occasion elapse between the point when a decision on tax that may specifically affect the terms of issue of Government securities is taken and its eventual announcement. As the statement explains, an element of doubt about the point at which the decision should be disclosed in the particular case of the recent measure to change the tax treatment of accrued interest on fixed interest securities led the Inland Revenue to bring forward the announcement of that measure, which would otherwise have formed part of the Chancellor's Budget statement.

3. The Treasury statement clarifies the position, and explains that a new paragraph will be included in future Government stock prospectuses and related documents.

4. The Chief Secretary to the Treasury told the House of Commons on 8 May that there had been suggestions that the CGT indexation provisions could be used by those seeking to establish a short term CGT loss on gilts and other debt instruments where counterbalancing gains did not normally arise. He said that if the Government were to conclude that any countervailing action were necessary it would be ready to introduce amendments to the Finance Bill at a later stage. Apart from this, the Government has at present no intention to introduce, nor has under consideration, any tax change affecting the terms of issue of any of its securities.

10 DOWNING STREET

Prime Minister (2)

Treasury are changing the way they present the monetary growth to prevent an erratic month early in the target period being annualised and distorting the picture.

AT

22/5

MT

- protection by the developed world harms developing countries; it worsens their debt problems by restricting their access to export markets, and it distorts their investment plans by creating uncertainty about future markets;
- one study estimates that rising protection in industrial countries would significantly reduce gross domestic product in both less developed countries and industrial countries.

Reasons for protection

The OECD report gives a number of reasons for the spread of protection. Major recession and increased international competition have raised the demand for protection from narrowly defined pressure groups. Import protection brings highly visible direct benefits to the protected groups, whereas the wider and less direct costs to the rest of the economy are much less visible. The multilateral system has become less able to prevent, or even regulate, protectionist measures.

Not cost-effective

The report concludes that import controls have not been cost-effective:

- they are fairly ineffective at transferring resources to the protected sector, and often the jobs saved do not go to the groups or regions it is intended to help;
- even when they are effective at aiding the protected sector, the industry may not make use of the opportunity to achieve necessary restructuring;
- some forms of protection are more cost-effective than others. Measures which are non-discretionary, transparent, and keep distortion of the price system to a minimum impose fewer costs, but a return to liberal trade is the best solution.

Silberston report

The report by Professor Silberston, *The Multi-fibre Arrangement and the UK economy**, is an independent study of the effects on the British economy of trade policies for textiles and clothing. It concentrates on the MFA, which is a set of bilateral agreements on trade in textiles and clothing negotiated between importing and exporting countries. Each agreement sets a ceiling on the volume of imports which the importing country is prepared to take from the exporting country. The MFA is excluded from the normal GATT rules. The first MFA was set up in 1973, although there were other arrangements before that restricting trade in textiles. The current MFA, the third, is due to expire in 1986. Negotiations will start shortly on a possible successor.

Treasury Working Paper

A new Treasury Working Paper has recently become available, *The Economic Effects of Lower Oil Prices* by Stephen Powell and Geoff Horton, with Annex by Keith Vernon, No. 34 (No. 76 in the *Government Economic Service Working Paper* series).

Drawing on the extensive literature already available, the first part of the paper shows how a sustained fall in oil prices might in theory be expected to affect the world economy generally and that of the UK, which is a net oil exporter, in particular.

The second part uses simulations on the Treasury's economic model to illustrate the possible effects on the world and UK economies of a sustained fall of 10 per cent in the world price of oil.

In the annex a number of studies of the relationship between changes in oil prices and in the sterling exchange rate are summarised.

Copies of Treasury Working Papers are available subject to a handling charge of 50p per copy, and cheques, money and postal orders for this amount (made payable to HM Treasury) should be sent with the order to Committee Section, HM Treasury, Parliament Street, London SW1P 3AG.

READERS' ENQUIRIES

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Editorial enquiries

Communications about the contents should be addressed to the Editor, *Economic Progress Report*, Information Division, HM Treasury, Parliament Street, London SW1P 3AG.

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Textiles and clothing

The report outlines the history of the MFA and charts the declining importance of the textile and clothing industries in the UK. Employment fell from nearly 1 million in 1972 to just over ½ million a decade later, although that still represented 9 per cent of total employment in manufacturing. A similar decline has occurred in all the major developed country groups, as developing countries have gained in importance. In 1980 developed countries as a whole still accounted for 65 per cent of world output in textiles and 75 per cent in clothing, but their employment shares were only 27 per cent and 39 per cent respectively.

The Silberston report

Conclusions

Abolition of the MFA would have the following effects on the UK after five years:

Textiles and clothing:	Landed import prices	5-10% lower
	UK producer prices	5% lower
	UK retail prices	5% lower
	Employment	10-50,000 lower
	Benefit to consumers (at 1982 prices)	£500 million
Whole economy:	Unemployment	37,000 lower

Quota rights

The direct effect of MFA barriers on imports to the UK is to raise prices paid by UK consumers and charged by UK producers of textiles and clothing. But import quotas, unlike tariffs, transfer much of the benefit from protection to overseas suppliers. This is known as the 'quota rent'. In Hong Kong quota rights are freely traded bet-

*HMSO, £4.80

ween companies. When import quotas are biting, these rights will trade at a premium; Silberston uses direct evidence on quota premia to estimate by how much the MFA raises import prices. He suggests that, in the absence of the MFA, landed import prices might fall by between 5 and 10 per cent, and retail prices of imports and domestically-produced textiles and clothing might be 5 per cent lower.

Job loss

Lower selling prices would obviously have a direct effect on UK producers of textiles and clothing. They would squeeze profits and reduce domestic output and employment. Silberston estimates that the job loss five years after abolition of the MFA could be in the range from 10,000 to 50,000.

Cost to consumers

But consumers would gain from lower textile and clothing prices. Abolition of the MFA would be worth an estimated £½ billion per year (at 1982 prices) to them. So the extra jobs in textiles and clothing protected by the MFA cost consumers at least £10,000 per job (at 1982 prices), and possibly as much as £50,000 per job, depending on the employment effect. Even the lower figure is about twice as much as the average textiles and clothing worker earns.

Exporting industries

Moreover, the effects of the MFA are not confined to the textiles and clothing industries. Silberston argues that exporting industries in particular would benefit from abolition of the MFA:

- because of higher imports, the UK's exchange rate would tend to depreciate and improve the UK's competitiveness;
- countries whose exports are currently restricted by the MFA would earn more foreign exchange and so be able to import more from us.

Unemployment

Silberston estimates that, on balance, unemployment in the economy as a whole would be 37,000 lower after five years if the MFA were abolished, and 61,000 lower after 10 years. These figures are obviously subject to a lot of uncertainties, but he concludes that 'on balance, employment generally would still be likely to benefit' from abolition of the MFA, 'or at the worst remain unchanged'.

Efficiency

Silberston discusses briefly the 'dynamic' effects of the MFA. He identifies conflicting forces. On the one hand, protection makes it easier for less efficient firms to survive. On the other hand, it allows greater economies of scale to be realised and, by increasing profits, encourages investment and innovation. He believes that some UK firms have used the opportunity afforded by the MFA to rationalise and invest, in anticipation of the ending of the MFA; so 'on balance the MFA has probably been a significant factor encouraging investment in textiles and clothing, and has therefore carried with it consequential benefits'.

Benefits and costs

Nevertheless, Silberston concludes that, 'taking all considerations into account, the benefits to the economy as a whole of relaxing the MFA would appear to outweigh the costs'. The report illustrates well the importance of taking into account not only the effects of protection on the industry directly affected but also the wider macroeconomic effects on consumers and on other industries.

The monetary aggregates

The Chancellor announced in the Budget the target ranges in 1985-86 for growth in broad money (£M3) and narrow money (M0). (See *Economic Progress Report,* March-April 1985 and box on page 9.) The range for broad money is 5-9 per cent and for narrow money 3-7 per cent.

It has been decided to make some technical changes in the precise definition of how these target ranges will apply in 1985-86, and the way in which progress during the year is presented. This note explains these changes, and the consequential alterations that will be made in the official presentation of the regular monetary statistics. The purpose of the changes is to reflect more accurately the way in which monetary policy is in practice operated.

Monetary targets

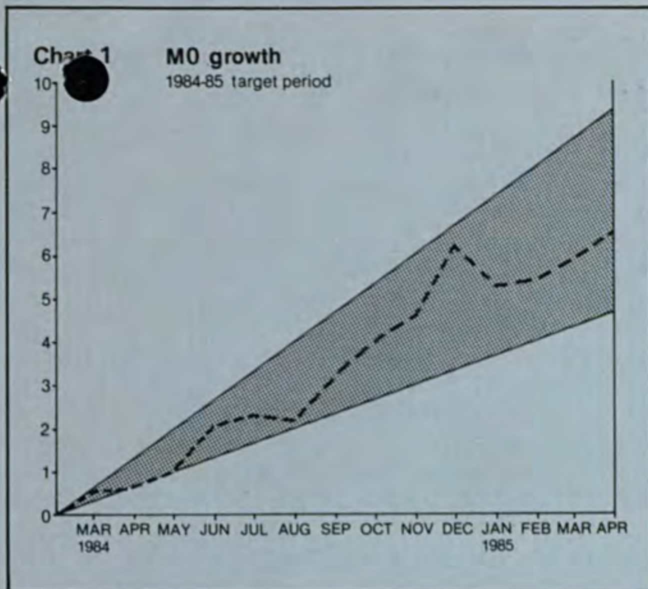
In recent years the target ranges for monetary growth have been defined as applying to growth expressed at an annual rate over a 14-month period, beginning in mid-February one year and ending in mid-April the next. The monetary statistics have therefore shown the annualised cumulative growth in the target aggregates since mid-February, which has been published alongside the 3, 6 and 12-month growth rates for the target aggregates. The 'cone' presentation of progress within the target period (see charts 1 and 2) has also come to be widely used.

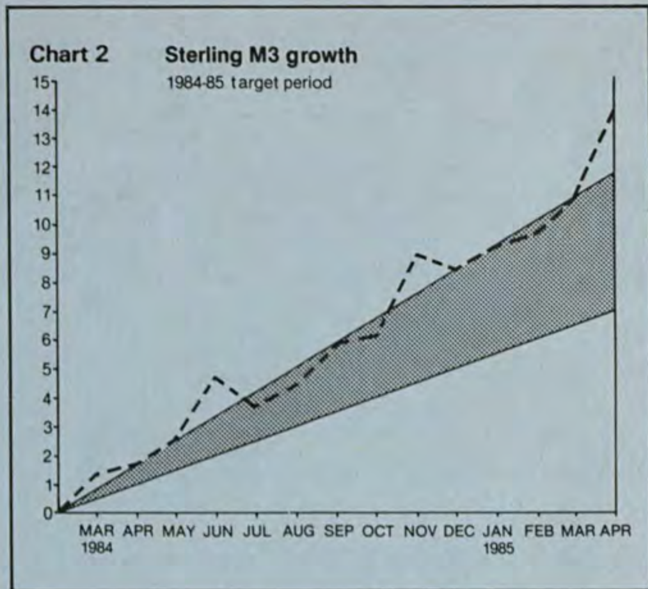
Measuring problems

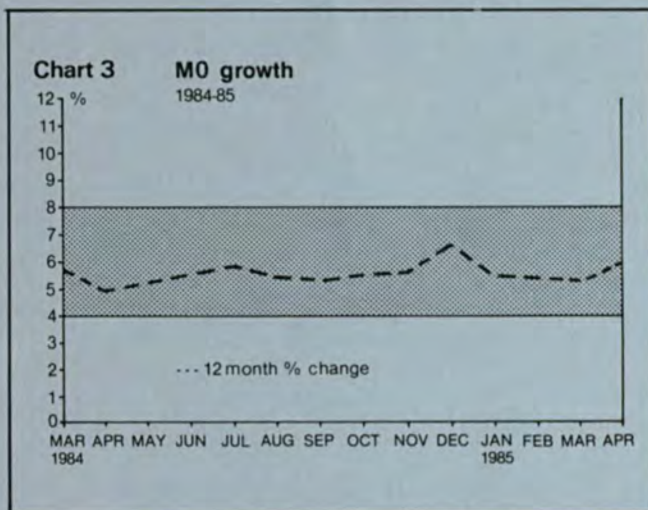
But this presentation has substantial disadvantages and can be misleading. It gives a different weight to different months' figures as the target period progresses. In the early months of the period erratic growth for a single month can have a disproportionate effect, whereas towards the end of the period each new month's figure has only a modest effect on the growth rate measured over the target period as a whole. Moreover, the Government are concerned to maintain satisfactory monetary growth throughout the year, not merely as measured between the beginning and end of the target period. The changes in the form and presentation of the targets described below are designed to represent this aim better.

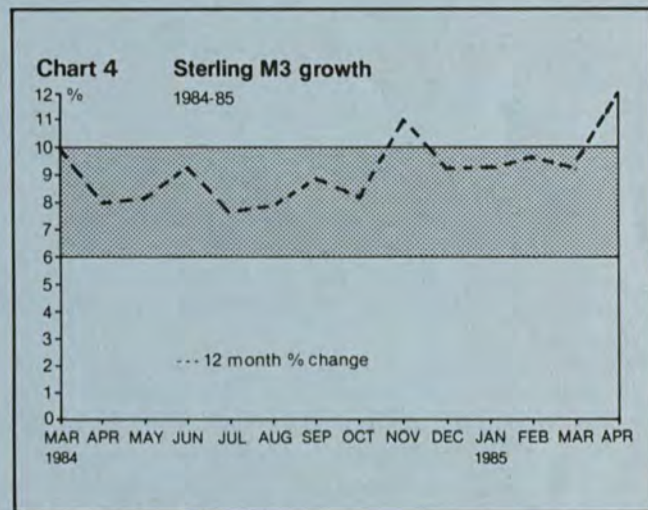
Twelve-month growth rate

A concept commonly used in presenting other economic statistics is the 12-month growth rate. This provides a measure in which, as the year progresses, one month is as important (no more, no less) as any other month.









For the reasons described, it has been decided that the target ranges will in future apply continuously to that 12-month growth rate, rather than to growth between the beginning and end of the target period. It will therefore no longer be necessary to specify either a 14-month target period or a particular base month. The ranges announced in the Budget for £M3 and M0 will apply throughout the 1985-86 financial year. Ranges for 1986-87 will be announced in next year's Budget. Charts 3 and 4 show how the ranges for 1984-85 would have operated had they been expressed in this form.

Other indicators

As explained in the Budget statement and *Financial Statement and Budget Report (FSBR)*, monetary conditions will continue to be interpreted in the light of other indicators, and significant changes in the exchange rate are also important in judging the acceptable rate of monetary growth.

