PREM 19/1458

PART 14

MT

205

SECRET

Confidential filing

1

Domestic Monetary Policy.

ECONOMIC POLICY

Pt 1: MAY 1979

Pt 14: JULY 1985

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
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29.11.85							
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PREM 19/1458

In Folder attached:

Draft white paper: Banking supervision: Nov. 1985.

PART 14 ends:-

DN to PM 29.11.85

PART 15 begins:-

DN to HMT 2.12.85

10 DOWNING STREET

Prime Minister

Received too late for me to read I'm afraid.

Treasury tell me there are one or two points still to be settled.

If you have time I suggest you read chapter 1.

Agree to circulate, but say you may have comments when you have had an opportunity to consider it further?

DLW
29/11

The tone doesn't match the perceived gravity of the situation. It doesn't increase one's confidence in the new awareness [illegible]

VR73

CONFIDENTIAL

cc BG

BF
// Await P/U comments

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

29 November 1985

David Norgrove Esq
10 Downing Street
London SW1

Dear David

WHITE PAPER ON BANKING SUPERVISION

In Folder attached.

I wrote to you on 20 November setting out the timetable for the White Paper on Banking Supervision. I now enclose the draft White Paper. Subject to the Prime Minister's views, the Chancellor intends to circulate this to colleagues on E Committee on Monday. The main points are summarised in the Introduction and summary (Chapter 1). The Chancellor will also write a personal foreword for the White Paper and plans to show the text to the Prime Minister next week.

As recorded in your letter to me, the Chancellor was asked to report back on two points discussed at the Prime Minister's meeting on 28 October:

(i) The role of bank auditors

As the Prime Minister knows, this is a key area. Our detailed proposals are in Chapter 9 and Appendix 4 of the White Paper.

The Bank of England and the Head of the Government Accountancy Service have made very considerable progress towards reaching agreement in exploratory talks with representatives of the auditing profession and the banks, on the basis of the draft guidance note, reproduced as Appendix 4. These proposals do, however, raise points of principle both for the auditors and the banks, so that extended consultation will be necessary on the basis of the White Paper. But the Prime Minister may like to know that the British Bankers Association, in their representations to the Bank of England, accepted that there could be exceptional circumstances where it would be right for the auditor to approach the supervisor directly, without the knowledge of his client.

The Chancellor hopes that agreement will be reached on a code of practice like that in Appendix 4. This could be issued by the Bank of England with the agreement of the auditing bodies and the banks. It would be supported by minimal statutory provision, to put beyond doubt the auditors and the supervisors' ability to disclose information to each other, and to give qualified legal immunity to such contacts.

If agreement could not be reached on a voluntary code, more extensive legislation would have to be considered.

(ii) Board of Banking Supervision

The Prime Minister also asked the Chancellor to discuss further with the Governor his proposal for a Banking Commission. The Chancellor and the Governor have now agreed on a statutory Board of Banking Supervision within the Bank of England, which would advise the Governor. The proposed terms of reference and arrangements for the Board are set out in paragraphs 5.5 to 5.8 of the White Paper. The Chancellor is satisfied that these proposals will secure an independent input at the highest level from experienced commercial bankers into the supervisory process.

I am copying this to John Bartlett (Bank of England).

Yours ever
Rachel

RACHEL LOMAX

229/015

BANKING SUPERVISION

CONTENTS

229/001

1. Introduction and Summary

1.1 The system of banking supervision that has been developed in the United Kingdom has served the nation well.

1.2 But changes are needed. The system of supervision must be adapted in the light of developments in banking and across the whole financial services sector. Moreover after six years in operation, the Banking Act is due for review. A number of deficiencies, some minor and technical, others more significant, have already become apparent. And the lessons learnt from the Johnson Matthey Bankers affair in Autumn 1984 have added urgency to the need for the reform of banking supervision and its statutory framework.

Have they been fully learnt

1.3 In the light of these considerations, the Chancellor of the Exchequer set up a Committee under the chairmanship of the Governor of the Bank of England, to consider the system of banking supervision. The Government have now considered the recommendations in the Committee's report (Cmnd 9550). This White Paper sets out the Government's proposals.

1.4 The Banking Act 1979 provides the present statutory framework for the authorisation of deposit-taking businesses. It makes the Bank of England responsible for authorising and supervising them. The Act does not cover specialist institutions such as building societies, and credit unions, which are regulated under separate legislation.

1.5 The main proposals for change are as follows:

(i) **A Board of Banking Supervision**

The Government propose to provide in statute for a new Bank of England Board of Banking Supervision to assist the Governor in his banking supervisory responsibilities. This will bring independent commercial banking experience to bear on banking supervisory decisions at the highest level. (Chapter 5)

(ii) **The Banking Supervision Division of the Bank of England**

Important improvements in the organisation of supervision, for which legislation is not required, are being introduced. In particular, steps are being taken to improve the commercial banking and accountancy expertise of the supervisors, by training and by a programme of inward and outward secondments. (Chapter 6)

This says that they were really rather bad - if that is so - why?

(iii) **The coverage of banking supervision**

The basis of the 1979 Act is the protection of depositors, and the supervision of deposit-taking businesses. This will also be the basis of the new banking supervision legislation. But in order to ensure that it can be adapted to cope with changes in banks and banking techniques, the Government propose that the new Act should permit amendment by secondary legislation of the definitions of "deposit" and "deposit-taking business". (Chapter 4)

(iv) **The two-tier system**

Under the 1979 Act authorisation and supervisory powers are based on a distinction between recognised banks and licensed deposit-taking institutions. The Government propose that all authorised institutions should be subject to the same criteria for authorisation, and to the same supervisory powers. (Chapter 7)

(v) **Banking names**

In the light of representations, the Government propose that the use of names including the word "bank" be confined to institutions with at least £5m paid-up equity capital. Chapter 7)

(vi) **Inspection of banks**

The Government have considered establishing a banking inspectorate, on the lines followed in some other countries, but have concluded that it would be more effective to strengthen the Bank's existing statutory powers and resources. The Bank intend to increase the frequency of supervisory visits to banks, both where the Bank have prudential concerns and on a routine basis. (Chapters 6 and 10)

(vii) **The role of bank auditors**

The absence of routine inspection adds importance to the relationship between supervisors and auditors. Statutory provision will be made for increased co-operation and discussion between supervisors and auditors of authorised institutions. (Chapter 8 and Appendix 4).

Has the [illegible] advised? And the Lord Chancellor

(viii) **Supervisory information and statistics**

Routine statistical returns and other supervisory information are at present provided to the supervisors on a voluntary basis. The Government intend to create a new criminal offence of recklessly or knowingly misleading the supervisor. This would apply equally to information provided voluntarily and under statute. Breach of information requirements will also be seen as a warning sign, requiring close investigation by the supervisors. It is also proposed to extend to all authorised institutions the Bank's present power to require information; and to cover routine submission of supervisory information. Failure to comply would expose banks to criminal sanctions. (Chapter 9)

(ix) **Individual large exposures**

Such exposures have proved to be of particular importance in recent bank failures, in the UK and overseas. The Government therefore propose to provide in statute for the notification of such exposures to the supervisor. (Chapter 10)

1.6 These and other proposed changes are described in more detail in this White Paper. A summary of other, minor changes appears in Annex 1.

2. The background

2.1 The environment in which financial institutions operate has in recent years been subject to widespread and rapid change, both in the UK and abroad. Banks have discovered new opportunities. But there are also new risks. The legislative framework must keep pace.

2.2 The number of banks operating in the UK has increased rapidly over the last decade. There are now some six hundred recognised banks and licensed deposit-takers. The number of representative offices of overseas banks has also been increasing. The range and complexity of services offered to the public and to corporate customers has grown. New instruments and markets are constantly being devised. Competitive pressures are intense.

2.3 Banking legislation will complement other measures designed to bring the statutory framework of supervision up to date. The Building Societies Bill, currently before Parliament, provides for the gradual extension of the powers available to building societies, and strengthened prudential powers to be exercised by a new Building Societies Commission. The Financial Services Bill provides for a new statutory framework, based on self-regulation, for a range of investment, securities and insurance businesses. The Government believe that these measures will provide for effective but flexible supervision of rapidly changing markets.