Other measures

The authorities will also continue carefully to monitor other measures of the rate of growth of the target aggregates, bearing in mind some particular features of the 12-month growth rate. For example, the 12-month rate will be affected by an erratic pattern of growth a year earlier. It is clear, for example, that there will be distortions to the figures for both £M3 and M0 in the months falling a year after last autumn's British Telecom issue.

The authorities are, of course, well aware that growth expressed as a 12-month rate responds only slowly to changes in trend. For this reason it is clearly important to continue to monitor short-term growth rates, and the 3 and 6-month growth rates will continue to be published alongside the 12-month rate.

Changes to published figures

The changes described above mean that, in the Bank of England's monthly press releases, figures will no longer be shown for annualised growth rates from the beginning of the target period. The press release for the provisional figures will continue to show 3, 6 and 12-month growth rates, along with the growth rate for the latest month, and provisional estimates of the counterparts to £M3.

As explained in the *FSBR*, no special role is being assigned to M2 and PSL2 in 1985-86. The press release for the provisional figures will, therefore, no longer include figures for M2 and PSL2 and will be confined to M0 and £M3. Figures for M2 and PSL2 will continue to be published, along with a range of other aggregates, in the press release giving the full money supply figures later in the month.

Economic assessment

Based on figures published up to 14 May.

- **Exports of goods, excluding oil, in the first quarter of 1985 were 12 per cent up on the same period of 1984. Manufacturing production continues to rise.**
- **The UK employed labour force rose by some 342,000 between December 1983 and December 1984. Unemployment rose again in April; the increase in the underlying trend is probably in the range 10-15,000 a month.**
- **The PSBR outturn for 1984-85 was £10.1 billion, or 3 per cent of gross domestic product (GDP), close to the Budget estimate.**
- **In the first half of May the sterling index was 11 per cent above its all-time low in February. The rate against the dollar was 17 per cent up on its all-time low, also reached in February. Bank base rates — 14 per cent at the end of January — fell back in March and April, and in the first half of May were 12½ to 12¾ per cent.**
- **Retail price inflation was 6.1 per cent in the year to March 1985.**

Monetary aggregates

Table 1 shows growth in the aggregates for which there are targets, M0 and £M3, up to the end of the banking month of April, the last month of the 1984-85 target period. (The specification of the monetary targets in 1985-86, which is rather different, is explained in the article on page 4.) M0 ended the 1984-85 target period below the centre of its 4-8 per cent target range, with 12-monthly growth standing at 6 per cent. Though £M3 growth over the 14-month target period as a whole was some way above the 6-10 per cent range, the figure for April was clearly erratic. The 12-month growth rate to the end of the banking month of April was 12 per cent. Sterling lending was substantially affected by borrowing before the end of the tax year to take advantage of first-year capital allowances being higher than those available in 1985-86. There were some other erratic elements in the private sector influences on money supply, contributing to the high growth of £M3 in April.

Financial markets

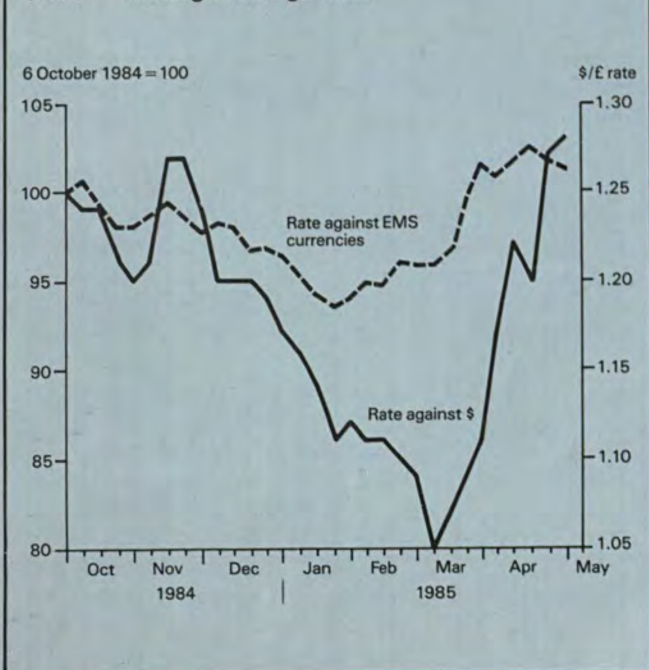
In the latter part of March, sterling became firmer against all major currencies, in a combination of dollar weakness, the end of the coal strike and favourable reaction to the Budget. Market interest rates eased as sterling strengthened, and bank base rates followed market rates down in a number of steps, from 14 per cent on Budget day to 12½ or 12¾ per cent by 19 April.

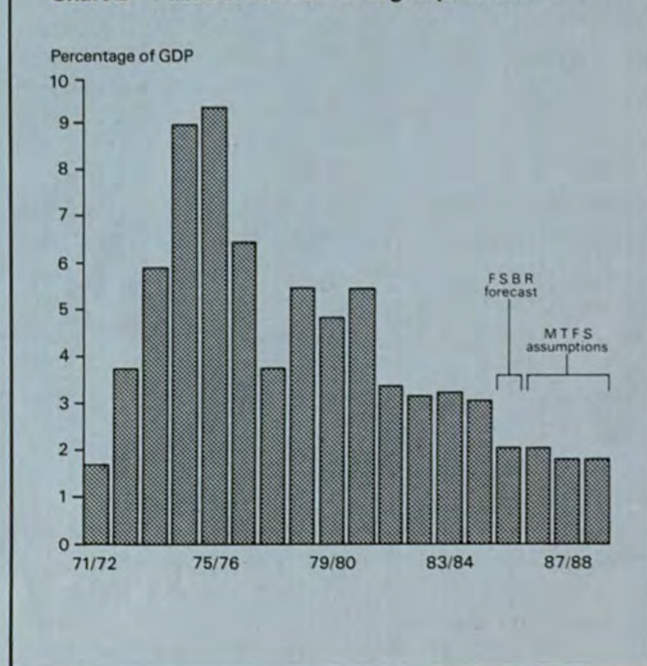
Table 1

Money supply growth

Annualised rates %

	Banking April	3 months	6 months	12 months	1984-85 target period (14 months)
M0	¾	5½	5¼	6	5¾
£M3	2¾ to 3	19	15½	12	12





W. Greenwell & Co.
Bow Bells House, Bread Street, London EC4M 9EL
Telephone : 01-236 2040 Telex : 883006 GRNWLL G

W. Greenwell Inc.
535 Madison Avenue, New York, N.Y. 10022
Telephone : 0101 212 702 5480 Telex : 429654
Facsimile (Groups 3, 2 & 1) 0101 212 702 5490

CURRENCY TRADED OPTIONS

An introductory note by Mariella Cassar

Currency traded options are becoming an essential risk management tool, as a consequence of the massive turnover in foreign exchange markets worldwide.

The first traded option on a currency in London is to be introduced by the London Stock Exchange on Thursday, 16th May, 1985. The contract will be in respect of Sterling/US Dollar.

This note provides a summary of the specifications of the contract and a guide to the mechanics of trading. Features of the contract which are peculiar to a currency option are highlighted.

The very important concept of volatility is discussed and is followed by an explanation of international interest rate differentials, which determine the discounts and premiums of forward currencies. An explanation of how to value the currency option, its "delta", "gamma" and "theta" is added before describing how the different potential users may need the facility provided.

15th May, 1985

R.H. Lawson
G.T. Pepper
The Lord Annaly
J.A. Rickards
L. Gooderham
T. Quinn
M.T. Higgins
D.G. Thomson
H.N. Seely
T.G. Wakeley
J.F.R. Hammond
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CONTENTS

INTRODUCTION TO CURRENCY OPTIONS 2

Definition 2

Call Option 2

Put Option 2

Action following acquisition of an Option 2

Exercising the Option 3

Payment of Premiums and Margin 3

Fungibility 3

Exercise Prices 4

Premium 5

THE PRICE OF AN OPTION 5

Intrinsic Value 6

Time Value 6

Time 7

Volatility 7

The Interest Rate Differential 8

Discounts and Premiums 8

Market Sentiment 9

HOW TO VALUE A CURRENCY OPTION 10

Delta 10

Gamma 10

Theta 10

HOW TO CHOOSE THE RIGHT OPTION 11

THE ROLE OF CURRENCY OPTIONS 12

WHO USES CURRENCY OPTIONS? 12

Speculators 12

Fund Managers 12

Corporate Treasurers 12

Banks 12

Arbitrageurs 12

APPENDIX: Details of Sterling/US Dollar Traded Option

INTRODUCTION

Definition

A currency traded option is the right to buy or sell a fixed quantity of one currency against delivery of a base currency at an agreed exchange rate.

The buyer of the option has the continuous right to exercise the option until the expiry date but has no obligation to do so. The buyer pays a premium to acquire this right.

The seller (writer) of the option has the continuous obligation to deliver or receive the option currency which will crystallise if the buyer exercises his right. The seller receives a premium in return for undertaking the risk attached to the obligation.

Notes

1. The fixed quantity of one contract is £12,500.
2. The option currency is sterling.
3. The base currency is US Dollars.
4. The agreed exchange rate is the Strike or Exercise Price.

Call Option

The buyer of one call option has the RIGHT to buy (£12,500) Sterling at the strike price and deliver (pay) the equivalent amount of US Dollars.

The seller (writer) has the OBLIGATION to sell (£12,500) Sterling at the strike price and receive the equivalent amount of US Dollars.

Put Option

The buyer of one put option has the RIGHT to sell (£12,500) Sterling at the strike price and receive the equivalent amount of US Dollars.

The seller (writer) has the OBLIGATION to buy (£12,500) Sterling at the strike price and deliver the equivalent amount of US Dollars.

Action Following Acquisition of an Option

Once an option has been purchased, the buyer has three alternatives:

a) let the option expire (note that the Stock Exchange do not provide for automatic exercise on the expiry date of In-The-Money options).

b) Sell the option at the current premium value.

c) Exercise the option.

Once an option has been sold, the seller (writer) also has three alternatives:

a) Let the option expire.
b) Close the position by buying back the option at the current premium value.
c) Should the buyer exercise, the seller will be required to fulfill his obligation. The seller has no control over this alternative and should he wish to avoid this occuring he must choose alternative (b).

Exercising the Option

Only a small percentage of option buyers exercise their right and the selection of writers for delivery is at random.

The buyer may choose to exercise the option at any time during the trading day up to 5.00 pm. On the expiry date (Friday before the third Wednesday of March. June, September and December) the time is extended to 6.00 pm. This is in line with American practice. An European option is only exercisable at expiry.

Delivery takes place on the third business day following submission of the Exercise Notice. This is to enable PHYSICAL currency to be delivered. SPOT currency is for delivery two days forward.

Payment of Premiums and Margin

Premiums are payable in full by the buyer of the option on the day following the transaction.

Margin is payable by the seller (writer) of the option. The requirement for clients is 10% of the face value of the contract in US$ plus or minus the in or out-of-the-money element. Clients holding spread positions are allowed an offset. Commercial rates of interest will be payable on collateral.

Fungibility

The London Stock Exchange Sterling Traded Option is identical to the Sterling Option traded on the Philadelphia Exchange. The two Exchanges are currently examining ways to improve their service to users through margin offset or even total fungibility (mutual offset) of the two contracts.

Exercise Prices

The exercise prices will be quoted in US Dollars and cents per one pound Sterling at 5 cent intervals.

The currency options in London take the US Dollar as the base currency. The method of quotation is the "Direct Method". That is the value of one unit of foreign currency is expressed as a multiple of the domestic (base) currency. This is equivalent to "American Terms" and has the advantage that one "tick" (minimum price fluctuation) has a constant US Dollar value. To convert "European Terms" into "American Terms" find the reciprocal.

Note that because historically the UK unlike the rest of Europe, has used the "Indirect Method" of quotation - that is 1 unit of domestic currency (Sterling) expressed as a multiple of the foreign currency - no adjustment is required to find "American Terms".

Example I
Conversion of European Terms into American Terms

European Terms			American Terms		
Foreign Currency		Local Currency	Foreign Currency		Local Currency
1 US $	=	DM 3.1250	1 DM	=	$ 0.3200
1 US $	=	SF 2.6325	1 SF	=	$ 0.3799
1 US $	=	YEN 251.50	1 YEN	=	$ 0.003976
			1 £	=	$ 1.2500

As the Exercise Price is quoted in US Dollars while the Sterling value of one unit of trading will remain constant at each Exercise Price (£12,500), the US Dollar equivalent will be variable.

Example II

Exercise Price Of Calls	Option Buyer Has The Right To Buy	and Deliver
$ 1.20	£ 12.500	US$ 15.000
$ 1.25	£ 12.500	US$ 15.625
$ 1.30	£ 12.500	US$ 16.250

At the start of trading there will be 5 strike prices for calls and 5 for puts. One close is the spot rate, 2 above and 2 below in each case. A new series will be introduced whenever the spot value of Sterling, as published regularly by LOCH on any day at the close of the currency options market, stands above or below the second highest or lowest Exercise Price hitherto available.

Premiums

Premiums will be quoted in US cents per Pound. The minimum price fluctuation will be 0.05c - "tick value" $ 6.25.

Example III
Premium Quotations

Spot Price on 14th May is $1.2690

Exercise Price	CALLS Jun	Sep	Dec	PUTS Jun	Sep	Dec
$ 1.15	*1200	*1310	r	035	230	r
$ 1.20	710	920	*1060	105	385	r
$ 1.25	410	645	805	290	r	825
$ 1.30	180	445	610	575	r	r
$ 1.35	70	300	450	r	r	r

r = Not traded

Cost to buy 1 Jun Call $ 1.25

£ 12,500 x $ 0.0410 = $ 512.50

Cost to buy 5 Sep Puts $ 1.20

5 x £ 12,500 x $ 0.0385 = $ 2,406.25

*Note that Topic displays can only display the last three digits so the fourth digit from the right will in practice be dropped. However, the omission should be obvious as large premiums requiring the extra digit occur on options deep in-the-money.

THE PRICE OF AN OPTION

The factors that determine the price of a currency option are:

1. The spot exchange rate.
2. The Exercise Price (Strike Price).
3. Time remaining until expiration of the option.
4. Volatility of the option currency (Sterling).
5. The interest rate differential between the option currency (Sterling) and the base currency (US Dollars).
6. Market sentiment.

The price of an option (the premium) may have INTRINSIC VALUE and/or TIME VALUE.