2.4 Other countries face similar changes. Some have recently brought their banking supervision up to date, or are planning to do so. These include Germany, France, Italy and the United

States. Annex 2 to this White Paper provides a brief analysis of practice in a representative group of countries. Supervisors in all countries have similar objectives, though their means of pursuing them naturally vary with local conditions, and the historical development of their banking, auditing and legal systems.

2.5 As noted earlier, the Bank of England is responsible for banking supervision in the UK. Foreign arrangements vary. Swiss supervision is conducted by the Federal Banking Commission, which is separate from the Central Bank. In Germany, the Federal Banking Supervisory Office reports to the Ministry of Finance. It is responsible for detailed regulation, but works closely with the Bundesbank. In the United States, different categories of banks are supervised respectively by the Comptroller of the Currency (part of the US Treasury) and by the Federal Reserve. The Federal Deposit Insurance Corporation also has supervisory responsibilities. Most of the individual States also have their own supervisory bodies. In the Netherlands and Italy the Central Bank is the supervisor. In Belgium there is a separate banking Commission. In France too there is a statutory Banking Commission, which is chaired by the Governor of the Banque de France, and serviced by Banque de France staff. In Canada there is a separate regulatory commission. In Japan the work is done by a division of the Ministry of Finance.

2.6 In all these countries, however, the Central Bank is closely involved in banking supervision (even where it does not actually carry it out or does not have the direct statutory responsibility), reflecting the historical Central Bank responsibility for a sound monetary and financial system.

2.7 Financial markets are becoming ever more international, aided by technological advances and the growing removal of artificial impediments such as exchange controls. There have been corresponding developments in co-operation between banking supervisors internationally. In modern circumstances, no national banking supervisory system can be effective in isolation.

2.8 The United Kingdom has played a leading part in these contacts. The banking supervisors of the Group of 10 countries[1] plus Luxembourg meet regularly in Basle, under the chairmanship of the Bank of England. The Basle Supervisors Committee met first in 1975. It seeks to encourage the gradual convergence of supervisory standards, for example in relation to the capital adequacy of banks. It has also aided co-operation between national supervisory authorities by promoting the development of supervisory policies, improving personal contacts, and thus helping in the resolution of specific problems. One of its main achievements has been agreement on the Concordat, revised in 1983, which sets out the principles for determining the shared supervisory responsibilities for banks' international establishments.

[1] The United States, United Kingdom, Japan, Germany, France, Italy, Belgium, Netherlands, Sweden, Switzerland, Canada. (The name "Group of 10" has been retained, even though with Switzerland the group now contains eleven countries.)

2.9 Within the European Community Member States' banking systems vary widely. Nevertheless, the first Credit Institutions Directive (1977) provides an outline framework for authorisation throughout the Community as a step towards a common market in banking services. The Banking Act 1979 implemented this Directive for the United Kingdom. The Consolidated Supervision Directive (1983) provides for groups headed by a bank to be supervised on a consolidated basis.

No further PM comments on remainder of draft, which has been removed from the file and destroyed. Copies will be available elsewhere.

CMWayland
9 January 2014

10 DOWNING STREET

Prime Minister

See page 3 of the ~~Phillips and Drew~~ forecast, attached, ~~[illegible]~~ published on Friday.

DLW
27/11

MT

Policy assessment

The forecasts that follow are based on the policy changes and assessments given below.

MAIN POINTS THIS MONTH
- ★ **Autumn Statement** suggests continuation of strong sterling policy underpinned by high interest rates; but financial markets now worried by drifts in Government's policies.
- ★ **PSBR target** for 1986/87 at £8bn (cf £7½bn in MTFS) with £2-2½bn of tax relief. PSBR outturn forecast at £9bn.

Autumn Statement

There is growing uncertainty about the direction of the Government's economic policies; uncertainty which the Autumn Statement signally fails to dispel. The Medium Term Financial Strategy was once intended to give clear signals and to inform public debate. More than anything else, it was seen as a constraint on profligate economic policies. Now the signals are muffled and key information is suppressed. As a result, financial markets are being asked to take a lot on trust. But 10 months after a sterling crisis, trust is in short supply.

We identify three main areas of concern. First, while we welcome the suspension of the target for broad money supply, £M3, we lament the absence of an acceptable alternative. Markets had learnt that a tight target for £M3 meant a tight target for public borrowing. That check on profligacy has now gone. The upward revision in the Autumn Statement for this year's PSBR — from £7.1bn to £8bn — seems to be only a taste of what is to come.

Secondly, the Government has shifted its attitude towards public expenditure. It has now adopted a 'middle way' approach, making a virtue out of persistent spending overshoots. The relatively trouble-free negotiations between Treasury and spending ministers this year suggests that the increase of £4bn in planned programme expenditure next year — details below — is more a reflection of a shift towards fiscal ease than of mere problems of control.

Thirdly, there is no suggestion in the Autumn Statement that the rapid extension of the Government's privatisation programme — to a £4.75bn for 1986/87 in the Autumn Statement from £2.25bn in the Budget — will be reflected in a planned reduction in the PSBR.

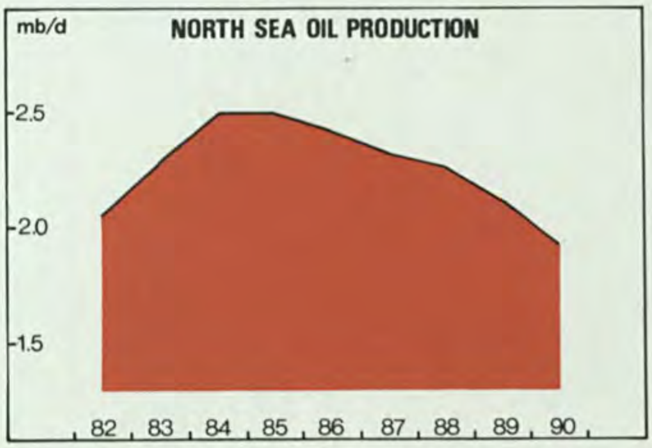
The overriding consideration appears to be the political one of income tax cuts. The Chancellor's refusal to publish a revised 1986/87 fiscal adjustment (the Treasury code for tax cuts) put at £3.5bn in the Budget forecast can only add to the financial market's unease.

In our view, the Chancellor's game plan is to combine an easing of fiscal policy with firm monetary policy — a 'touch of Reaganomics'. A combination of high real interest rates and sterling at an uncompetitive level is intended to keep inflation in check, especially by suppressing imported inflation.

The suppression of imported inflation is required at a time when pay is rising and productivity growth slowing, putting upward pressure on unit wage costs. Firm sterling helps contain the threat to the Government's inflation objectives. If successful, it allows the Chancellor to ease fiscal policy by a few notches to keep growth going.

As inflation falls on the back of lower import prices into 1986, some relaxation of fiscal policy should appear more acceptable to markets than it does now. Two key dangers remain, however. The first is pay. If pay were to continue to escalate on the back of tight labour maket conditions, the chances of steady growth with low inflation would evaporate.

The second danger is financial confidence. The Chancellor has to convince markets that relaxation of fiscal policy does not mean relaxation of monetary policy. The Autumn Statement forecast for the housing element of retail prices appears to imply, at most, a point reduction in interest rates by end-1986. This is realistic in our view. Base rates of 10 per cent or above are the best we hope for in 1986. The great fear is that at some stage the Government may be tempted to relax fiscal policy and monetary policy together. This would be to repeat the policy error of 1984. Result: sterling crisis. Interest rates have to stay high and the Chancellor has to take the muddle out of the MTFS.



1986 Budget

Even with an extra £2bn contingency reserve and £7½bn PSBR target for 1986/87, the current MTFS envisages scope for a positive 'fiscal adjustment' of £3½bn in the financial year. We think that the persistent overrun in public spending is likely to eat into this amount, perhaps leaving room for a net injection of only £2-2½bn on the personal direct tax front in the 1986 Budget, even though asset sales have been raised to £4¾bn from £2¼bn for 1986/87 in the present MTFS. Accordingly, the forecasts in this issue are based upon the assumption that £2¼bn tax relief is distributed by the Chancellor next year.

The PSBR target for 1986/87 could be raised to £8bn on the argument that it would still be consistent with a low inflation outcome. In practice, the PSBR in 1986/87 could turn out closer to £9bn.

Medium term judgement: The declining profile of North Sea output suggests that the preservation or improvement of cost competitiveness will be paramount in the years ahead. But the adjustment will be made less easy by a buoyant rate of 'core inflation' represented by unit labour costs. Only a modest fall in sterling is likely to be deemed acceptable. As regards tax relief, we assume a net £2bn pa is made available in each of the fiscal years 1987/88 and 1988/89. Even so, the tax reduction is less than that implied by the 1985 MTFS. Our assessment of the medium term outlook is presented on pp 22-23.

Economic Assumptions

The forecasts that follow are based on the economic assumptions given below.

MAIN POINTS THIS MONTH

- ★ **UK export market growth** of 4% in 1986 and 4¼% in 1987 after 4¾% in 1985.
- ★ **OECD inflation** to escalate gradually to around 5½% by end-1987.
- ★ **Non-oil commodity prices** in SDR terms to show a modest recovery in 1986 and 1987.
- ★ **Average oil price** to weaken slightly in dollar terms in early 1986, stabilising in nominal terms thereafter.

Export Markets

World trade volumes were boosted in 1984 by the remarkable growth in US imports — up 30% on 1983. Buoyant US demand stimulated trade in the rest of the world, especially the industrial countries. Weighted by importance to the UK, export markets for UK products probably grew by 8% in 1984.

Events in 1985 are dominated by the slowdown in US growth, from nearly 7% in 1984 to an annualised rate of only 2% so far this year. US import demand growth, partly responsible for the slowdown in overall US growth, is forecast at 10½% in 1985. Japanese growth is also likely to slip. Modest growth in Europe, with which the UK has close trade ties, helps secure 4¾% growth in UK export markets in 1985.

With import growth in the USA falling to under 4% in 1986 and 1987, though offset by maintained, if not more buoyant, trade growth elsewhere, UK export markets may grow by less than 4% in 1986 and only 4¼% in 1987.

OECD Inflation

Though some concern may start to develop about US inflation prospects, the general inflation outlook for the OECD area remains encouraging. In the USA, inflation, currently under 3½%, looks set to escalate over the next 18 months, reflecting the impact of a productivity slowdown and a weaker dollar. In Germany, inflation is likely to stay within the 2-3% range this year and next. In the OECD area as a whole, consumer prices may rise by around 4½% in 1985, down from 5¼% in 1984.

There is little reason to expect any major escalation of inflation in 1986; indeed, in Europe, inflation may fall slightly. By end-1987, however, rising US inflation may push the OECD average back towards 5½% although this would still be below the cyclical trough rate experienced in the 1970s between the two oil crises. It would mark a return to the inflation performance of the late 1960s/early 1970s.

Non-Oil Commodity Prices

Given the volatility of exchange rates, we find it more useful to assess trends in non-oil commodity prices in terms of SDR-based measures rather than by reference to indices denominated in any specific currency. In these terms, metal prices have relapsed in recent months after showing signs of tentative recovery earlier in the year. By the end of this year we assume that prices will have recorded a 9½% decline from end-1984 levels. In the course of 1986, some recovery in US industrial production and a possible resurgence in speculative interest primed by a rise in gold could well provide some price stimulation. We look for an advance in metal prices to leave the end-1986 level about 9½-10% higher than end-1985, with a 5% rate of increase assumed thereafter. As regards food prices, these have been weak and we expect them to end 1985 substantially lower than at end-1984. A modest recovery has been assumed for 1986 and 1987. Overall, these assumptions lead us to expect aggregate non-oil commodity prices to record a 10½% year-on-year decline to end-1985 in SDR terms. A pick-up starting early next year should limit the calendar 1986 decline to 2½%, giving way to a 3-3½% average year rise in 1987.

Oil

Spot crude markets have remained firm over the last month. Crude liftings have been low through the summer causing shortages in the spot market. For this reason, spot prices are generally above refinery net back, prices at which crude is normally available from OPEC. This situation has not existed for a long time. The October OPEC meeting ended without any agreement. Production quotas for individual members remain a source of contention and there is little adherence to official prices. We expect spot crude prices to remain firm in the coming months, as restocking ahead of winter demand occurs. The next major test of spot prices may be delayed until next spring when we assume a $1-2/bl fall in the price of Arab heavy taking it to around $24/bl. Against the background of a weaker dollar this implies a significant price reduction in real terms.

TABLE 1: Economic assumptions

	10-year average growth	*1985*					*1986*					*1987*				
		Q1	*Q2*	*Q3*	*Q4*	*Year*	*Q1*	*Q2*	*Q3*	*Q4*	*Year*	*Q1*	*Q2*	*Q3*	*Q4*	*Year*
Export markets	L	115.1	116.3	117.2*	117.9	**116.6**	119.3	120.6	121.9	122.7	**121.1**	124.2	125.7	126.9	128.0	**126.2**
(1980 base)	3.6	5.6	5.2	4.6*	3.4	**4.7**	3.6	3.7	4.0	4.1	**3.9**	4.1	4.2	4.1	4.3	**4.2**
OECD inflation	L	135.7	137.7	138.6*	140.1	**138.0**	141.7	144.0	145.3	147.5	**144.6**	149.1	151.6	153.0	155.5	**152.3**
	9.6	4.6	4.8	4.5*	4.4	**4.6**	4.4	4.6	4.8	5.3	**4.8**	5.2	5.3	5.3	5.4	**5.3**
Index of commodity	L	102.5	99.2	92.0*	89.7	**95.9**	91.8	93.2	94.0	94.6	**93.4**	95.0	95.9	96.8	97.8	**96.4**
prices SDR	7.1	−7.5	−9.6	−9.8*	−10.5	**−9.3**	−10.4	−6.0	2.2	5.5	**−2.6**	3.5	2.9	3.0	3.4	**3.2**
Index of commodity	L	112.1	103.6	96.9*	98.0	**102.7**	99.5	101.1	101.7	103.0	**101.3**	103.4	104.1	105.0	106.8	**104.8**
prices food SDR	10.4	−4.9	−14.9	−15.1*	−10.9	**−11.5**	−11.2	−2.4	5.0	5.1	**−1.3**	3.9	3.0	3.2	3.7	**3.5**
Index of commodity	L	89.7	90.9	82.6*	77.4	**85.2**	81.4	83.3	84.8	84.9	**83.6**	85.4	87.3	89.1	89.4	**87.8**
prices metals SDR	2.4	−5.9	−1.2	−3.2*	−9.4	**−4.9**	−9.3	−8.4	2.7	9.7	**−1.8**	4.9	4.8	5.1	5.3	**5.0**
Imported oil price	L	26.6	25.6	25.3*	25.5	**25.8**	25.0	24.0	24.0	24.0	**24.3**	24.0	24.0	24.0	24.0	**24.0**
Arab heavy $/bl	26.3	0.1	−5.0	−5.4*	−3.9	**−3.6**	−6.0	−6.4	−5.1	−5.9	**−5.8**	−4.0	0.0	0.0	0.0	**−1.0**

PRIME MINISTER 22 November 1985

THE ECONOMY

Money policy remains loose

Variable (Rough Scope)	Money Growth 3 Months % pa	1 Year
M_0 (mainly cash)	-1.5%	+3.4%
M_1 (M_0+ current a/cs)	+24.6%	+18.0%
£M_3(M_1+ deposit a/cs)	+19.5%	+14.5%
PSL2	+16.6%	+14.2%

(Source: Greenwells)

The tight control of M_0 mainly reflects high interest rates, which encourages holding cash on deposit, and the growing volume of transactions using credit cards rather than bank notes.

The easiness of money is shown by the rapid rise in share prices; by the weakness of sterling againist the yen, DM and other leading non-dollar currencies since July; and by the money figures themselves. The rise in £M_3 partly reflects the decision to stop overfunding against a background of strong private sector credit demand.