Intrinsic Value

The relationship between the first two factors, the Exercise Price and the SPOT Rate can be described by three phrases:

1. In-the-money (Spot above Exercise on Call option, Spot below Exercise on Put Option)
2. At-the-money (Spot is the same as the Exercise Price)
3. Out-of-the-money (Spot below Exercise on Call option, Spot above Exercise on Put option)

The intrinsic value is the difference between the Exercise Price and the Spot rate. A call premium has intrinsic value when the Spot rate is greater than the Exercise Price. Eg. A call option at $ 1.20 will have 5.25 cents of intrinsic value if the Spot rate is US $ 1.2525. A put premium has intrinsic value when the Spot rate is less than the Exercise Price. Eg. A put option at $ 1.30 will have 4.50 cents of intrinsic value if the Spot rate is $ 1.2650. Only In-the-money options have intrinsic value. At-the-money and Out-of-the-money options have only time value.

Time Value

The time value is the amount by which the option premium exceeds its intrinsic value.

Example IV

The Spot Rate is $ 1.2650

Series: June Calls

Exercise Price	Option Price	Intrinsic Value	Time Value	
$ 1.20	750	650	100	In-the-money
$ 1.25	430	150	280	In-the-money
$ 1.30	175	0	175	Out-of-the-money

The time value of an option decays over the life of the option. On the expiry date any premium value will be intrinsic value only. The rate of decay of an option is not linear. Decay is much more rapid in the last few weeks of its life. The rate of decay is related to the square root of the time remaining. Thus a 3-month option decays at twice the rate of a 9-month option, since the square root of 9 is 3.

The time value is determined by the last four factors - time, volatility, interest rate differential and market sentiment and also by whether the strike price is in, at, or out-of-the-money. The time value is greatest when an option is At-the-money.

Time

The number of days to expiry.

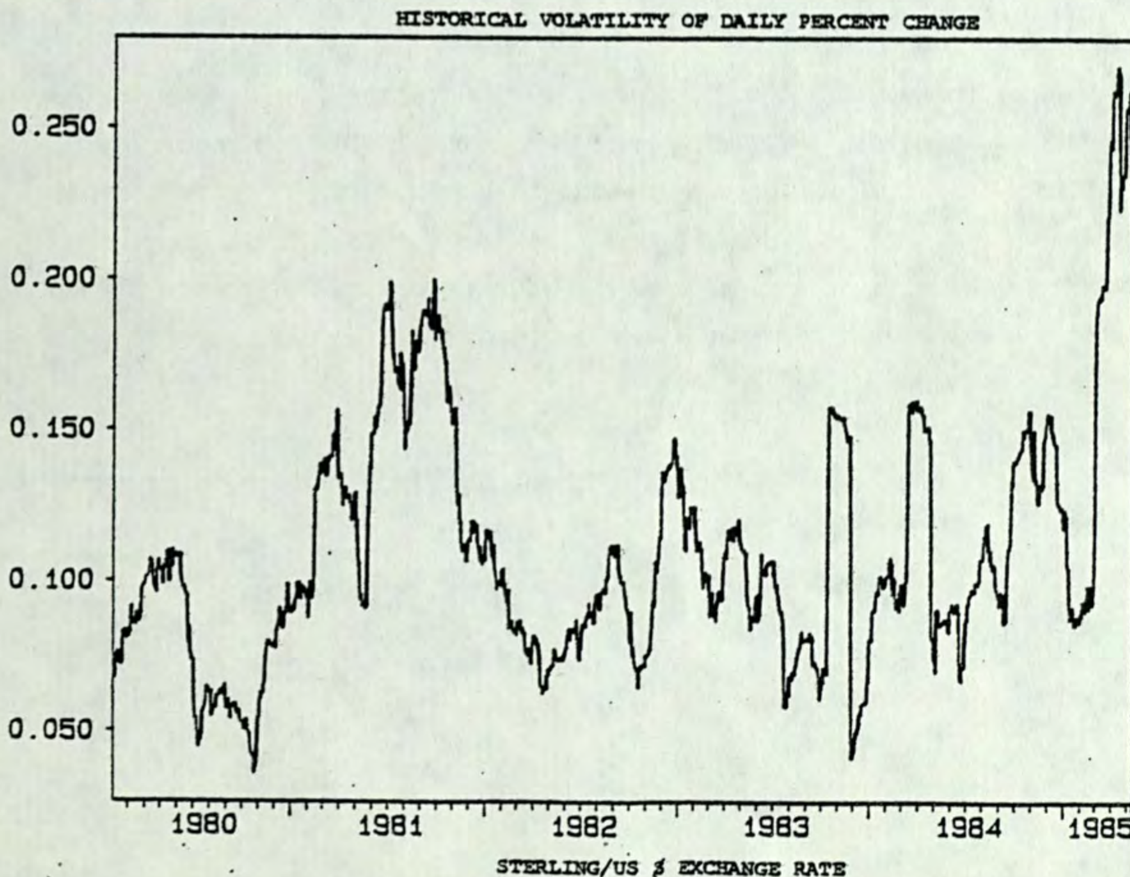
Volatility

Volatility measures price variability. The volatility figures used most frequently in currency option pricing models is the annualised standard deviation of daily percent changes in the exchange rate. The volatility is the most difficult element of the time value to estimate.

Historical volatility on Sterling Spot rates has varied between 1974 and 1984 from between under 5% to just under 20%. However, historical volatility is not a reliable guide to future volatility.

Another method for estimating future volatility is to use implied volatility. Implied volatility is the market's opinion of future volatility and this opinion is contained in the market price of an option. This may be found by using an 'A priori' model to value an option and inputting all the variables (factors 1-6 above) other than the volatility.

The graph below shows the historical volatility of Sterling since 1980. Note the increase in volatility since the beginning of the year.



The Interest Rate Differential

A special feature of a currency option is that the interest rate factor involves two interest rates and not one. The differential between the interest rate of both currencies over the time period of the option is multiplied by the SPOT Rate to obtain the FORWARD Rate applicable to the expiry date.

$$\text{FORWARD} = \text{SPOT} \times \frac{1 + \text{Interest Rate of base currency} \times T}{1 + \text{Interest Rate of option currency} \times T}$$

1. Interest Rate of base currency = Eurodollar rate.
2. Interest Rate of option currency = Eurosterling rate.
3. T = Number of days to expiry divided by 360 days (US$) or 365 days (£)

Example V
Calculating the Forward Rate

Sterling Spot rate = $ 1.20
Euro dollar rate = 10% pa
Euro sterling rate = 12% pa
Number of days = 90

$$F = 1.20 \times \frac{(1 + 0.10 \times \frac{90}{360})}{(1 + 0.12 \times \frac{90}{365})} = \frac{0.275}{0.280} = 0.9821$$

So that F = $ 1.1786

Discounts and Premiums

The currency which has the higher interest rate of the two is said to be at a discount. This is because it is cheaper to buy it forward than to buy it spot. The currency with the lower interest rate of the two is said to be at a premium. This is because it costs more to buy it forward than to buy it spot. The relationship between the spot and forward rates and the interest rate must be in equilibrium. If it were not, it would be possible to sell the low yielding currency in exchange for the high yielding one spot, buy it back forward and place the high yielding currency on a time deposit for the time period.

Banks quote the interest rate differential (the forward swap rate) independently to the spot rate. To find the Forward Rate - if the bid side of the swap rate is larger than the offer subtract the swap rate from the spot rate. If the bid side of the swap rate is lower than the offer, add the swap rate to spot rate.

Example VI
Calculating the Forward Rate

	£ Discount	£ Premium
Spot =	1.2010 - 20	1.2010 - 20
Swap =	45 - 40	40 - 50
Forward =	1.1965 - 80	1.2050 - 70

There are two important points to note with regard to the interest rate differential.

1. The difference between the spot price and the forward price will diminish as the exercise date approaches. On the exercise date the difference will be zero. If the option currency (sterling) is at a discount, this will cause the time value of a call option to decay more rapidly while the time value of a put option will decay more slowly. Naturally, the reverse is also true. We can therefore state that:

    a) When the forward rate is higher than the spot rate there is a positive bias on the call premium and a negative bias on the put premium
    b) When the forward rate is lower than the spot rate there is a negative bias on the call premium and a positive bias on the put premium
    c) The time value of the option premium will alter whenever the interest rate differential between the two currencies alters.

2. It is necessary to calculate the "theoretically correct" forward price in order to identify and exploit any price anomaly that may arise between the Forward Rate, the Future and the Option.

Market Sentiment

Market sentiment also affects the price of an option. When the market is bullish the increased demand for call options will raise the time value of premiums on calls. This is also necessary to offer a greater return to the writers of call options who may be more reluctant to accept the risk. The same is true of put option premiums when market sentiment is bearish.

This factor must not be confused with the volatility. The currency may in fact be relatively stable, but if market sentiment is very disposed one way or the other, the time value of the premium will rise all the same.

HOW TO VALUE A CURRENCY OPTION

Having discussed the factors that determine the price of an option the next step is to try to evaluate whether the price is a fair one. This may be done by using an option pricing model. The most widely used formula is the Black-Scholes Model. This is not the place to discuss the mathematical derivation of the formula nor its relative merits and drawbacks.

The main point is that many software packages are available which will derive the value of any one variable once the value of each of the other variables ins input. Most packages will also show a number of ratios which are very important to decide on the option most suited to one's requirements.

The ratios refer to change and the main ones are Delta, Gamma and Theta. Of these, Delta is the most important.

Delta

The Delta is the amount by which the option premium will increase or decrease if the stock price moves by 1 point.

It is also known as the Hedge Ratio as it indicates the number of options, relative to the underlying asset, required to fully hedge the asset against movements in the price.

Delta has a value from 0 to 1. Generally speaking, a deep in-the-money option will have a delta of 1. An at the money option will have a delta of 0.5 and a deep out-of-the-money option a delta close to 0.

As the deltas implied by the model are not accurate except for very small exchange rate movements, it is difficult to achieve a good hedge performance in volatile FX markets, as frequent hedge rebalancing may be required.

Gamma

This is the ratio by which 'Delta' changes when the price moves by one point.

Theta

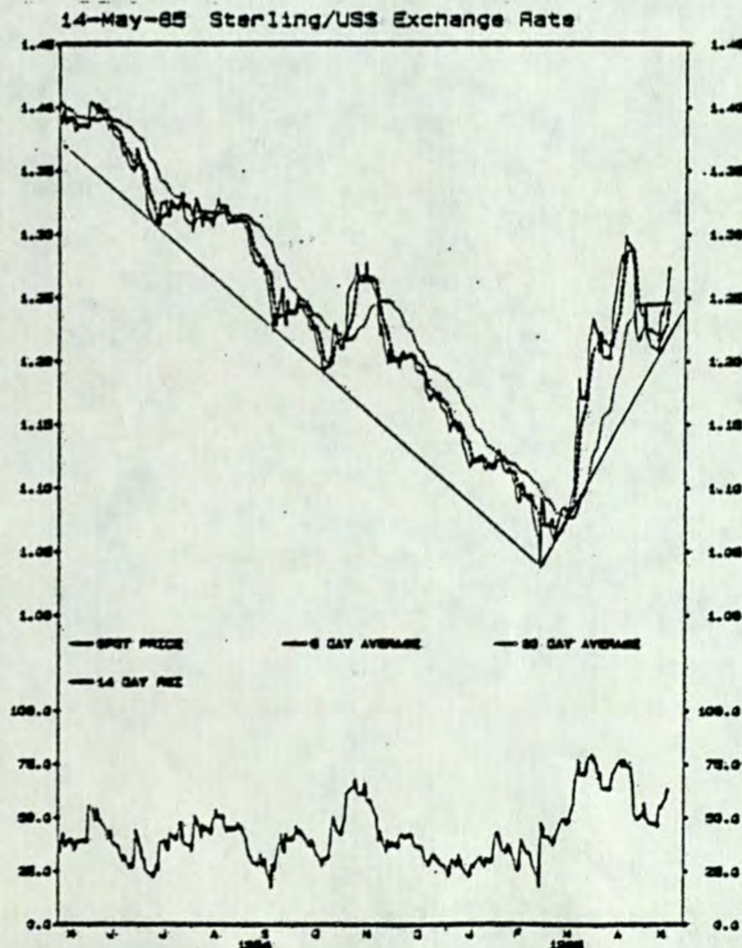
This shows the change in the value of the option premium if the price remains constant over a period of time.

HOW TO CHOOSE THE RIGHT OPTION

The option a trader chooses initially depends on his risk profile, whether he wishes to assume risk or whether he wishes to lay-off risk attached to a pre-existing position. To state the obvious, the single most important factor to profit from trading currency options is the ability to forecast accurately the future level of the underlying exchange rate. The second, is the manner in which the trader anticipates that level will be reached. This second consideration has been briefly discussed under the heading 'Volatility'.

Forecasting an exchange rate is fraught with difficulty. The two main methods are fundamental analysis, based on the study of the economies of the two countries whose currencies are being traded and technical analysis based on the study of historic price data.

Both methods are used by professional traders. However, for short term movements technical analysis tends to dominate. It is important to determine levels of "support" and "resistance" in the exchange rate and to estimate when the current trend is losing momentum. The chart below shows the price movement of Sterling/US Dollar over the past year together with 5 and 20 day moving averages, trend lines, and the Relative Strength Index (a momentum indicator), at the bottom.



THE ROLE OF CURRENCY OPTIONS

The Foreign Exchange Market has the highest daily turnover of any market. An average of over 200 billion dollars are traded spot or forward daily. The major currencies are traded continuously around the world. As currencies are becoming more volatile they represent a greater measure of risk to anyone involved in a foreign currency exposure. Currency options provide a valuable new tool to manage that risk. Options may be used in simple or complex strategies, on their own or in combination with other financial instruments.

WHO USES CURRENCY OPTIONS?

1. **Speculators**

   To profit from exchange rate movements by assuming risk. The risk to a Buyer of traded options is limited to the loss of the premium. The risk to the Naked Writer (one who does not have an opposite position in the underlying currency) is unlimited.

2. **Fund Managers**

   To hedge the currency value of a portfolio in overseas investments when a large movement in the exchange rate is expected, by buying options. To reduce the variability of quarterly returns and improve the performance of the portfolio by earning premium income through the covered writing of call and put options.

3. **Corporate Treasurers**

   To hedge a foreign exchange exposure that MAY materialise. Buying a call or put option is similar to paying an insurance premium to cover an event that may occur. If the foreign exchange liability is KNOWN the cheapest method to hedge the exposure is to buy the currency required forward in the interbank market. However, he may still wish to buy a currency option if he expects the exchange rate to move in his favour before the settlement date and he wishes to be able to benefit from the move.

4. **Banks**

   To hedge the over-the-counter options they write for corporate customers and to generate income from a matched book or spread activity. The only symmetric offset of an option is to take an opposite position in another option.