City commentators are, in the main, apprehensive

They point to the higher level of asset sales, falling oil revenues, likely PSBR and public spending overruns, and continuing difficulty in curbing spending. Simon & Coates see it as a case of "reflation, inflation". Capels call it "monetary muddle, fiscal fudge". Messels (Tim Congdon) foresee "a general deterioration in financial control . . . the MTFS is crumbling". Panmure's are relaxed, seeing it as a sensible extension of the story so far. And Hoare Govett think a limited dose of "Reaganomics" will work for a while. Several quote the NIESR article by Odling Smee and Riley "Approaches to the PSBR", as these two Treasury economists can be portrayed as critical of current Government policy.

Options

There are three possible options:

1. Enter the EMS and tighten policy to German standards. This would mean higher interest rates, further cuts in public spending, or no tax cuts to try and halt the creeping devaluation of the pound against the DM. The strain could not all fall on monetary policy: fiscal policy too would need adjusting.

2. Carry on as we are. The world is still very deflationary, commodity prices are falling (or should be if cartels are allowed to break up), expansion elsewhere (especially the easier money in the US) will help us, and a pound strong against the dollar and weak against the yen and DM has some charms.

3. Tighten domestic policy a little without the extreme jolt of 1 above. Attack the less sensitive areas of public spending more vigorously (eg force some tightening of working capital in nationalised industries to cut PE by, say, £500 million; let grants to Industry and Agriculture undershoot budgets; avoid bailing out the tin cartel with any additional money to that already lost, etc); and be cautious in the 1986 Budget about the extent of tax cuts that have immediate effect.

Assessment

You need more growth for more jobs; you do need to continue to persuade people that the Government is not in the business of cutting popular areas of public spending; but you need to keep the achievement on inflation.

Option 1 is the most foolish. It means a tight reining back now - even if you devalue on entry to the EMS. It will undermine the Government's credibility if you then have to leave the EMS before the Election, having stressed its importance to economic discipline in the meantime. It will impede growth, force you into more borrowing overseas, and in the end squander the reserves.

Option 2 is tempting - try and prove the commentators wrong again. Certainly Treasury forecasts of inflation have been better than private ones in recent years; and the strength of the pound against the dollar, coupled with lower commodity prices, means it's different from 1973-74 (when the monetary position was similar to today's). It is encouraging to see that the very rapid rate of growth in bank lending has slowed down in recent months.

If this was 1986, Option 2 would clearly be right. The danger with it in 1985 is that it may force you to an earlier Election than is ideal, as it warms up the economy too soon.

I conclude in favour of Option 3. It is reasonable to replace falling oil revenues with higher asset sales. 1986-87 needs to see public spending undershooting targets through good control over extraordinaries and through some strong pressures on the easier areas to keep it down. There can be little chance of lower interest rates for the time being until the pound and the money aggregates look better. This may not happen for several months.

About Budget time you may wish to reaffirm to colleagues that overruns in 1986-87 will usually have to be absorbed within the departments' budgets, and you could consider a small package of expenditure reductions in less sensitive areas.

JR Redwood

JOHN REDWOOD

FILE

DA

cBG

10 DOWNING STREET

From the Private Secretary 21 November 1985

BANKING WHITE PAPER

The Prime Minister has noted the timetable for the Banking White Paper described in your letter to me of 20 November.

I am copying this letter to David Morris (Lord Privy Seal's Office), Murdo Maclean (Chief Whip's Office) and Michael Stark (Cabinet Office).

(David Norgrove)

Mrs. Rachel Lomax,
HM Treasury.

BM

VR47

CONFIDENTIAL

cc BG.

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

20 November 1985

David Norgrove Esq
10 Downing Street
London SW1

Prime Minister 2

To note.

DRN
20/11

MT

Dear David,

BANKING WHITE PAPER

As the Prime Minister will recall from her meeting on 28 October with the Chancellor and Governor on Banking Supervision, the Chancellor intends to publish a White Paper this year, with a view to introducing legislation at the beginning of the 1986-87 session. I am writing to let you know that he expects to be able to meet his public commitment to publish a Banking White Paper this year, and to make a Statement on the day of publication during the week beginning 16 December. The Chancellor will of course be circulating the text of the Statement to interested colleagues, and clearing the White Paper in correspondence with members of E Committee.

I am copying this letter to Private Secretaries to the Lord Privy Seal, the Chief Whip and the Secretary to the Cabinet, and to Bernard Ingham.

Yours ever
Rachel

RACHEL LOMAX

ECON POL: Domestic Monetary Policy: Pt 14.

21. XI

BANK FOR INTERNATIONAL SETTLEMENTS

Prime Minister 2

DBR 20/11

12th November 1985

PRESS COMMUNIQUÉ

At its meeting held on 12th November 1985 the Board of Directors of the Bank for International Settlements elected The Rt. Hon. Lord Richardson of Duntisbourne as its Vice-Chairman as from 28th November 1985 to succeed Monsieur Bernard Clappier, Honorary Governor of the Bank of France, who, while remaining a member of the Board, had expressed the wish to retire from the office of Vice-Chairman. Lord Richardson, who was Governor of the Bank of England from July 1973 to June 1983, has been a member of the Board of Directors of the BIS since July 1973.

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Monetary Bulletin

No. 178 November 1985.

The first part of this Bulletin considers the Chancellor's Autumn Statement. The second part, beginning on page five, analyses what might have happened in the Barber Boom years of the early 1970's if the authorities had been using the new monetary policy laid down in the Chancellor's Mansion House speech last month. The third part looks at the latest monetary statistics.

Claims have been made, both before and after the Autumn Statement last Tuesday, that the Chancellor is already engineering a reflation of the economy in anticipation of the next general election. In our view, neither monetary policy nor the fiscal stance has yet been significantly eased.

The forecasts for 1986/7 in the Autumn Statement rely on assumptions that do not seem to us to add up to a central estimate. In particular, real GDP growth is not likely to be quite as high as the Treasury project, inflation and public expenditure are not likely to be as low and the combination of significant tax cuts and a £7½bn PSBR looks unattainable.

Given political pressures, however, we now expect tax cuts of around £2bn in the next budget, even if the prospective PSBR is higher than was forecast in March 1985. Tax cuts of this size, however, would not seriously lay the Chancellor open to a charge of fiscal laxity. On our calculations, a properly adjusted PSBR would show only a relatively small change between this year and next.

Autumn Statement : PSBR Outlook

The Government's public expenditure plans continue to appear optimistic and not a central estimate. Even without presenting a critique of the individual programmes, an analysis of the total plans suggests that past optimism has not been removed.

The contingency reserve for 1985/6 has now been completely allocated. Even so, the public expenditure planning total, excluding special sales of assets, is officially projected to be lower in real terms than in 1984/5. The miners' strike raised public expenditure, substantially in 1984/5 and to a lesser extent this year. If these exceptional expenditures are subtracted, the official projection would be for an unchanged planning total between 1984/5 and 1985/6, as Table I shows. Even this adjustment implies an implausible deceleration in public expenditure growth.

Possibly. But the coal strike & higher inflation were the major factors in 1984-85.

It must be probable that public expenditure in the current year will be higher than the £130.2bn indicated in Table I, perhaps by an additional £1bn. Higher expenditure this year implies a new and higher base for 1986/7, at a time when political and wage cost factors will continue to exert upwards pressure. Indeed, the contingency reserve for next year, which has already been reduced from £6bn to £4½bn, is now smaller than the £5bn reserve which was available at the beginning of the current financial year. It seems very likely, therefore, that next year's public expenditure outturn will be at least £1bn higher than the latest published forecast.

Table I - Public Expenditure Planning Total*

£bn	Current Prices	Real Terms (base 1984/5) As published	Adj. for Miners' Strike	Change
1981/2	104.6	122.2	122.2	+2.4
1982/3	113.9	124.4	124.4	+2.2
1983/4	121.5	126.9	126.9	+2.5
1984/5	131.8	131.8	129.3	+2.4
1985/6 (est)	136.7	130.2	129.3	-
1986/7 (for)	143.9	131.1	131.1	+1.8

*Excluding Special Sales of Assets

The implication must be that the PSBR this year will overshoot the Chancellor's revised estimate of some £8bn. £9bn looks at this stage to be a more reasonable outturn. The Chancellor's analysis for 1986/7 is also optimistic. In his Budget last March he projected a PSBR in 1986/7 of £7½bn, which included a fiscal adjustment, i.e. tax cuts, of £3½bn. This projection was not revised in the Statement but the Chancellor did declare that "the framework of public expenditure control .... should allow scope for considered and justified reductions in the burden of taxation". The room for tax cuts is likely to be much less than that indicated last March because of the rise in sterling against the dollar. This, according to the official estimates, has already reduced oil revenues by £2bn in the current fiscal year and there is likely to be an even larger shortfall next year.