5. **Arbitrageurs**

   Professional traders to take advantage of temporary price anomalies and make a risk-free turn.

APPENDIX

STOCK EXCHANGE STERLING/DOLLAR TRADED OPTIONS

Contract Size:	£12,500
Option Series:	3, 6, 9 and 12 months Calls and Puts. Jun, Sep, Dec, Mar cycles.
Exercise Prices:	$US and cents per £1 Sterling; 5 cent intervals.
Introduction of New Series	New Series will be introduced whenever the spot value of Sterling, as published regularly by LOCH, on any day at the close of the currency options market stands above or below the second highest or lowest Exercise Price hitherto available.
Exercise Timing:	Continuous.
Expiry Date:	Expiry will take place at 6.00pm on the Friday before the third Wednesday of March, June, September and December.
Delivery Timing:	Third business day following submission of Exercise Notice.
Delivery Method:	Sterling to be delivered to a London Bank nominated by the International Commodities Clearing House (ICCH) against immediate payment of the Exercise Price in $US and cents to a New York Bank nominated by ICCH.
Selection of Writers for Delivery:	At random.
Method of Quoting Premium	US Cents per £1 Sterling; minimum price movement 0.05 cents.
Payment of Premium	Payable in full on the business day following the purchase of the options.
Acceptance of Exercise Notices	Exercise Notices may be submitted to LOCH up to 5.00pm (6.00pm on Expiry Days).
Commission for Clients and Registration Fees:	Negotiable.
Trading Hours:	Initially 9.00 am to 3.30 pm.
Position Limit:	The maximum number of contracts that may be held or written by a single party or parties in concert is 10,000 contracts in any one Class.
Margin:	Further information will be made available on the matter.
Mnemonic:	YBP.

Meeting with Governor

(B)

14 May 1985

PRIME MINISTER

JMB

The announcement of total provisions of £245 million against total loans of £450 million at Johnson Matthey Bankers comes as no surprise - we knew the news was going to be bad. The original suggestion by the Bank that they would return JMB early to the private sector has slipped, and the cost has mounted. It is doubtful whether the Bank will recover the £100 million of special deposit which it made last year, and which it is now converting into equity and loan capital. Nonetheless, the Bank should be encouraged to press on with the task of restructuring and returning to the private sector as soon as possible, and writing off any loss as an unfortunate episode in its history as a regulator.

The Bank's Press Notice publicly denies this.

Walter Salomon has sent me the attached memorandum concerning banking supervision, which he has asked that I show to you.

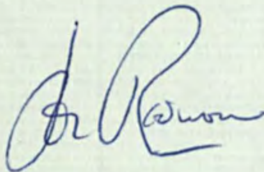
He is right that the system of banking supervision needs a substantial overhaul, and it may well need new blood to strengthen the vigilance of the regulators. At the moment we have the worst of all possible worlds. The system is reluctant to take early action to limit banks building up

unreasonable exposure. And yet, when the position becomes obvious - as with JMB - the Bank is all too ready to take it over and to pump public money in to pay for the costly mistakes that have been made.

This ignores the fact that Johnson Matthey PLC lost £180 million, though it is not clear whether all the guilty executives have lost their jobs.

This means that for many banks there is no encouragement in the system to be prudent, as they know that ultimately they can be bailed out by the Bank of England; whilst the effort that goes in to monitoring and regulating is wasted for most of the time, as nobody is prepared to take a hard decision early enough to prevent disaster.

I suggest that I say to Sir Walter that you are interested in his views, and that the appropriate time to review it is when the Report is available on JMB.



JOHN REDWOOD

MEMORANDUM

1. There can be no doubt that the Banking Act and Banking Supervision need a thorough overhaul.

2. The first point is that it should be seriously considered (as in other countries) that banking supervision is taken out of the hands of the Bank of England and an independent authority set up to deal with it.

3. When the Banking Act was originally introduced I gave an address at The Institute of Bankers City of London Centre on 1st April, 1980, a copy of which I have already sent to you, in which I explained my reservations about it. I think events have proved how right I was.

4. The present supervisory authority consists of a number of people hardly any of whom can be called "practical bankers".

5. When I challenged Peter Cooke as to where they got their knowledge to enable them to make their judgments, he said they learned it by doing it, to which I retorted that this might be an extremely costly and not necessarily successful cooperation. Again, I have not been far off the mark.

6. The recent case concerning Johnson Matthey is, in my opinion, a glaring example of total inefficiency and inexperience. Those responsible are still in charge of banking supervision. If this were a private enterprise business I assume the Board would have dismissed them straight away.

7. However, as our friend does not like criticism without practical suggestions as to what should be done, here are my practical suggestions which are, of course, open to discussion.

   - A separate supervisory body should be formed.
   - In the first instance this should be by way of a loose consultant committee, and here are the names of those I would suggest:

   Apart from Sir Peter Middleton and his officials -

From the Bank of England	-	one should call on Mr. George Blunden and, of course, the Governor could ex gratia always attend every meeting.
From the banking side	-	I would suggest Sir Timothy Bevan, Chairman of Barclays Bank, and as well Mr. D. Vander Weyer, formerly Deputy Chairman of Barclays Bank.

From the industrial side - I would suggest Dr. David V. Atterton of Foseco Minsep.

A further member should be Mr. Robin Hutton, Director General of the Accepting Houses Committee, and he should be appointed Secretary to the Committee.

As temporary consultants before the thing is finalised I would recommend Lord Seebohm and, with due humility, myself as both he and I have got the practical experience which might be helpful to the committee.

I recommend also The Rt Hon Sir Patrick Nairne, GCB MC, formerly Permanent Secretary at the Ministry of Pensions, and now Master of St Catherine's College, Oxford.

WHS
22.4.1985

File

JOHNSON MATTHEY BANKERS : CAPITAL REORGANISATION

Background

1. The capital reorganisation is intended to provide JMB with a capital base on which it can reasonably continue business and to facilitate its return to the private sector as soon as practicable. The reorganisation entails the injection of £100m of capital (£50m ordinary, £25m redeemable and £25m subordinated loan stock). Existing capital will be cancelled. The Bank's announcement yesterday explained that the capital injection does not involve a fresh commitment of resources since the provision of new capital will allow the deposit of £100m made by the Bank last year to be repaid. (Deposit was public knowledge at the time.)

2. The Bank also announced that on the latest estimate of JMB's losses existing capital will be absorbed and the indemnities provided by the Bank and the private sector banks called to be extent of £65m. Half of this figure will be met by the Bank. The £100m of new capital therefore represents full value in the company, not offset by provision for losses.

Line to take

Q: More public money at risk?

A: No. The Bank became responsible for JMB last year. Recapitalisation no more than a visible expression of that commitment. Will also enable repayment of £100m deposit with JMB made by the Bank last year.

Q: If nothing has changed, why has it been done?

A: To provide confidence and enable JMB to continue business on a proper footing, and to facilitate sale back to private sector as soon as practicable and for the best possible price.

Q: Public entitled to full account of JMB affair?

A: Chancellor to report to House soon on review of banking supervision. Bank of England's annual report will include account of events at JMB and rescue operation.

HMT 14 May 1985

Bank of England

Press Notice

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

JOHNSON MATTHEY BANKERS: CAPITAL REORGANISATION

After six months' ownership of Johnson Matthey Bankers (JMB) and in order to facilitate its return to the private sector as soon as practicable, the Bank of England intends to reorganise the capital of JMB. The reorganisation will entail the injection of £50 million of Ordinary £1 shares, £25 million of Redeemable £1 shares and £25 million of subordinated loan stock with a final maturity date of 1995. At the same time there will be a cancellation of £59,999,900 existing issued shares and £15 million unissued shares of £1 each.

The reorganisation will provide JMB, a recognised bank, with a capital base appropriate to its continuing business.

This capital restructuring does not involve a fresh commitment of resources by the Bank of England since the provision of new capital will allow the deposit of £100 million made by the Bank of England in November 1984 to be repaid. The Bank expects its £100 million investment to be returned intact when the Bank's present involvement comes to an end.

The review of JMB's loan portfolio has been largely completed. As at 30 April £225 million of fresh provisions had been identified; taken with the provisions of £20 million made by the previous management, the total of provisions presently recognised by the board of JMB amounts to £245 million. Approximately £130 million of the resources of the JMB Group (prior to the capital reorganisation) and the £50 million contributed by Johnson Matthey PLC have already been absorbed in meeting these losses; the balance is to be met by the indemnity agreement signed in March. The call under the indemnity to be made as at 31 March will be of the order of £65 million of which half would fall to be met by the Bank of England and half by the other indemnitors.

13 May 1985

NOTES FOR EDITORS

In order to carry out this restructuring an order from the High Court is required. The necessary steps to seek such an order are being taken.

2 As a result of these changes the JMB Group will be able to produce a balance sheet as at 30 June 1985 which properly reflects its renewed capital position.

3 The setting of provisions reflects judgments at a particular time. Changing circumstances will indicate whether or not any adjustment of the provisions needs to be made. At the present time, however, and from the information currently available to the board, it is thought that JMB's loan losses are adequately provided against.

4 JMB's problems were brought about by inadequately controlled and imprudent lending to an over-concentration of injudicious loans. Other parts of its business continue to trade profitably.

SECRET (AND PERSONAL UNTIL 2:30 PM THURSDAY 16 MAY 1985)

Fd

MONTHLY MONETARY REPORT: MARCH-JUNE

SUMMARY

- £M3 grew erratically fast in April. With a 12 month growth rate of 12% £M3 is well above the top of its new target range. M0, with a 12 month growth rate of 6%, is above the centre of its range. Other indicators (exchange rate, real interest rates in particular) suggest that monetary conditions nevertheless remain tight.

- Bank lending in May was clearly affected by transactions (particularly leasing transactions) brought forward to benefit from the higher 1984-85 investment allowances. But the underlying level of company borrowing from banks remains remarkably strong, despite a record level of new issues.

- The forecast projects a slow decline in the underlying level of bank lending in response to high short term interest rates, a faster decline in the recorded level (as special factors for earlier months unwind), and a turnround from the exceptionally high April figure for other counterparts. It assumes continued gross gilt sales of £1¼bn a month

- On these assumptions, falls of 0.1% in both £M3 and M0 are forecast for May - giving 12-month growth rates of 11% and 5½% respectively. But a sharp increase in £M3 is projected for June with big redemptions and a high PSBR. A shortfall in gilts sales in May (which now seems highly likely) and the oversubscribed BAe offer could, however, add to £M3 growth.

- £M3 growth in April reflected an erratically large increase in wholesale deposits, as well as the erratic rise in lending. The past pattern of wholesale flows suggests months of rapid growth are succeeded by months of very low growth. That pattern would also suggest a fall in £M3 in May.

SECRET (AND PERSONAL UNTIL 2:30 PM THURSDAY 16 MAY 1985)

MONTHLY MONETARY REPORT: APRIL-JULY

Monetary Aggregates

In banking April £M3 growth was 1.5 per cent above forecast, at 2.9 per cent, with MO growth marginally below forecast at 0.7 per cent. The £M3 figure was clearly erratic. £M3 growth over the 14month 1984-85 target period as a whole has ended up at 11.9 per cent, well outside the target range. 12-month growth is similar, but 3 and 6-month rates are higher still. MO ended the 1984-85 target period at 5.7 per cent, below the middle of its target range, with 3 and 6-month rates below this level, and 12-month growth at 6 per cent.

2. Now that the 1984-85 target period has ended future reports will not quote target period growth rates, but will concentrate on 3, 6 and 12-month growth rates, in line with Ministerial decisions on presentation and monitoring of the targets in 1985-86. Table 1 below shows recent growth in the main aggregates, and annex table 1 provides further detail, also covering real MO and real £M3. Other measures of money are shown in annex table 4.

Table 1: Main Aggregates : Recent Experience

per cent, s.a.

	MO	£M3
monthly change		
March	0.4	1.0
April	0.7	2.9
Growth to mid-April at an annual rate		
over past:-		
3 months	5.4	19.0
6 months	5.2	15.5
12 months	6.0	12.0
Target period	5.7	11.9

3. Though bankers' balances at the Bank of England did recover somewhat from their unusually low level at the end of the previous month, the recovery was not as marked as we had expected, accounting for only about 0.1 per cent of this month's rise in MO. Notes and coin grew slightly more quickly than forecast. As last month it seems that more £1 coins are being issued than £1 notes withdrawn. Information we have in the first 3 weeks of banking May suggests that the note issue may now be slowing down again, compensating for the £1 coin.

4. In contrast to MO there has been clear signs of a deceleration of NIB M1 growth in the wake of the recent interest rate measures. This is illustrated in Chart 1. Econometric evidence suggests that non-interest bearing sight deposits are more interest sensitive than MO, as might be expected, while the phasing out of the £1 note could have temporarily boosted MO as retailers and banks maintain stocks of both £1 notes and coin. Alternatively, it is possible that MO has been affected recently by seasonal influences not properly allowed for in the seasonal adjustment.

5. Public sector transactions did not cause the exceptional April £M3 figure. On the usual counterparts analysis the public sector contribution was contractionary by £¼bn, rather better than forecast. In contrast, sterling lending to the private sector was almost £1bn higher than forecast. Of this, the Bank have identified about £1bn that seems to represent borrowing to finance capital investment brought forward to get the benefit of higher capital allowances in 1984-85. Most of the £1bn represents leasing transactions. This leaves underlying lending at close to its forecast, uncomfortably high, level. The externals and net non-deposit liabilities, taken together were also unusually expansionary. Although we have no strong evidence, this could reflect, in the main, currency hedging by the non-bank private sector.

6. Even allowing for these special factors, growth in £M3 remains uncomfortably high, and shows little sign yet of turning down significantly in response to the rises in interest rates earlier in the year. One possibility is that, unusually, growth may be being driven by the rise in bank deposits, itself a reflection in part

SECRET

of the downward sloping yield curve and in part, perhaps, of changed exchange rate expectations leading to reduced institutional flows out of sterling. But it is hard to see how this could be occurring if banks were not finding a reasonably receptive market for additional lending which, when set alongside the high level of capital market borrowing, would suggest a fairly strong growth in the real economy.

7. PSL2 grew by 2.2 per cent in April, for once substantially lower than £M3, since this month's extraordinary growth was limited to the banks. The building society contribution to PSL2, at £970m, was below the recent average of around £1.2bn, but inflows did pick up after the rise in building society deposit rates on 1 April. Recent inflows are still not sufficient however to maintain the societies' liquidity ratios.

Other indicators of monetary conditions

8. Inflation: The unexpectedly large rise in retail price inflation to 6.1 per cent in March, is likely to be followed by a further sharp increase. The annual growth of the RPI in the 12 months to April may exceed 6½ per cent, partly as a result of the buildings societies' decision to raise mortgage rates with effect from April 1. Better news was provided by producer input prices, which fell 2.5 per cent between March and April bringing their annual growth rate down to 6 per cent. This fall was attributable to a larger than usual seasonal fall in electricity prices and lower prices for petroleum products, and also reflects sterling's recovery since February. Producer output prices in April were 5.5 per cent higher than a year earlier. However the budget effect on this series is quite significant. The 12-month growth rate of producer output prices for manufacturing industries other than food, tobacco and drink, which is less distorted, has been 6¼-6½ per cent in the first four months of 1985 compared with 5½-5¾ per cent throughout most of 1984. The underlying growth rate of average earnings dipped slightly to 7¾ per cent in February, but wage settlements in the private sector are, on average, about ½ per cent higher now than in last year's pay round.

9. Asset prices: The DOE monthly house price series suggest that between February and March house price inflation increased from about 7½ per cent to 8 per cent.

SECRET

10. Real interest rates: Real short term interest rates remain at high levels, though they have probably fallen recently, more than suggested in Annex Table 8, to the extent that the March RPI figure has increased short term inflationary expectations. Indexed gilt yields fell in the early part of April but, rather surprisingly, rose again following the RPI figure.

11. Exchange rate: Although there have been wide fluctuations in exchange rates recently, sterling has broadly maintained its gains of March throughout April. The exchange rate index against EMS currencies in April was at its highest monthly average since February 1984, as was the average D-mark/sterling exchange rate.

Three month forecast

12. As usual, it is assumed that there will be no change in interest rates over the forecast period; and it is assumed, formally, that gross gilts sales will run at £1¼bn a month. MO is forecast to fall by 0.1 per cent in banking May. This low figure reflects information already available on the first 3 weeks of the month. For June and July MO is forecast to grow at around 0.3 per cent, a moderate growth rate consistent with the current high level of interest rates. It is assumed that a continued increase in the (£1) coin issue will be offset by slower growth in the note issue. 12-month growth is expected to fall to 5.5 per cent by the end of this month, and to 4.8 per cent - near the mid-point of the 1985-86 target range - by the end of the forecast period.

13. £M3 is forecast to fall by 0.1 per cent in banking May, bringing 12-month growth down to 11 per cent. This improvement on last month's forecast reflects in part improved prospects for the "PSBR". We have also assumed the year-end surge in borrowing for leasing and investment brought forward transactions that would otherwise have occurred over the next 4 or 5 months. Some roundtripping is also expected to unwind this month. With our assessment of the underlying trend in bank lending unchanged, recorded lending is expected to be well below recent experience, at £1.1bn in both May and June. It is also expected that a small part of the April's abnormal increase in the banks' currency assets will unwind in May, while Barclays' rights issue will make nndls more contractionary than usual. The

SECRET

forecast assumes the May gilt sales target of £1¼bn is reached. With only 3 days of the month left this now looks fairly unlikely. If, taking the extreme assumption, no more gilts sales took place this banking month after 9 May, £M3 would be projected to <u>rise</u> in May by nearly ½ per cent.

14. Projected £M3 growth over the forecast period is extremely uneven. May's fall is followed by an increase of almost 2 per cent in June and a further fall in July. This pattern of very bad months followed by very good months does of course tend to happen in practice. But so far as the forecast is concerned, it is the simple result of projected public sector transactions. Erratic movements in the private sector counterparts could ask to offset these; or could exaggerate the fluctuations. With a gross gilt sales target of £1¼bn assumed throughout the period a larger redemption makes gilt transactions an expansionary factor in June. The BT first call produces a substantially negative "PSBR" in July. The profile would be smoothed somewhat if higher gilt sales were achieved in June.

Table 2: Main Aggregates : Summary of Forecast

per cent, s.a.

	MO	£M3
Monthly change		
May	-0.1	-0.1
June	0.3	1.9
July	0.3	-0.4
growth to mid-April at an annual rate		
over past:-		
3 months	5.4	19.0
6 months	5.2	15.5
12 months	6.0	12.0
Target period	5.7	11.9
growth to mid-July at an annual rate		
over past:-		
3 months	2.3	5.6
6 months	3.8	12.1
12 months	4.8	11.5

SECRET

15. The British Aerospace offer for sale closed on 10 May. The forecast assumes that the offer is fully subscribed but no more. In fact, the offer has been significantly oversubscribed (5 times or more) and this could inflate the growth of £M3 in May - though the extent of this will depend partly on when and if cheques are cashed or returned, and the mix of institutional and personal bids.

16. Table 2 summarises the forecast for the different aggregates, and Chart II shows past and projected movements in the 12 and 3-month growth rate for MO and £M3. The outturn for the 14-month 1984-85 target period is illustrated in chart 5 at the back of the report using the traditional cone presentation for the last time.

Public Sector Borrowing

17. In banking April the PSBR of £1bn was £0.3bn less than forecast due entirely to the contribution of the other public sector. The CGBR was more-or-less as forecas t at £0.8bn.

18. The outlook for the next 3 months for the CGBR is very uneven. In particular, there is expected to be a large deficit of £1.8bn in June, mainly because of the unusually long banking month not being fully compensated in the seasonals, and a surplus of £0.8bn in July, when there is the BT second call of £1.2bn. Over the 3 months as a whole, the CGBR(0) only averages £0.3bn , which is low both in comparison with the expected monthly average and the corresponding period a year ago. However this deceleration is totally accounted for by the BT and British Aerospace asset sales, with the latter contributing £190m in banking May.

19. As to the rest of the public sector expect we are projecting a slightly higher borrowing profile than a year ago. The local authorities are almost certain to be facing a different profile of rate income in 1985-86 because of the new provision which allows large rate payers to pay monthly rather than semi-annually. In the forecast period this means less rate income in banking June but more in July. The net effect on May of this change is small but some extra borrowing is expected by those councils who have not yet set

SECRET

a rate. Also in May the Electricity Council have repaid market borrowing with a NLF loan and in the forecast period they are expected to repay more, perhaps by using the proceeds of a loan being arranged from the European Investment Bank.

Table 3: Public Sector Borrowing

£ million, monthly average

	mid Feb 84 - mid Apr 85	Forecast mid Apr 85 - mid July 85	[mid Apr 84 - mid July 84]
CGBR (O)	536	288	605
'LABR'	246	160	27
PCBR	77	14	-40
'PSBR'*	859	462	592

*PSBR less non-bank private sector transactions in other public sector debt

Debt Sales

(a) Gilts

20. Gross gilt sales in the 4 weeks of banking April totalled £1310m, compared to a target of £1¼bn. Net official sales were £1.1bn. The issue of 3% Treasury 1989 raised only £14m. Sales of the two new tranches issued on 24 March brought in some £480m and the tranches issued last banking month raised some £695m. There were net official purchases of index-linked stock of £175m. The redemption of 12% Exchequer Convertible 1985 on 22 March cost £138m and other buying-in cost £66m.

21. Table 4 compares the April outturn with performance over the previous forecast period and with the 3 month forescast for gilt sales. In April, overseas and discount house purchases were as expected, rather higher than usual, net sales to the nbps reached only £700m. This was slightly lower than forecast, because banks appear to have sold Treasury bills to buy gilts this month.

Table 4: Gilt Sales*

Banking monthly averages £mn

	Actual	Forecast				Forecast
	Feb 84 - Apr 85	April	May	June	July	mid April 85 - mid July 85
Gross sales	1247	1310	1250	1250	1250	1250
Redemptions	-264	-138	-	-1177	-810	-662
Next maturities	-103	-66	-13	-250	-20	-95
Net sales	880	1106	1237	-177	420	492
of which:						
Monetary sector	48	158	100	-50	-15	12
Public corporations	2	-4	-	-	-	-
Overseas	105	245	150	125	-115	53
Non-bank private sector	725	707	987	-255	550	427

* excluding repos.

22. The profile over the forecast period is very uneven indeed. This is a result of the combination of the formal assumption of gross sales of £1¼bn in each month, and a very uneven pattern of redemptions. Superficially May looks a very good month, with no significant buying-in redemptions, but we are still about £740m short of the gross sales target, with only 3 days of the month to go. Over £2bn of stock will fall to be redeemed in June and July, with the bulk falling in June.

23. It may be possible to achieve higher gross sales in 3 months by attracting some of the cash fixed by the two redemptions back into gilts, but experience has shown that redemption outflows normally take a number of months before they are re-invested in gilts. If the assumed gross sales are achieved, but no more, then gilts' contribution to funding over the 3 month forecast period will be less than two-thirds of the average last year.

(b) CTDs

24. As expected CTDs contributed almost £¼bn to funding in banking April, with purchases buoyant and surrenders negligible, perhaps reflecting expectations of falling interest rates. Purchases have slowed and surrenders accelerated so far in banking May, in which CTDs are now projected to be expansionary by £150m. In June and July purchases are expected to pick up somewhat in preparation for the heavy tax payments in the Autumn, but over the forecast period as a whole the impact of CTDs is expected to be mildly expansionary.

(c) National Savings

25. National Savings contributed £¼bn (unadjusted, £220m seasonally adjusted) to funding in banking April; very much as forecast. The 30th Issue Certificate and Income Bond continued to do well, and as usual there was a useful contribution from accrued interest.

26. The forecast assumes that the only change in interest rates will be the ½ per cent rise in Income and Deposit Bond rates on 12 May. On this assumption, we expect the healthy inflows of the last two months to continue over the forecast period with the Income Bond continuing to perform well, though sales of the 30th Issue will probably decline as the initial surge of purchases wanes.

27. There is as yet no firm evidence that the extension of CRT rules to retail bank deposits has benefitted National Savings to any large extent. The Income Bond has performed well, but the other gross products (Deposit Bond and especially INVAC) have not.

The PSBR and Funding

28. Table 5 summarises net funding over the target period and that implied by the forecast. In the 1984/85 target period there was overfunding seasonally adjusted of £2.9bn on the conventional definition and £5.2bn on the alternative definition. In April there was modest overfunding and this is expected to continue in the forecast period. One notable feature in recent months has been substantial

SECRET

external finance of the public sector. Indeed in the last 4 months it has totalled £1.4bn with gilts sales accounting for £1.1bn of this. In the forecast period, however, we expect some slowdown, partly due to gilt redemptions, with total external finance of only £0.3bn.

Table 5: The PSBR and Funding

£ billion, seasonally adjusted

	Actual mid April 1984 - mid April 1985	Forecast mid April 1985 - mid July 1985	mid July 1984 - mid July 1985
"PSBR"	9.8	1.4	9.4
Debt sales to nbps	-13.0	-2.2	-13.0
of which:-			
Gilts	- 9.0	-1.3	- 9.0
National Savings	- 3.1	-1.0	- 3.4
CTD's	- 1.0	0.1	- 0.8
Over(-)/Under funding (+)	- 3.2	-0.8	- 3.6
(Unadjusted)	(-3.1)	(-0.3)	(-3.6)
External finance of the public sector	- 1.8	-0.3	- 1.8
Over(-)/Under funding (+) alternative definition	- 5.0	-1.0	- 5.4
(Unadjusted)	(- 4.9)	(-0.6)	(-5.4)

Money market influences

29. The large unadjusted CGBR, and purchases of reserves, caused a surplus in the money markets in April of £1.1bn. In the forecast period there is again expected to be a small net surplus causing money market assistance to fall to £16.7bn at end July, compared with the end banking month peak of £17.6bn in March. However there are considerable differences between months with the large CGBR leading to a £3bn surplus in June and the BT issue helping to cause a £2.4bn shortage in July.

SECRET

Sterling Lending to the Private Sector

30. Bank lending increased by £2.6bn in April, the largest ever recorded figure. The 3 and 6 month annualised growth rates are now over 20 per cent while the 12-month rate is at 17½ per cent. This unexpected increase is all the more surprising because new issues were exceptionally high in calendar March, the PSBR for the banking month was close to its trend level and the extra lending for accelerating VAT payments should have ended in mid-February.

31. There are however good reasons for treating the April figure as erratically high. About £1bn of the lending is probably due to increased leasing activity concentrated in the final week of the financial year to take advantage of the higher capital allowances available in 1984-85. This figure is supported by the direct evidence on the timing of the lending, and by the calendar quarter statistics which show increased OFI borrowing. Some of the extra lending may have been the result of companies borrowing directly from banks to finance accelerated investment. As yet, no data on fixed investment in Q1 are available but we know that imports of capital goods rose strongly in calendar March.

TABLE: 6 SECTORAL BREAKDOWN OF BANK LENDING+

	OFI's		ICCs		Unincorporated Businesses		Persons				Total	
							Housing	Other	Total			
1984	£m	%	£m	%	£m	%	£m	£m	£m	%	£m	%
Q2	430[1]	11	960	11	460	13	590	670	1270	18	3110[1]	14
Q3	1330[1]	37	1200	13	560	16	390	580	950	12	4040[1]	17
Q4	1270	33	2200	26	30	1	790	930	1720	22	5210	22
1985 Q1*	1730	43	2900	33	1000	28	730	530	1260	15	6890	28

\+ The percentage growth rates are obtained by annuallising the seasonally adjusted flows divided by the unadjusted levels for the previous quarter.

* Provisional

1 Adjusted for the special transaction between two clearers and their leasing subsidiaries

SECRET

32. The sectoral breakdown of lending in Table 6 shows that ICC's and incorporated businesses' borrowing increased, as might be expected if the main factor were the phasing out of capital allowances. The increase in business borrowing may also reflect increased activity. The CBI April Survey indicated that the volume of new orders expected over the next 4 months was the highest since 1977. And exports of non-oil goods (excluding erratics) are 12 per cent up on a year ago. Some of the borrowing may also have been used to finance take-overs. Cash expenditure on mergers and acquisitions of industrial and commercial companies in 1984 was 3 times the 1980-83 average. And there is little sign of any slowdown in Q1. On the other hand, borrowing by persons for non-housing purposes seems to have decelerated in Q1 despite the 4½ per cent increase in the volume of retail sales compared to the same quarter last year.

Table 7: Issues by Listed UK Companies

Calendar month averages, £m

	Net Issues	Gross Issues Queue* (Equities)
1982	97	-
1983	234	-
1984	143	-
1984 Q1	51	850
Q2	199	1510
Q3	218	1030
Q4	106	1215
1985 Q1	400	
1985 Jan	275	1610
Feb	201	2943
Mar	723	4100**
Apr	989	

* Excluding privatisations, currently consisting of £1bn for British Airways and £½bn for British Aerospace.