Given the assumptions which probably lie behind the Chancellor's inflation forecast, and which are discussed in the next section, there will be barely any room for tax cuts next year as long as the PSBR is kept to its projected £7½bn. The loss of revenue because of lower sterling oil prices will be just too great. This will be so even if GDP growth of 3% is attained, which we think is unlikely.

Even so, the political pressures for significant tax cuts next year seem irresistible. At this stage, cuts of at least £2bn seem likely, i.e. just over half the level projected last March. In our view, the PSBR outturn would then most probably exceed last March's projection of £7½bn by a similar amount. Even if this proves to be a correct forecast, it will not represent a dramatic easing of fiscal policy.

A somewhat crude but roughly correct way to demonstrate this is to make certain adjustments to the PSBR, expressed as a percentage of GDP, as shown in Table II. The overall message of this analysis is similar to that given by the less widely followed public sector financial deficit.

Table II - Stance of Fiscal Policy

£bn	(Row)	Actual 1980/1	1981/2	1982/3	1983/4	1984/5	W.G. & Co. Estimates 1985/6	1986/7
PSBR	(1)	12.7	8.6	8.9	9.7	10.2	9	9½
less Miners' Strike Cost	(2)					-2.7	-1	
plus Privatisation	(3)	0.4	-0.1	0.5	1.1	2.0	2½	4¾
plus Council Houses	(4)	0.6	1.0	1.9	2.0	1.6	1¾	1½
Adj. PSBR	(5)	13.6	9.6	11.2	12.9	11.1	12¼	15¾
% GDP	(6)	5.9%	3.8%	4.0%	4.2%	3.4%	3.4%	4.1%
plus Oil revenues	(7)	3.9	6.5	7.8	8.8	12.0	11½	8
Adj. PSBR	(8)	17.5	16.0	19.0	21.7	23.1	23¾	23¾
% GDP	(9)	7.6%	6.3%	6.8%	7.1%	7.1%	6.7%	6.2%

Row 1 of Table II shows actual PSBR figures up to 1984/5 plus our estimates for 1985/6 and 1986/7. This series is then adjusted for the miners' strike and asset sales. Row 6 shows this adjusted PSBR as a percentage of GDP, and it will be seen that some fiscal reflation is projected for 1986/7. This is not, however, the end of the matter. It is arguable that the PSBR should be further adjusted for North Sea revenues. An argument against making such an adjustment is that in the absence of North Sea oil, other revenues would have been higher, e.g. corporation tax from an otherwise larger manufacturing industry. If a comparison is being made between consecutive years, the balance of the argument is in favour of making the adjustment. This basis is shown in row 9; the PSBR is estimated to drop from 7.1% of GDP in 1984/5, to 6.7% in 1985/6 and to 6.2% next year. There is, in practice, no perfect way to adjust the PSBR to obtain an estimate of changing fiscal stance, but rows 6 and 9 taken together do not indicate that the Chancellor has yet eased fiscal policy. Nor do they imply that he would be doing so to a significant extent if, as assumed in Table II, he introduced £2bn tax cuts in the budget.

Inflation Outlook

There is little disagreement with the Treasury's 3¾/4% retail price inflation forecast for the second quarter of 1986. But their forecast for the rest of the year appears optimistic. Certainly, the assumptions which underlie the 3¾% forecast for the fourth quarter seem accident prone. This overall forecast is the product of a 3½% increase in food prices (20% weight in total index), a 3½% increase in the prices of other goods and services (57% weight), a rise of 5% in the prices of goods and services supplied by nationalised industries (9% weight) and a 4½% rise in the cost of housing (14% weight).

Our analysis indicates that a 4½% rise in the housing component implies a reduction of at least 1% in mortgage interest rates. The easiest combination of factors to achieve the 3½% increase in the other goods and services component would be for unit labour costs to rise by no more than 5%, despite a 7 to 8% increase in earnings (i.e. for labour productivity to grow by 2 to 3%), for sterling to remain firm at a time when oil prices fall, and for other commodity prices to be largely unchanged. The Statement does throw light on the Treasury's assumptions on two of these factors. Firstly, when referring to sterling it states that "the (economic) forecast is also based on the assumption that the effective exchange rate will not change much from its average level since March", i.e. 80½. Secondly, when discussing oil prices, it states "... some excess of supply over demand, which could bring about a fall in oil prices, as indicated by the futures market". At the time of the Chancellor's Statement, oil futures six months out were being quoted down to $26 a barrel. The subsequent rise in this price to $27½ on Thursday will probably prove to be temporary.

The combined impact of the assumptions for mortgage rates, oil prices and sterling suggests that they can become most easily compatible by sterling rising against the US dollar and falling against most other currencies, such as the deutschemark. For example, sterling spot rates of $1.55 and Dm3.50 would be consistent with a Bank of England sterling index of around 80. This pattern would have important implications for the government's oil revenues, and thus for PSBR and fiscal policy.

Economic Outlook

Following expected real growth in GDP of 3.7% this year the Autumn Statement forecast a further 2.9% rise in 1986. This, as Table III shows, is ½% higher than our own forecast for 1986, itself more optimistic than the average forecast of outside commentators. The two main areas of Treasury optimism are consumers' expenditure and fixed investment. The 4¼% forecast rise in consumers' expenditure is based on a 3 to 4% increase in real earnings, a further rise in employment and a cut in taxes, of unstated size, in the next budget. As the Treasury is forecasting retail price inflation to average no more than 4% next year, the implied growth in money earnings is 7 to 8%. In our view, the Treasury's forecast for inflation is too low. The outturn is likely to be up to 1% higher by the end of 1986. If the growth of consumers' expenditure were ½% lower than the Treasury forecast, GDP growth would be reduced by almost ¼%.

Table III - GDP Forecasts for 1986

		1986	
Real Growth	**(Weight)**	**W.G.&Co.**	**HMT**
Consumers'Expenditure	(59)	3¾	4¼
Government Consumption	(23½)	1	-½
Investment	(19)	2	3½
Change in Stocks (% of GDP)		¼	½
Exports	(32)	3	2¼
less Imports	(-33½)	4	3¾
GDP (average estimate)		2½	3
Retail Price Inflation			
Fourth quarter		4¾	3¾

Fixed investment is the other main area of Treasury optimism. They are projecting investment growth of 3½% for next year, more than double the estimates of many other forecasters. Following the revisions to public expenditure plans, public investment may rise slightly in 1986 following a small fall this year; private sector housing should rise by 5% or so next year, reflecting the recent pick up in housing starts, after a fall of 3% this year. The main contrast between the Treasury and most other forecasts is in private sector business investment. The Treasury forecast implies a rise of about 4% next year, compared to some 8% this year. The current investment surveys are difficult to interpret because investment is likely to be temporarily very buoyant ahead of the final reduction in capital allowances at the end of next March. But if business investment rises by an average of only 2%, GDP growth next year would be cut by a further ¼%.

The Chancellor's New Monetary Policy - Would it have averted the Barber Boom?

Considerable scepticism has been expressed on the question of whether the Chancellor's new monetary policy, outlined in the Mansion House speech, can control monetary and economic developments. It is of course obvious that to move away from a simple targetting system gives any Chancellor the opportunity to return to the bad old ways. What we are concerned with here, however, is whether the new system, if operated honestly, can provide a workable and effective measure of monetary tightness or ease. One way to analyse this problem is to take an extreme example. Specifically, if the new policy had been honestly applied during the Barber Boom years, would monetary policy have been tightened much earlier than it was? Although an extreme example, this is by no means an irrelevant one given the comparative rates of increase in the growth of broad money; M3 grew by 14% in 1971, roughly the same as £M3 this year.

The Chancellor's new system entails a change in funding policy and the use of short term interest rates in response to developments in a range of monetary indicators. The principal elements in this range are Mo, inflation and money GDP forecasts and the behaviour of sterling and domestic asset markets. These will be considered in turn.