** As of May 1985

TABLE 8

STERLING LENDING TO PRIVATE SECTOR

Seasonally adjusted

		Moving Averages of Underlying Lending						Moving Averages of Recorded Lending					
		3 months		6 months		12 months		3 months		6 months		12 months	
		£m	%*	£m	%*	£m	%*	£m	%	3m	%	£m	%
1984	Jan	1116	15.1	1117	14.9	1157	15.9	1195	15.6	1271	17.1	1084	14.9
	Feb	1076	13.7	1171	15.3	1158	15.6	1283	16.5	1278	16.7	1076	14.5
	Mar	1095	13.7	1303	17.0	1200	16.1	1282	16.2	1340	17.5	1161	15.5
	Apr	1627	20.9	1396	17.9	1268	17.0	1445	18.4	1320	16.9	1273	17.0
	May	1424	17.7	1250	15.7	1240	16.2	1322	16.4	1302	16.4	1230	16.1
	June	1563	19.2	1329	16.5	1262	16.5	1297	15.8	1290	16.0	1267	16.5
	July	882	10.4	1255	15.5	1186	15.3	936	11.1	1190	14.7	1231	15.9
	Aug	1098	12.9	1261	15.3	1216	15.3	887	10.3	1104	13.3	1191	15.0
	Sept	1028	11.9	1295	15.4	1299	16.3	850	9.81	1074	12.7	1207	15.1
	Oct	1637	19.4	1260	14.8	1328	16.3	1452	17.1	1194	14.0	1257	15.4
	Nov	1831	21.6	1464	17.1	1357	16.4	1785	21.0	1336	15.6	1319	16.0
	Dec	1788	20.8	1408	16.3	1368	16.3	1793	20.9	1321	15.2	1305	15.6
1985	Jan	1684	19.3	1660	19.3	1457	17.4	1748	20.1	1600	18.6	1395	16.7
	Feb	1614	18.1	1722	19.8	1492	17.5	1715	19.3	1750	20.1	1427	16.7
	Mar	1611	17.8	1699	19.3	1497	17.3	1821	20.3	1807	20.6	1440	16.6
	Apr	1671	18.2	1677	18.8	1468	16.7	2022	22.3	1885	21.2	1540	17.5
Forecast													
	May	1633	17.5	1624	17.8	1544	17.4	1857	20.1	1786	19.7	1561	17.6
	June	1593	16.8	1602	17.4	1505	16.8	1636	17.3	1729	18.8	1525	17.0
	Jul	1550	16.1	1610	17.1	1635	18.2	1306	13.4	1664	17.7	1632	18.1

* Based on stock of recorded lending

33. There is no evidence that the April figures were inflated by roundtripping to any appreciable extent. We estimate that there might have been around £300m arbitrage activity in one month bills but this should have been more than offset by unwinding of arbitrage in 1 month and 3 month bills issued in March and January. And there do not appear to have been any opportunities for base rate roundtripping in banking April.

34. Since there appears to have been little net arbitrage in April, and there is no reason to suppose that the increased buoyancy in real economy in the first quarter was concentrated in the last two weeks of calendar March, we are left with leasing as the only credible explanation of April's surge in lending.

35. Over the forecast period we expect bank lending to be unusually low, averaging around £1¼bn. Increases of this magnitude would leave the 6 and 12 month growth rates of lending at around 18 per cent (see Table 8). We are assuming that the extra borrowing brought forward in April would otherwise have occurred over the next four to five months. (It would probably not be worthwhile to bring forward investments any more than this because of the extra interest costs associated with earlier payments would outweigh the extra investment allowances). In banking May the picture is complicated because there may be some borrowing to come through as a result of leases that were signed before April 1 for which the lessors allowed for delayed payment. Against this we have allowed for some net unwinding of roundtripping in April in one month bills, although there were a few further profitable opportunities for 1 month bill arbitrage in banking May.

36. Lower lending levels over the next 3 months would be consistent with the high level of new issues in March and April which are likely to continue for some months judging by the size of the gross issues queue (see table 7).

Externals and net non-deposit liabilities (NNDLs)

37. In April there were large positive externals of £1.4bn partly offset by contractionary net non-deposit liabilities. Taken together,

these counterparts were a positive influence on money of £0.8bn against an average contractionary influence of £0.4bn over the preceding 13 months of the target period. The main factor behind the extraordinary externals figure was a £0.9bn net switch into foreign assets by banks, caused by heavy UK private sector foreign currency borrowing. The externals are never easy to interpret, but one explanation for this would lie in currency hedging by UK companies and institutions in a month when the £/$ rate appreciated by 10 per cent.

38 The forecast assumes some unwinding of the April externals - largely on the basis that the April figure looks erratically large. Apart from that, the forecast for both externals and nndls is much affected by the foreign currency perpetual issues announced by a number of banks in the last week or so. Although under standard assumptions they have no net effect on £M3 they boost externals and cause a larger contraction of nndls. Taken together nndls and externals are projected to be contractionary by around £½bn a month in the forecast period.

Building Societies

39 Retail inflows into building societies in banking April at £830 (adjusted) were slightly below forecast. Assuming no change in interest rates the underlying level of retail inflows is expected to rise in banking May (reflecting the first full month effect of the rise in societies' rates on 1 April, but thereafter remain little changed. However in banking June we assume inflows are reduced by £130m (and in July by £20m) as BT shareholders prepare and make their second payments for BT shares, the precise assumptions on the effect of the BT 2nd call on retail savings are discussed in paragraph below.

40. Table 9 shows our forecast for retail inflows and the other balance sheet flows over the next three months.

SECRET

Table 9 : Building Societies' balance sheet flows

(unadjusted)

Flows

	Assets				Liabilities				
	Mortgages	Liquid inside PSL2	other	Other Assets	Retail Inflows	Wholesale nbps	Wholesale other	Other Liabi- lities	Total Flow
		*			*	*			
Banking: May	+1170	-	+147	+18	+929	+30	+149	+227	+1335
June	+1457	-	+16	+18	+831	+100	+156	+404	+1491
July	+1181	-	+57	+18	+967	+60	+30	+199	+1256

* These figures, together with net inflow of term shares, contribute to PSL2.

41 These figures, together with net inflow of term shares contribute to PSL2. The societies' balance sheet is forecast to expand by over £1¼bn per month. With retail inflows fairly depressed and wholesale funding only expected to progress at a moderate rate (except in June where the effect of the BT second call on retail inflows forces the societies into the wholesale market), the relative strength of mortgage demand implies little room for accumulation of liquid assets. The forecast is consistent with a decline on the liquidity ratio (unadjusted) from 16½ per cent at the end of banking April to 16.1 per cent at the end of July. It is likely that the societies will view the level of liquidity with some concern, but we do not expect that concern to prompt societies to increase their interest rates, though premium share rates could edge up.

42 Overall the forecast implies the building societies' contribution to PSL2 will be about £1¼bn per month (adjusted), much the same as the monthly average over the 1984-85 target period.

Retail Inflows

43 Table 10 below shows outturn and forecasts for retail savings. In Banking April building society and National Savings inflows were very much as expected. However retail bank deposits, and hence total retail savings, were much higher than forecast. Last month's forecast, however, was largely based on a very low initial estimate of retail

SECRET

TABLE: 10

A BREAKDOWN OF RETAIL FLOWS

Seasonally adjusted £ million

	OUTTURN				FORECAST		
	Average monthly increase since mid-February 1984	MARCH initial	MARCH revised	APRIL	MAY	JUNE	JULY
RETAIL BANK DEPOSITS							
NIB SIGHT	+105	-133	-135	+186	)		
IB CHEQUABLE	+185	+340	+488	+536	) +500	+585	+95
IB OTHER	+27	+25	+267	-96	)		
TOTAL BANK DEPOSITS	+317	+232	+620 [+590]	+626 [280] (+50)	+500 [180]	+585 [160] (+130)	+95 (-380)
BUILDING SOCIETIES	+1055	+790	+856 [860]	+830 [915]	+935 [1220]	+890 [1225] (-130)	+980 (-20)
NATIONAL SAVINGS	+261	+169	+163 [150]	+218 [205]	+265 [250]	+405 [315]	+305
TOTAL RETAIL	+1633	+1191	+1639 [1600]	+1674 [1400] (+50)	+1700 [1650] (-)	+1880 [+1700] (-)	+1380 (-400)

Notes: [ ] last months forecast

( ) assumed BT 2nd call effect

bank deposits in banking March, which has since been substantially revised upwards.

44. Our view of underlying inflows in May to July is of little change in building societies' and banks' retail inflows. National Savings' inflows are also little changed, though the forecast for June benefits from a large lump of accrued interest on index-linked certificates.

45. Our estimates of the effect of the second call for BT shares are based on the assumption that the personal sector will have to fund about £400m for the second payment. This is to be paid on 24 June, 2 working days into banking July.

46. The logistics of the payment, and its impact on retail savings are assumed to be as follows:-

(i) a notional £50m has already been deposited in bank accounts;

(ii) in banking June £130m is transferred from building society accounts into bank accounts in preparation for payment. Hence in that month building society inflows are below trend, bank deposits above trend. (The societies make good the shortfall through the wholesale market);

(iii) in banking July a further £20m leaves building society accounts in the form of cheques issued by societies direct to the Government;

(iv) bank deposits fall by £380m in banking July to finance the remainder of the payment. The £380m is made up of £180m alredy built up by banking June and a £200m once and for all run down in bank deposits in July.

47. Overall, therefore, the forecast assumes that the £400m payment will be financed from lower building society deposits (£150m) and bank deposits (-£250m). National Savings are assumed to be unaffected.

SECRET

The message from direct forecasting of the components of £M3

48 This month's forecast for £M3 growth is, as usual, largely based on projections of the counterparts to £M3. In recent reports we have also set out the prospects for retail bank deposits in the section on the retail savings market. We have been considering whether we could develop a similar approach for looking directly at wholesale inflows. This of course would be particularly important were there grounds for thinking the growth of £M3 were being driven as much or more by deposit growth than by the growth of lending (and other counterparts). There is one very simple but consistent feature of movements in wholesale deposits from month to month, illustrated by chart 4 , attached, which shows the profile of wholesale deposits over the last 3 years. There is a clear negative correlation between wholesale deposits one month and the next. This sugests, as does some further econometric work in progress in HF3, that wholesale deposits could fall substantially in banking May. The broad message is that if we thought £M3 at present was being driven by the nbps' demand for bank deposits, rather than the counterparts, the fall in £M3 in May could be sharper than this forecast suggests.

MONTHLY MONETARY REPORT: TABLES

Money

1. Nominal and real target aggregates: historical
2. Monetary aggregates: forecast summary
3. Counterparts to change in £M3: forecast summary
4. Other monetary aggregates: historical
   (a) Target aggregates
   (b) Other narrow aggregates
   (c) Other wide aggregates
5. (a) Components of £M3: historical
   (b) Components of broader liquidity: historical
6. Composition of M0: historical
7. Retail deposits: historical

Other indicators of monetary conditions

8. Nominal and real interest rates
9. Prices and earnings

Details of forecast

10. Bank lending: forecast summary
11. Gilts: forecast summary
12. Money market influences: forecast summary

TABLE 1: PERCENTAGE GROWTH RATES IN SELECTED MONETARY AGGREGATES

		Weekly averaged MO	M2	£M3	PSL2	Real* MO	Real* £M3	RPI less Mortgage Element
(a)	Financial Years (12 month changes to banking April)(%)							
	1980-81	6.8		20.4	14.8	-5.0	7.1	12.4
	1981-82	2.0		12.2	10.9	-6.6	2.8	9.1
	1982-83	6.1	8.9	10.9	11.4	1.2	5.7	4.9
	1983-84	4.9	10.4	7.9	11.0	0.0	2.9	4.9
	1984-85	6.0	9.1	12.0	16.0	(1.0)	(6.7)	(5.0)
(b)	Changes in 12 months to (%)							
1984	May	5.2	10.5	8.1	11.6	0.3	3.1	4.9
	June	5.4	11.3	9.2	13.0	0.5	4.1	4.9
	July	5.8	11.4	7.6	12.0	1.2	2.9	4.5
	August	5.4	12.3	7.8	12.1	1.0	3.4	4.3
	September	5.2	12.1	8.8	13.1	1.3	4.7	3.9
	October	5.4	12.2	8.0	13.5	1.2	3.8	4.2
	November	5.6	12.9	10.9	15.6	1.4	6.6	4.1
	December	6.6	11.4	9.1	14.5	2.4	4.9	4.1
1985	January	5.4	10.2	9.2	14.7	0.8	4.5	4.5
	February	5.4	10.1	9.7	15.3	0.8	4.8	4.6
	March	5.3	9.6	9.3	14.6	0.1	3.9	5.2
	April	6.0	9.1	12.0	16.0	(1.0)	(6.7)	(5.0)
(c)	Changes (at an annual rate) in 6 months to (%)							
1984	May	4.0	15.7	9.2	14.1	-0.7	4.2	4.8
	June	4.9	15.6	11.2	17.1	0.2	6.1	4.7
	July	5.0	12.2	7.6	14.6	0.3	2.7	4.7
	August	4.4	13.1	9.0	15.4	0.0	4.3	4.5
	September	5.3	10.5	8.8	14.5	1.2	4.5	4.1
	October	6.8	9.3	8.7	14.9	2.7	4.6	3.9
	November	7.2	10.1	12.7	17.2	4.7	10.0	2.4
	December	8.3	7.3	7.2	12.0	4.5	3.5	3.6
1985	January	5.9	8.2	10.8	14.9	1.1	5.9	4.7
	February	6.4	7.2	10.3	15.2	1.6	5.4	4.8
	March	5.3	8.6	9.8	14.8	-1.4	2.8	6.8
	April	5.2	9.0	15.5	17.1	(-1.3)	(8.3)	(6.6)
(d)	Changes (at an annual rate) in 3 months to (%)							
1984	November	9.9	9.4	18.4	20.5			
	December	12.3	9.1	10.2	14.1			
1985	January	5.0	8.5	12.0	15.3			
	February	3.1	5.0	2.8	10.2			
	March	-1.3	8.2	9.3	15.3			
	April	5.4	9.5	19.0	19.0			
(e)	Changes in month to (%) (£m figures in brackets)							
1985	February	0.1(20)	0.6(759)	0.5(531)	1.1(2133)			
	March	0.4(60)	0.9(1183)	1.0(1147)	1.1(2131)			
	April	0.7(103)	0.8(1119)	2.9(3173)	2.2(4269)			