Funding the PSBR

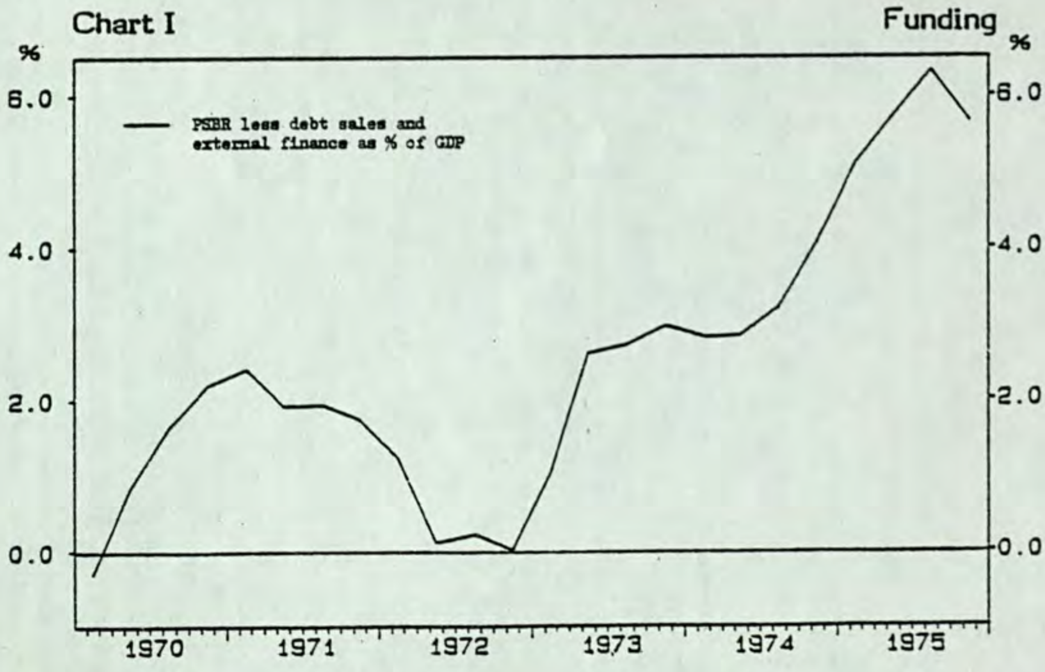
Under the new funding policy, sales of public sector debt to the non-bank private sector and foreigners will be just sufficient to fund the PSBR. The impact on £M3 will in general be different if the debt is sold to a foreigner rather than to a U.K. resident, but the new policy does mean that the authorities will not print money directly. If this policy had been followed in the Barber years, the underfunding in 1970 and 1971, as shown in Chart I, would have been avoided, broad monetary growth would have been much lower than it was and interest rates would have been raised much earlier than they in fact were. Chart I also suggests that the new funding policy would have prevented some of the excesses of the mid and late 1970s.

Growth of Mo

Mo was accelerating sharply in the first half of the 1970's, as is shown in Chart II, on page 7. Its annual growth rate was artificially depressed in the first half of 1972 by sharp falls in bankers' balances at the Bank of England, which reflected the introduction of Competition & Credit Control in the autumn of 1971. This masked the sharp underlying rise in currency in circulation which began in the first half of 1972. Even if action had been

Chart I

Funding



delayed until Mo itself had begun to grow rapidly on an annual basis, there should have been a response by the third quarter of 1972 and interest rates would not have been permitted to fall in the first half of 1973. Certainly, if the components of Mo had been closely monitored in the early 1970's, the Barber Boom would have been constrained by rising short term interest rates at an early stage.

Inflation

It is less straightforward to monitor inflation, both actual and forecast. Price increases were delayed both by the prices and incomes policy and by increased subsidies, especially to nationalised industries. Chart III, on page 7, shows that the annual rate of increase of input prices began to accelerate in 1972, commodity prices at the start of the year and producer input prices by mid-year. This was in spite of the growing subsidies to nationalised industries. Output prices did not start to rise sharply until the second half of 1973, as shown in Chart IV, on page 7. Unless correct account had been taken of the distortions to the published inflation data, which were mainly government induced, policy would not have been tightened much earlier or more dramatically than was actually the case.

Asset Prices & Sterling

In contrast to published inflation developments, asset markets and sterling's exchange rate do provide a definite message. As is shown in Chart V, on page 8, house prices began to rise very rapidly in mid-1971; by the end of 1972, they were rising at an annual rate of more than 50%. By the end of 1973, average house prices were three times higher than at the beginning of 1970.

The rise in the U.K. equity market was less dramatic than for houses but there was still a 60% rise during 1971 and 1972, as is shown in Chart VI, on page 8. The fall in the market did not really begin until 1973 by which time Bank Rate had been raised from a low of 5% to 9%. The fall in dividend yields on the equity index from about 5% in early 1971 to 3% by mid-1972 strongly supported the view that the market was overvalued.

The weakness of sterling from mid-1972 provided further evidence, if any was needed, that monetary policy was much too easy. Chart VII, on page 8, shows the sterling index; it was very weak from mid-1972 despite the sharp increases in U.K. short term interest rates.

Conclusion

The evidence from the Barber Boom years of the early 1970's is quite clear. If the new rules of the game had been in operation, monetary growth would have been lower and monetary policy would have been tightened much earlier. If the PSBR had been fully funded one important counterpart to M3 would have not contributed to its excessive growth. A correct analysis of both Mo's growth and inflation would have indicated early on that restrictive action was necessary; the strength of asset prices, especially houses, and the weakness of sterling provided further strong supporting evidence.

To conclude that the new policy would have avoided the excesses of the Barber Boom is not to conclude that it will necessarily be effective in the future. Perhaps the most disturbing feature of the present monetary situation is the build up in liquidity that has already taken place. What we have been discussing is whether the new policy could have averted the accumulation of liquidity in the early 1970s, not whether it would or could have controlled the spending of excess liquidity. Nevertheless, an honest application of the new framework will certainly give reliable warning signals.

Chart II

Change in Mo

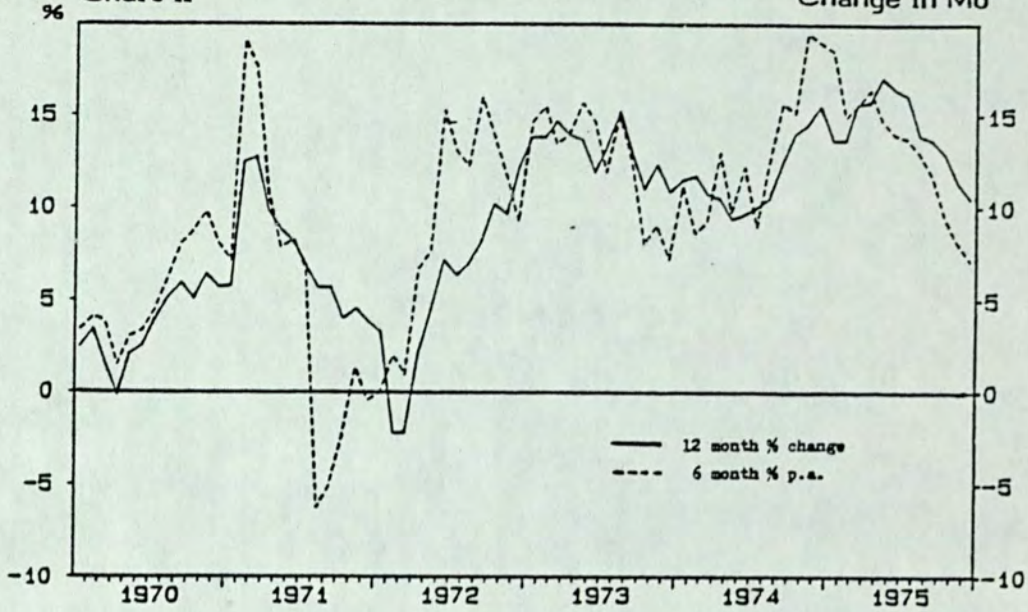


Chart III

Annual changes in Input Prices

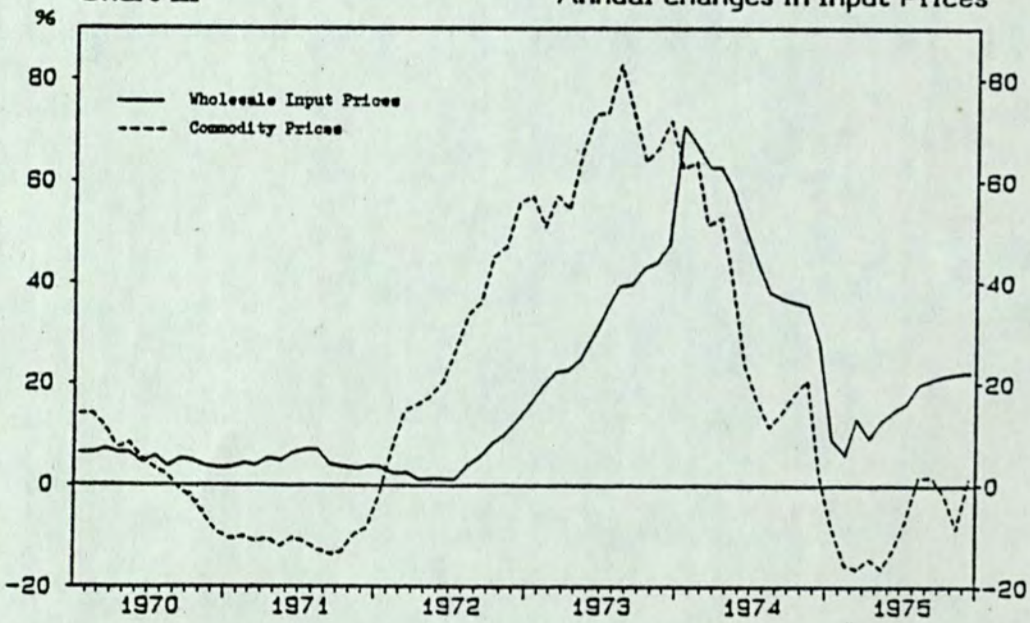


Chart IV

Annual changes in Output Prices

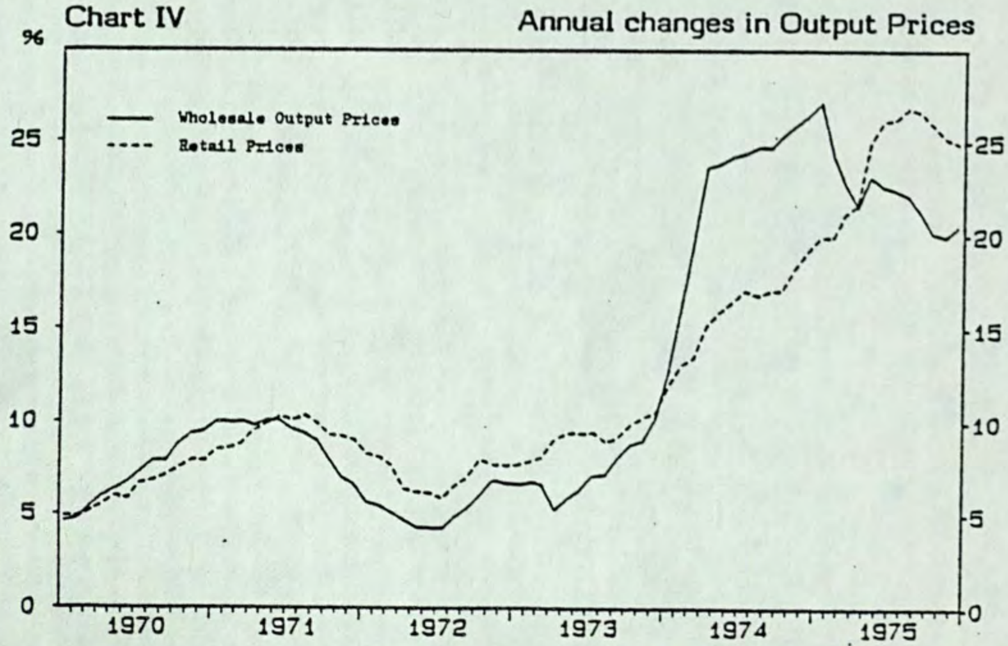


Chart V Annual change in House Prices

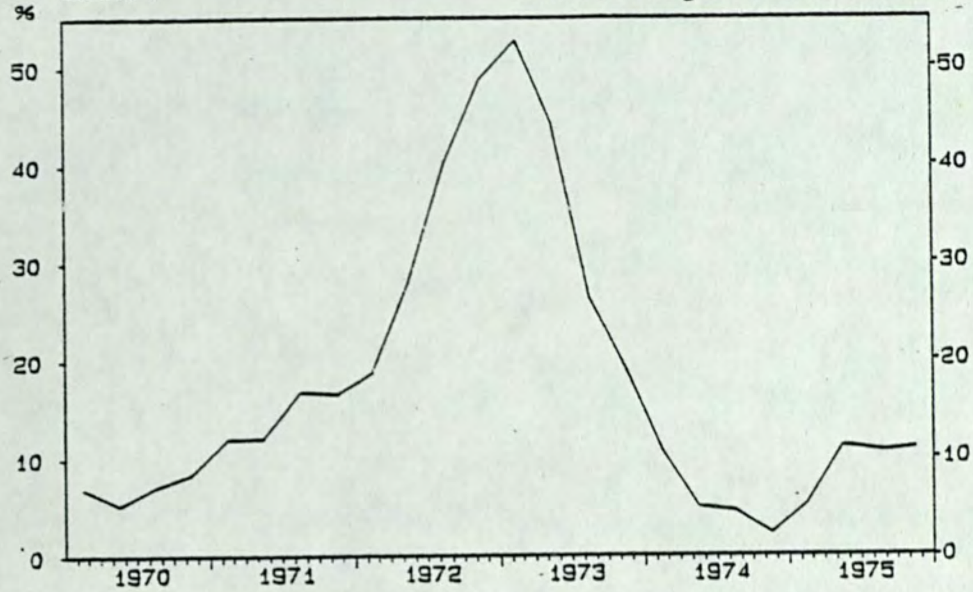


Chart VI FT/Actuaries 500 Index

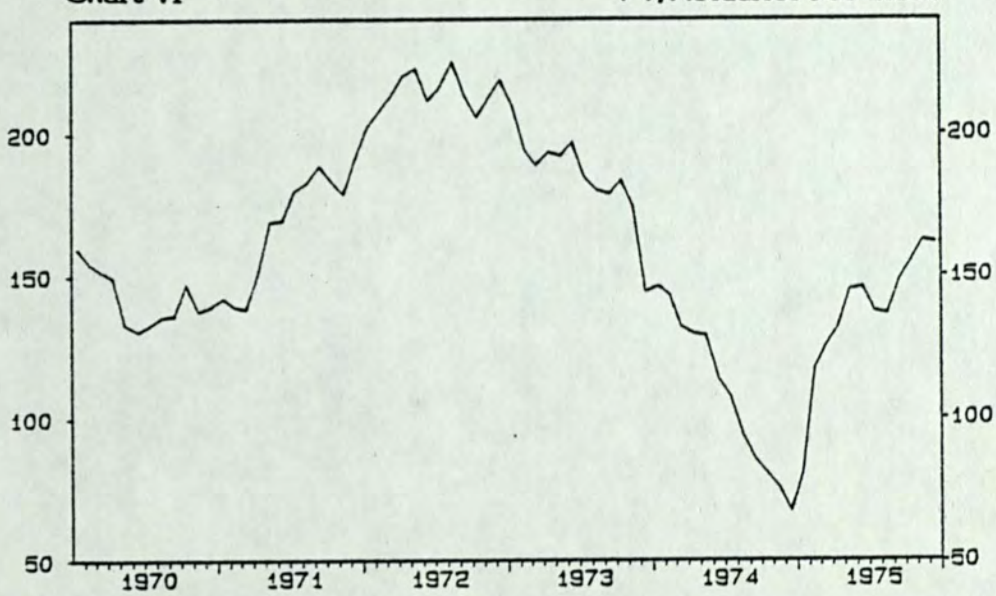
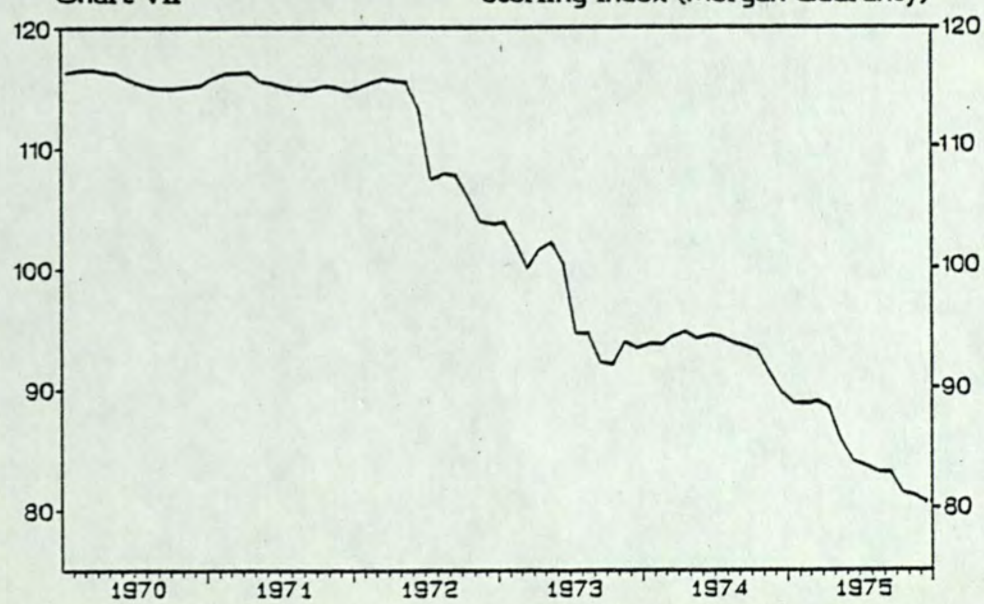


Chart VII Sterling Index (Morgan Guaranty)



Monetary Growth in the Month to Mid-October

The highlight in the monetary data for the month to mid-October was the overfunding of £983m. This reflected £535m sales of gilt-edged stock and £477m of national savings & certificates of tax deposit to the non-bank private sector. The PSBR, net of sales of other public sector debt, was only £228m and was virtually offset by £199m in public sector external finance. The Bank of England in its press release mentions this overfunding but stresses that the Chancellor's new funding policy, i.e. of selling just enough debt to finance the PSBR, refers to the financial year as a whole.

Given that recent data are available only on a banking, i.e. mid-month, basis it is not possible to monitor the new funding requirements with precision. It is believed that the starting point for official monitoring is Mid-March, since when there has been modest overfunding of £519m. Even if the PSBR outturn for 1985/6 is £1bn higher than the Treasury's new forecast, funding will not have to run at much more than £650m a month for the rest of the financial year. This compares with a rate of £820m a month in the seven months to mid-October. As the £650m is likely to include at least £200m a month from national savings, net sales of gilt-edged stock should have to average only £450m a month if the external finance component is in balance.

Turning to the aggregates, seasonally adjusted data for the four weeks to 16th October are shown in Table IV.

Table IV
Changes in the Month to mid-October

	£m	pa
Mo	-33	-3%
Currency	-96	-9%
Retail M1	157	6%
M1	1,324	28%
Sterling M3	958	10%
PSL1	1,222	12%
PSL2	2,451	14%
Bank lending in sterling to private sector	2,136	19%

The pattern over the longer term, together with our estimates of the underlying trend over the last six months, are shown in Table V. Our estimates of the underlying trend make no allowance for the yield curve, the high level of real short term interest rates nor for the recent change in funding policy.

It will be seen that narrow aggregates continue to grow at a modest rate, with Mo's growth over the last year at the bottom of its 3-7% target range. The indications for Mo from the first four weeks of the five week banking month to 20th November are that bankers' balances and the currency component have risen, suggesting an increase in Mo over the five weeks of about ½%. If these indications are correct, the growth rates of Mo over six and twelve months will be 3% p.a. and 3½% respectively.