SECRET

TABLE 2 : PERCENTAGE CHANGES IN MONETARY AGGREGATES

per cent. s.a

Banking months	MO	NIB M1	M1	M2*	£M3	M3	PSL2	PSL2A
(1) In month								
Apr	0.7	0.6	3.2	1.4	2.9	0.9	2.1	1.9
May	-0.1			0.4	-0.1		0.4	0.3
Jun	0.3			0.4	1.9		1.7	1.4
Jul	0.3			0.4	-0.4		0.5	0.4
(2) latest 3 months (a.r)								
Apr	5.4	2.4	22.2	*	19.0	7.9	18.6	15.9
May	4.5			*	16.1		15.5	13.3
Jun	4.0			*	20.1		18.2	15.6
Jul	2.3			*	5.6		10.8	9.0
(3) latest 6 months (a.r)								
Apr	5.2	3.3	14.9	*	15.4	13.8	16.9	14.2
May	3.8			*	9.3		12.8	10.7
Jun	1.3			*	14.6		16.7	14.1
Jul	3.8			*	12.1		14.6	12.4
(4) latest 12 months (a.r)								
Apr	6.0	3.6	14.9	9.2	12.0	11.1	15.9	13.5
May	5.5			9.1	11.0		15.0	12.7
Jun	4.7			7.8	10.8		14.3	12.0
Jul	4.8			7.0	11.5		14.8	12.4

* not seasonally adjusted

SECRET

TABLE 3: £M3 COUNTERPARTS

	APRIL		FORECAST		
	FORECAST	OUTTURN	MAY	JUN	JUL
1. CGBR					
Own-account (u.a)	2895	2784	400	2990	-1820
On-lending (u.a)	-30	3	230	365	370
Total (u.a)	2865	2787	630	3355	-1450
TOTAL CGBR (s.a)	885	823	775	1875	-820
2. NET PURCHASES OF CG DEBT BY NBPS					
Gilts	-800	-707	-990	255	-550
Treasury bills	0	-63	0	0	0
National Savings	-205	-218	-285	-405	-305
CTDs,etc	-220	-245	150	-35	-10
TOTAL DEBT	-1225	-1233	-1125	-185	-865
3. OTHER PUBLIC SECTOR					
Local Authorities	180	-11	180	-105	-115
Public Corps.	275	158	-335	-20	-50
TOTAL OPS	455	147	-155	-125	-165
4. £ LENDING TO PRIVATE SECTOR	1750	2627	1145	1140	1635
5.NET EXTERNALS	160	1422	300	1085	440
6.NET NON-DEPOSIT LIABILITIES	-500	-613	-1070	-1630	-700
CHANGE IN £M3 £m	1525	3173	-130	2160	-475
(%)	(1.4)	(2.9)	(-0.1)	(1.9)	(-0.4)
"PSBR"	1340	970	620	1750	-985
OVER(-)/UNDERFUNDING(+)	115	-263	-505	1615	-1810

1984-85 KEY AGGREGATES **Table 4 A**

TARGET AGGREGATES

		AUG	SEP	OCT	NOV	DEC	JAN	FEB	MARCH	APRIL
£M3	(Exc. Public sector deposits)									
	Monthly change (£ millions)	+739	+1,365	+319	+2,809	-535	+760	+531	+1,147	+3,173
	Monthly % change	+0.7	+1.3	+0.3	+2.7	-0.5	+0.7	+0.5	+1.0	+2.9
	Three-monthly % change a.r.	+7.2	+4.2	+9.7	+18.4	+10.2	+12.0	+2.8	+9.3	+19.0
	Six-monthly % change a.r.	+9.0	+8.8	+8.7	+12.7	+7.2	+10.8	+10.3	+9.8	+15.5
	12 Monthly % change	+7.8	+8.8	+8.0	+10.9	+9.1	+9.2	+9.7	+9.3	+12.0
	% Change since Feb-83 a.r.									
	% Change since Feb-84 a.r.	+9.0	+10.1	+9.3	+12.1	+10.1	+10.0	+9.7	+9.9	+11.9
MO	Averaged weekly									
	Monthly change (£ millions)	-17	+133	+105	+83	+210	-125	+20	+60	+103
	Monthly % change	-0.1	+1.0	+0.8	+0.6	+1.5	-0.9	+0.1	+0.4	+0.7
	Three-monthly % change a.r.	+4.6	+4.4	+6.7	+9.9	+12.3	+5.0	+3.1	-1.3	+5.4
	Six-monthly % change a.r.	+4.4	+5.3	+6.8	+7.2	+8.3	+5.9	+6.4	+5.3	+5.2
	12-monthly % change	+5.4	+5.2	+5.4	+5.6	+6.6	+5.4	+5.4	+5.3	+6.0
	% Change since Feb-83 a.r.									
	% Change since Feb-84 a.r.	+4.4	+5.5	+6.1	+6.2	+7.5	+5.8	+5.4	+5.4	+5.7

CROSS CHECKS

		AUG	SEP	OCT	NOV	DEC	JAN	FEB	MARCH	APRIL
PSL2	Monthly change (£ millions)	+1,706	+2,409	+2,036	+4,244	-97	+2,601	+2,133	+2,074	+4,153
	Monthly % change	+1.0	+1.3	+1.1	+2.3	-0.1	+1.4	+1.1	+1.1	+2.1
	Three-monthly % change a.r.	+13.9	+9.9	+14.5	+20.7	+14.2	+15.4	+10.2	+15.2	+18.6
	Six-monthly % change a.r.	+15.4	+14.5	+14.9	+17.3	+12.0	+14.9	+15.3	+14.7	+17.0
	12-monthly % change	+12.1	+13.1	+13.5	+15.7	+14.5	+14.8	+15.3	+14.6	+15.9
	% Change since Feb-83 a.r.									
	% Change since Feb-84 a.r.	+15.4	+15.7	+15.5	+17.1	+15.2	15.5	+15.3	+15.2	+16.1
M2 unadjusted	Monthly change (£ millions)	+378	-16	+738	+1,142	+1,955	+228	-122	+1,179	+1,838
	Monthly % change	+0.3	-	+0.6	+0.9	+1.5	+0.2	-0.1	+0.9	+1.4
	12-monthly % change	+12.3	+12.2	+12.1	+12.8	+11.3	+10.4	+10.2	+9.7	+9.2
	(exc re-classifications)	+9.5	+9.4	+9.3	+10.0	9.8	+9.8	+9.6	+9.3	+8.8
Levels :	£M3 (Exc. Pub Sec Deps)	104,171	105,547	105,870	108,678	108,607	109,368	109,898	111,019	114,186
	MO (Averaged weekly)	13,445	13,578	13,683	13,766	13,976	13,851	13,871	13,931	14,034
	PSL 2	180,547	182,968	185,002	189,245	189,632	192,233	194,366	196,407	200,559
	M2 (unadjusted)	129,827	129,811	130,549	131,691	133,748	133,976	133,854	135,033	136,871

Table 4B

OTHER NARROW AGGREGATES

		AUG	SEP	OCT	NOV	DEC	JAN	FEB	MARCH	APRIL
NIB M1	Monthly change (£ millions)	+668	-267	+221	+720	+271	-660	+59	-60	+203
	Monthly % change	+2.1	-0.8	+0.7	+2.2	+0.8	-1.9	+0.2	-0.2	+0.6
	Three-monthly % change a.r.	+6.9	-	+7.9	+8.4	+15.7	+4.1	-3.9	-7.6	+2.4
	Six-monthly % change a.r.	+11.5	+6.4	+4.0	+7.7	+7.6	+6.0	+2.1	+3.4	+3.3
	12-monthly % change	+9.3	+7.6	+7.3	+9.2	+8.5	+6.7	+6.7	+4.9	+3.6
	% Change since Feb-84 a.r.	+11.5	+8.3	+8.3	+10.5	+10.4	+7.1	+6.7	+6.0	+6.1
M1	Monthly change (£ millions)	+685	+507	+811	+1,598	+422	-1,068	-102	+1,020	+1,622
	Monthly % change	+1.5	+1.1	+1.7	+3.3	+0.8	-2.1	-0.2	+2.1	+3.2
	Three-monthly % change a.r.	+11.1	+7.7	+18.4	+27.1	+26.0	+8.1	-5.8	-1.2	+22.1
	Six-monthly % change a.r.	+19.3	+14.9	+14.8	+18.9	+16.5	+13.1	+9.4	+11.6	+14.9
	12-monthly % change	+14.3	+15.6	+15.5	+18.5	+18.2	+14.9	+14.2	+13.2	+14.9
	% change since Feb-84 a.r.	+19.3	+18.5	+19.0	+21.8	20.7	+15.9	+14.2	+15.2	+17.2
M2	Partially seasonally adjusted									
	Monthly change (£ millions)	+1,332	+268	+869	+1,816	+188	+744	+709	+1,183	+1,119
	Monthly % change	+1.0	+0.2	+0.7	+1.4	+0.1	+0.6	+0.5	+0.9	+0.8
	Three-monthly % change a.r.	+10.8	+5.6	+7.9	+9.4	+9.1	+8.7	+5.0	+8.2	+9.3
	Six-monthly % change a.r.	+13.1	+10.5	+9.3	+10.1	+7.3	+8.3	+7.2	+8.6	+9.0
	12-monthly % change	+12.3	+12.1	+12.2	+12.9	+11.4	+10.2	+10.1	+9.6	+9.1
	% Change since Feb-84 a.r.	+13.1	+11.5	+11.1	+11.8	+10.8	+10.4	+10.1	+10.2	+10.2
Levels :	NIBM1	32,956	32,689	32,910	33,630	34,002	33,342	33,401	33,341	33,544
	M1	47,140	47,650	48,460	50,060	50,590	49,520	49,420	50,440	52,060
	M2 (Partially S/A)	129,991	130,240	131,112	132,939	133,201	133,022	134,704	135,875	137,066

Table 4C

OTHER WIDE AGGREGATES

		AUG	SEP	OCT	NOV	DEC	JAN	FEB	MARCH	APRIL
PSL1	Monthly change (£ millions)	+735	+1,458	+686	+2,932	-740	+752	+432	+1,289	+3,299
	Monthly % change	+0.7	+1.4	+0.6	+2.7	-0.7	+0.7	+0.4	+1.1	+2.9
	Three-monthly % change a.r.	+8.5	+3.9	+11.2	+20.2	+10.9	+11.1	+1.6	+9.0	+18.8
	Six-monthly % change a.r.	+10.2	+9.6	+10.2	+14.2	+7.3	+11.1	+10.5	10.0	+14.9
	12-monthly % change	+7.8	+9.0	+8.5	+11.2	+9.5	+9.7	+10.4	+9.8	+12.6
	% Change since Feb-84 a.r.	+10.2	+11.2	+10.8	+13.5	+11.1	+10.9	+10.4	+10.7	+12.6
PSL2A	Monthly change (£ milions)	+1,639	+2,273	+1,933	+3,973	-225	+2,398	+1,943	+2,998	+4,030
	Monthly % change	+0.8	+1.1	+1.0	+1.9	-0.1	+1.1	+0.9	+0.9	+1.9
	Three-monthly % change a.r.	+12.2	+8.3	+12.3	+17.3	+11.7	+12.5	+8.1	+12.7	+15.9
	Six-monthly % change a.r.	+13.7	+12.7	+12.9	+14.7	+9.9	+12.4	+12.6	+12.2	14.2
	12-monthly % change	+12.2	+12.6	+12.5	+14.1	+12.8	+12.8	+13.2	+12.4	+13.5
	% Change since Feb-84 a.r.	+13.7	+13.8	+13.6	+14.9	+13.2	+13.3	+13.2	+13.1	+13.9
M3	(Exc. Public Sector Deposits)									
	Monthly change (£ millions)	+267	+2,788	+418	+3,387	+300	+2,130	+1,113	+153	+1,218
	Monthly % change	+0.2	+2.3	+0.3	+2.7	+0.2	+1.7	+0.9	+0.1	+0.9
	Three-monthly % change a.r.	+9.3	+11.4	+12.1	+23.7	+14.0	+20.2	+11.6	+11.0	+7.9
	Six-monthly % change a.r.	+6.9	+8.8	+8.4	+16.2	+12.8	+16.0	+17.5	+12.6	+13.8
	12-monthly % change	+9.4	+11.5	+10.4	+13.1	+10.9	+11.8	+12.1	+10.7	+11.1
	% Change since Feb-84 a.r.	+6.9	+10.1	+9.3	+12.2	+11.2	+12.2	+12.1	+11.2	+11.2

Levels :

	AUG	SEP	OCT	NOV	DEC	JAN	FEB	MARCH	APRIL
PSL1	108,050	109,520	110,205	113,136	112,880	113,632	114,064	115,305	118,603
PSL2A	200,913	203,198	205,130	209,102	209,361	211,759	213,702	215,667	219,696
M3 (ex. Pub. Sec. Deps)	120,640	123,451	123,863	127,247	128,076	130,202	131,314	131,449	132,674

SECRET

TABLE 5 (a)

The Components of £M3

seasonally adjusted

		Banking Deposits			
	Notes and Coins	Retail		Wholesale	Change in £M3
		nib	ib		
% change	A	B	C	D	E
1983-84[1]	5.6	11.3	-1.8	15.2	7.9
1984-85[1]	5.3	8.8	1.9	16.8	9.2
over 12 months					
1984 May	4.7	12.0	-3.0	17.0	8.1
June	5.3	12.0	-2.3	19.3	9.2
July	5.4	8.4	-1.7	16.0	7.6
August	5.5	11.6	-1.5	14.7	7.8
September	5.5	8.8	-0.7	18.3	8.9
October	5.5	8.4	0.2	15.5	8.1
November	5.4	11.4	1.1	21.1	10.9
December	4.8	10.7	2.9	14.9	9.2
1985 January	5.3	7.5	3.8	15.6	9.2
February	5.8	7.2	5.9	15.0	9.6
March	5.9	4.3	8.4	13.5	9.3
April	4.2	3.3	9.5	21.0	12.0
over 6 month at annual rate					
1984 November	6.5	8.4	9.5	19.4	12.6
December	4.6	9.3	3.8	9.6	7.2
1985 January	4.6	6.8	4.6	20.0	10.9
February	4.9	0.5	7.1	20.1	10.4
March	4.7	2.6	10.8	14.2	9.8
April	3.9	2.9	12.2	28.3	15.4
£mn changes					
monthly average					
1983-84[1]	56	183	-39	445	645
1984-85[1]	42	56	238	683	1017
monthly change					
1984 November	58	662	365	1739	2809
December	14	257	-137	-669	-535
1985 January	-6	-654	27	1393	760
February	79	-20	400	72	531
March	75	-135	755	452	1147
April	17	186	440	2530	3173

1 April on April

SECRET

3/9b

TABLE 5 (b)

Components of Broader Liquidity

Seasonally adjusted

		Building Societies						
	Money[1]	Retail[2]	Wholesale	Liquid Assets (inc -)	Other[3]	PSL2	PSL2A	PSL2A and National Savings
% change	F	G	H	I	J	K	L	M
1983-84[4]	7.9	19.0	-	-46.8	5.2	11.0	11.8	11.8
1984-85[4]	9.2	21.2	-	-18.3	10.6	13.8	12.8	12.6
Over 12 months								
1984 May	8.2	19.2	N/A	-44.1	7.5	11.7	12.0	11.8
June	9.3	19.7		-36.6	11.4	13.0	13.2	12.9
July	7.6	19.5		-28.0	9.7	12.1	12.2	12.0
August	7.8	19.4		-22.1	8.7	12.1	12.2	12.0
September	8.9	20.1		-26.1	9.7	13.1	12.6	12.7
October	8.2	21.7		-20.1	12.0	13.5	12.6	12.5
November	11.0	22.8		-12.6	11.1	15.6	14.0	13.8
December	9.2	22.4		-6.6	10.0	14.5	12.8	12.6
1985 January	9.3	22.9		-12.7	11.4	14.7	12.8	12.6
February	9.7	22.8		-1.01	12.8	15.3	13.1	12.9
March	9.2	22.0	-	-2.7	11.3	14.6	12.4	12.2
April	12.0	21.6	-	-6.7	11.4	15.9	13.5	13.2
Over 6 months at annual rate								
1984 November	12.7	22.8	N/A	-12.2	16.9	17.2	14.6	14.9
December	7.2	21.7		-26.5	5.2	12.0	9.9	10.5
1985 January	10.9	23.9		-47.0	8.9	14.9	12.4	12.5
February	10.4	25.5		-39.6	9.1	15.3	12.6	12.4
March	9.6	24.9		-38.6	11.5	14.6	12.1	11.2
April	15.4	22.7		-24.9	7.0	17.0	14.1	13.1
£mn changes								
monthly average								
1983-84	639	852	59	-100	38	1488	1711	1911
1984-85	1001	1156	44	-29	128	2300	1287	2420
monthly change								
1984 November	2841	1583	-98	-248	109	4187	3916	4133
December	-545	778	-20	-128	-182	-97	-225	-154
1985 January	739	1767	200	-218	113	2601	2398	2472
February	457	1466	-137	301	46	2133	1943	1936
March	1095	984	25	-225	252	2074	1998	2140
April	3171	955	-76	-50	153	4153	4030	4223

1. £M3 less deposits of over 2 years maturity.

2. Net inflow excluding Term shares, SAYE, CD's and Time deposits

3. Treasury bills, bank bills, LA temporary debt, CTD's and some national savings accounts.

4 April on April.

TABLE 6

GROWTH RATES OF COMPONENTS OF WEEKLY AVERAGED MO

		Notes and Coins	Bankers Balances	Total MO
(a)	Financial Years (12 month change to banking April) (%)			
1980-81		5.9	27.4	6.8
1981-82		2.1	-0.2	2.0
1982-83		6.6	-15.6	6.1
1983-84		5.4	-23.4	4.9
1984-85		6.0	3.2	6.0
(b)	Changes in 12 months to (%)			
1984	May	5.2	5.3	5.2
	June	5.3	20.1	5.4
	July	5.4	57.1	5.8
	August	5.4	1.2	5.4
	September	5.4	-9.7	5.2
	October	5.4	7.2	5.4
	November	5.6	5.3	5.6
	December	5.1	129.7	6.6
1985	January	6.2	-37.4	5.4
	February	5.7	-12.4	5.4
	March	5.8	-29.4	5.3
	April	6.0	3.2	6.0
(c)	Changes (at an annual rate) in 6 months to (%)			
1984	May	4.6		4.0
	June	4.6		4.9
	July	6.0		5.0
	August	5.1		4.4
	September	6.4		5.3
	October	6.5		6.8
	November	6.6		7.2
	December	5.6		8.3
1985	January	6.3		5.9
	February	6.3		6.4
	March	5.2		5.3
	April	5.5		5.2
(d)	Three month moving average change (£m) (% change at an annual rate in brackets)			
1984	November	102 (9.5)	5	107 (9.9)
	December	60 (5.5)	72	133 (12.3)
1985	January	69 (6.3)	-13	56 (5.0)
	February	36 (3.2)	-1	35 (3.1)
	March	56 (5.0)	-71	-15 (-0.1)
	April	53 (4.8)	8	61 (5.4)
(e)	Changes in the month to (£m) (% changes in brackets)			
1985	January	92 (0.7)	-217	-125 (-0.9)
	February	-18 (-0.1)	38	20 (0.1)
	March	93 (0.7)	-33	60 (0.4)
	April	85 (0.6)	18	103 (0.7)

TABLE 7: RETAIL DEPOSITS

Seasonally adjusted

	BANKS				
	interest bearing deposits	non-interest bearing deposits	Total	Building[1] Societies	National[2] Savings
% change	C	B	O	P	R
1983-84[3]	-1.8	11.3	3.2	18.7	14.3
1984-85[3]	1.9	8.8	4.5	17.1	13.9
Over 12 months					
1984 May	-1.8	11.3	3.2	18.2	14.5
June	-2.3	12.0	3.1	18.6	14.1
July	-1.7	8.4	2.1	18.2	13.8
August	-1.5	11.6	3.4	17.9	13.8
September	-0.7	8.8	3.0	17.4	15.7
October	0.2	8.4	3.4	17.6	14.9
November	1.1	11.4	5.0	17.5	14.7
December	2.9	10.7	6.0	16.7	14.0
1985 January	3.8	7.5	5.3	16.6	13.7
February	5.9	7.2	6.4	16.1	13.0
March	8.4	4.3	6.7	15.2	12.5
April	9.5	3.3	7.0	14.8	12.3
Over 6 months at annual rate					
1984 November	9.5	8.4	9.0	15.6	17.7
December	3.8	9.3	6.0	14.6	16.3
1985 January	4.6	6.8	5.4	16.0	15.6
February	7.1	0.5	4.4	16.9	14.0
March	10.8	2.6	7.5	16.6	7.4
April	12.2	2.9	8.4	15.0	7.3
£mn changes					
monthly average					
1983-84	-39	183	144	1050	271
1984-85	238	56	294	1028	262
monthly change					
1984 November	365	662	1027	1343	292
December	-137	257	120	640	84
1985 January	27	-654	-627	1543	175
February	400	-20	380	1202	64
March	755	-135	620	856	163
April	440	186	626	830	218

Notes

1. Total retail funds, including terms shares and SAYE.
2. Total inflows
3. April on April.

TABLE: 8

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NOMINAL AND REAL INTEREST RATES

		NOMINAL RATES				REAL RATES				
		Three month interbank	Three month Eurodollar	Base Rate	Long Rate (20 year Gilts)	Expected inflation over 12 months*	Real 3-month interbank rate	Yield on Index-linked Gilts** 1988	1996	2011
1982	(1)	14.3	15.1	14.1	14.7	10.3	4.0		3.0	
	(2)	13.4	15.1	12.8	13.7	9.2	4.1	3.5	3.4	3.0
	(3)	11.5	12.6	11.4	12.2	8.0	3.4	3.6	3.3	3.0
	(4)	9.9	9.9	9.7	10.8	6.3	4.8	2.7	2.6	2.7
1983	(1)	11.1	9.2	10.8	11.5	6.3	4.8	2.7	2.6	2.5
	(2)	10.2	9.4	10.0	10.5	6.2	4.0	3.7	3.2	2.7
	(3)	9.8	10.1	9.5	10.9	6.3	3.5	4.2	3.6	3.1
	(4)	9.4	9.9	9.0	10.4	6.0	3.4	3.7	3.5	3.0
1984	(1)	9.2	10.1	8.9	10.3	5.8	3.4	4.1	3.6	3.2
	(2)	9.3	11.4	8.9	10.9	5.6	3.4	4.8	3.8	3.3
	(3)	11.1	11.7	11.0	11.2	5.5	3.7	5.6	4.4	3.7
	(4)	10.1	9.8	10.0	10.6	5.6	4.5	4.7	3.8	3.2
1985	(1)	12.8	8.9	12.9	10.9	5.7	7.1	5.0	3.7	3.2
1984	July	11.6	11.7	11.5	11.7	5.6	6.0	5.7	4.4	3.7
	August	10.9	11.8	10.9	11.0	5.5	5.4	5.5	4.4	3.7
	September	10.8	11.6	10.5	10.8	5.5	5.3	5.5	4.4	3.6
	October	10.6	10.7	10.5	10.8	5.6	5.0	4.7	3.9	3.2
	November	9.9	9.6	9.9	10.4	5.6	4.3	4.7	3.7	3.2
	December	9.8	9.0	9.5	10.5	5.7	4.1	4.8	3.7	3.1
1985	January	11.3	8.3	11.0	10.9	5.7	5.6	5.2	3.8	3.3
	February	13.4	9.1	14.0	11.0	5.7	7.7	4.9	3.8	3.2
	March	13.6	9.4	13.8	10.9	5.7	7.9	4.8	3.6	3.2
	April	12.7	8.7	12.8	10.7	5.7	7.0	4.8	3.9	3.3
	May 9	12.8	8.4	12.6	11.0	5.7	7.1	5.0	3.9	3.4

* Unweighted average of forecasts by Phillips and Drew, National Institute and the London Business School; the expected rate of inflation for a given month is the change in the price level between six months earlier and six months ahead. This is assumed to approximate roughly to average inflation expectations over the three months immediately ahead.

** Average of yields calculated for each Friday of month or quarter. Assumes inflation averages 5 per cent per annum to redemption.

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TABLE 9

PRICES AND EARNINGS (% change on same period a year before)

	Retail Prices	Producer Price Index: Output Prices (excludes food etc)	Producer Price Index: Input Prices (All manufactured products)	Underlying Average Earnings	Unit Wage Costs*	Commodity Prices**
1982 (1)	11.1	7.6	13.2	10.8	3.2	-7.1
(2)	9.3	7.1	7.6	10.1	4.3	-13.1
(3)	8.0	6.8	4.8	8.9	4.8	-13.7
(4)	6.2	6.1	4.0	8.4	5.1	-6.2
1983 (1)	4.9	5.1	5.6	7.9	2.6	3.1
(2)	3.8	5.4	6.7	7.5	2.8	23.5
(3)	4.6	5.4	8.1	7.7	1.2	27.1
(4)	5.0	5.6	7.5	7.8	1.2	23.6
1984 (1)	5.1	5.8	7.2	7.8	2.7	15.5
(2)	5.1	5.6	8.4	7.8	2.3	-3.5
(3)	4.7	5.5	7.3	7.5	3.7	-13.9
(4)	4.8	5.7	9.2	7.5	5.1	-10.4
1985 (1)	5.5	6.3	9.5			-9.5
1984 March	5.2	5.9	7.0	7.8	3.7	11.7
April	5.2	5.6	8.7	7.8	2.7	4.2
May	5.1	5.6	8.5	7.8	2.2	-5.1
June	5.1	5.5	8.1	7.8	2.1	-9.7
July	4.5	5.5	8.4	7.5	3.6	-13.7
August	5.0	5.5	6.6	7.5	3.6	-13.0
September	4.7	5.6	6.9	7.5	3.9	-14.9
October	5.0	5.7	9.4	7.5	4.3	-12.1
November	4.9	5.6	9.3	7.5	5.0	-9.4
December	4.6	5.7	9.0	7.5	5.8	-9.8
1985 January	5.0	6.2	9.0	7.5	5.8	-8.9
February	5.4	6.4	10.0	7.3	5.5	-9.2
March	6.1	6.3	9.6			-10.8
April	6½	6.5	6.1			-6.8

* In manufacturing - percentage change of the latest 3 months on the same 3 months a year earlier.

** Economist industrial (non-oil) commodity price index in SDRs.

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SECRET (AND PERSONAL UNTIL 2.30PM, THURSDAY 16 May 1985)

Table 10: Sterling lending to the private sector

£ million
Seasonally adjusted

	Actual			Forecast		
	FEB	MAR	APR	MAY	JUNE	JULY
Adjusted lending	1715	1670	1630	1600	1550	1500
Bills held by NBPS(-)	-	-160	170	-50	150	-100
PSBR offsett	-200	-110	65	95	-410	465
Capital allowances	50	100	1000	-250	-250	-250
Net round tripping	75	200	-100	-250	-50	-
British Telecom 2nd call	-	-	-	-	150	20
Error in clearing	-	140	-140	-	-	-
Actual/forecast recorded lending	1640	1840	2625	1145	1140	1635

Table 11: Gilts

£ million

	Actual			Forecast		
	FEB	MAR	APR	MAY	JUNE	JULY
Calls*	435	611	-	-	-	-
Other gross sales	1879	1093	1310	1250	1250	1250
'GROSS' SALES	2314	1704	1310	1250	1250	1250
Buying-in next maturities/	-35	3	-66	-13	-250	-20
Redemptions	-1	-389	-138	-	-1177	-810
TOTAL NET SALES	2278	1318	1106	1237	-177	420
Purchases (-) by:						
Overseas	-407	-265	-245	-150	-125	115
Banks	-318	-252	36	) -100	50	15
LDMA	61	-21	-194	)		
Public Corporations	-62	10	4	-	-	-
NET SALES TO NBPS (+)	1552	790	707	987	-255	550

* of which calls on : -
-

/ of which, buying in of: - 11½% Treasury to be redeemed on 15 July
- 8¾% Treasury to be redeemed on 3 September

3/2d

SECRET (AND PERSONAL UNTIL 2.30 PM, THURSDAY

Table 12: Money Market Influences

£ million
not seasonally adjusted

	Actual	Forecast		
	Apr	May	June	July
A. Money market influences				
CGBR (increase +)	2670	680	3405	-1400
Reserves etc (+)	331	155	-20	-10
Notes and coin (-)	-207	-10	-105	-345
National Savings (-)	-263	-265	-325	-225
CTDs (-)	-308	315	-100	-50
Gilts (-)	-1106	-1235	177	-420
Other Exchequer items etc	-10	-	-	-
TOTAL MONEY MARKET INFLUENCES (Market surplus + / shortage -)	1107	-360	3032	-2450
B. Money market operations				
Commercial bills (purchase +)				
- Issue Department	900			
- Banking Department	-1230			
LA bills (purchase +)				
- Issue Department	-191			
- Banking Department	-2			
Treasury bills (purchase +)	-247			
Market advances	- 3			
Other †	-201			
TOTAL MONEY MARKET OPERATIONS	-974	360	-3032	2450
Change in bankers' balances	133			
TOTAL ASSISTANCE OUTSTANDING*	16882	17242	14210	16660

* excluding Treasury bills

† Export Credit Repo 36
Gilt Repo -237

PART 12 ends:-

JR to AT 26.4.85

PART 13 begins:-

Monthly Monetary Report 10/5/85

KODAK Q-60 Color Input Target

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