Table V
Monetary Growth in the Longer Term

		3 months Published % p.a.	6 months Published % p.a.	6 months Underlying % p.a.	One Year Published %	Notes
Narrow money:	Mo	-1.5	1.4	3	3.4	1
	Currency	0	1.3	3	2.4	1
	Retail M1	4.7	2.1	6	2.3	2
	M1	24.6	21.7	13	18.0	3
	M2	n.a.	n.a.	8	7.9	4
Broad money:	Sterling M3	19.5	13.6	13	14.5	5
	PSL1	17.1	12.3	12	13.8	5
	PSL2	16.6	12.0	12	14.2	6

Notes.
1. Revised upwards because of abnormally low banker's balances and currency in October.
2. Revised upwards because of a switch from current accounts to high interest chequing accounts.
3. Revised downwards because of the newly available high interest chequing accounts and the greater use of overnight deposits by Other Financial Institutions.
4. 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.
5. The downward adjustment is to allow for arbitraging and the increase in high interest chequing accounts where funds have not come from other bank deposits. This is partially offset by upwards adjustment due to abnormally high April level.
6. The adjustment for changes in term shares of building societies is now upwards; it is partially offset by a downward adjustment to allow for arbitraging.

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MONETARY GROWTH
In Nominal Terms

Percentage Annual rates		Mo	Currency	Retail M1	M1	M2	Sterling M3	PSL1	PSL2
Changes in year to:									
1984	Nov.	6	6	9	18	13	10	11	15
	Dec.	7	5	9	18	11	9	9	14
1985	Jan.	5	5	7	15	10	9	10	15
	Feb.	5	6	7	14	10	10	10	15
	Mar.	5	6	5	13	10	9	10	15
	Apr.	6	4	4	15	9	12	13	15
	May.	5	5	4	16	8	12	12	14
	June.	5	4	10	18	9	12	12	14
	July.	5	4	3	16	7	12	12	14
	Aug.	4	4	3	18	7	13	13	14
	Sep.	4	4	2	17	8	14	13	14
	Oct.	3	2	2	18	8	14	14	14
Changes in 6 months to:									
1985	May.	4	4	0	12		11	11	12
	June.	3	5	11	19		17	16	15
	July.	5	3	0	19		13	13	12
	Aug.	3	3	3	28		16	16	13
	Sep.	3	3	2	23		18	17	13
	Oct.	1	1	2	22		14	12	12
Changes in 3 months to:									
1985	Aug.	2	2	2	23		14	13	13
	Sep.	1	2	-22	5		12	10	11
	Oct.	-1	0	5	25		19	17	17

In Real Terms

		Mo	Currency	Retail M1	M1	M2	Sterling M3	PSL1	PSL2
Changes in year to:									
1984	Nov.	1	1	4	13	8	5	6	10
	Dec.	2	0	4	14	7	5	5	10
1985	Jan.	0	0	2	10	5	4	5	10
	Feb.	0	0	1	9	5	4	5	10
	Mar.	-1	0	-1	7	4	3	4	9
	Apr.	-1	-2	-3	8	2	5	6	9
	May.	-2	-2	-3	9	1	5	5	7
	June.	-2	-3	3	11	2	5	5	7
	July.	-2	-3	-4	9	0	5	5	7
	Aug.	-2	-2	-4	12	1	7	7	8
	Sep.	-2	-2	-4	11	2	8	8	8
	Oct.	-2	-3	-3	12	2	9	8	9
Changes in 6 months to:									
1985	May.	-3	-3	-7	5		4	3	5
	June.	-4	-1	5	13		10	10	9
	July.	-1	-3	-6	13		7	7	6
	Aug.	-2	-3	-3	22		11	10	7
	Sep.	-2	-3	-3	18		13	12	8
	Oct.	-4	-4	-3	17		9	7	7
Changes in 3 months to:									
1985	Aug.	-3	-4	-3	17		9	8	7
	Sep.	-4	-3	-28	0		7	5	6
	Oct.	-6	-5	0	20		14	12	12

Chart 1 - Monetary Growth in NOMINAL Terms (% p.a.)

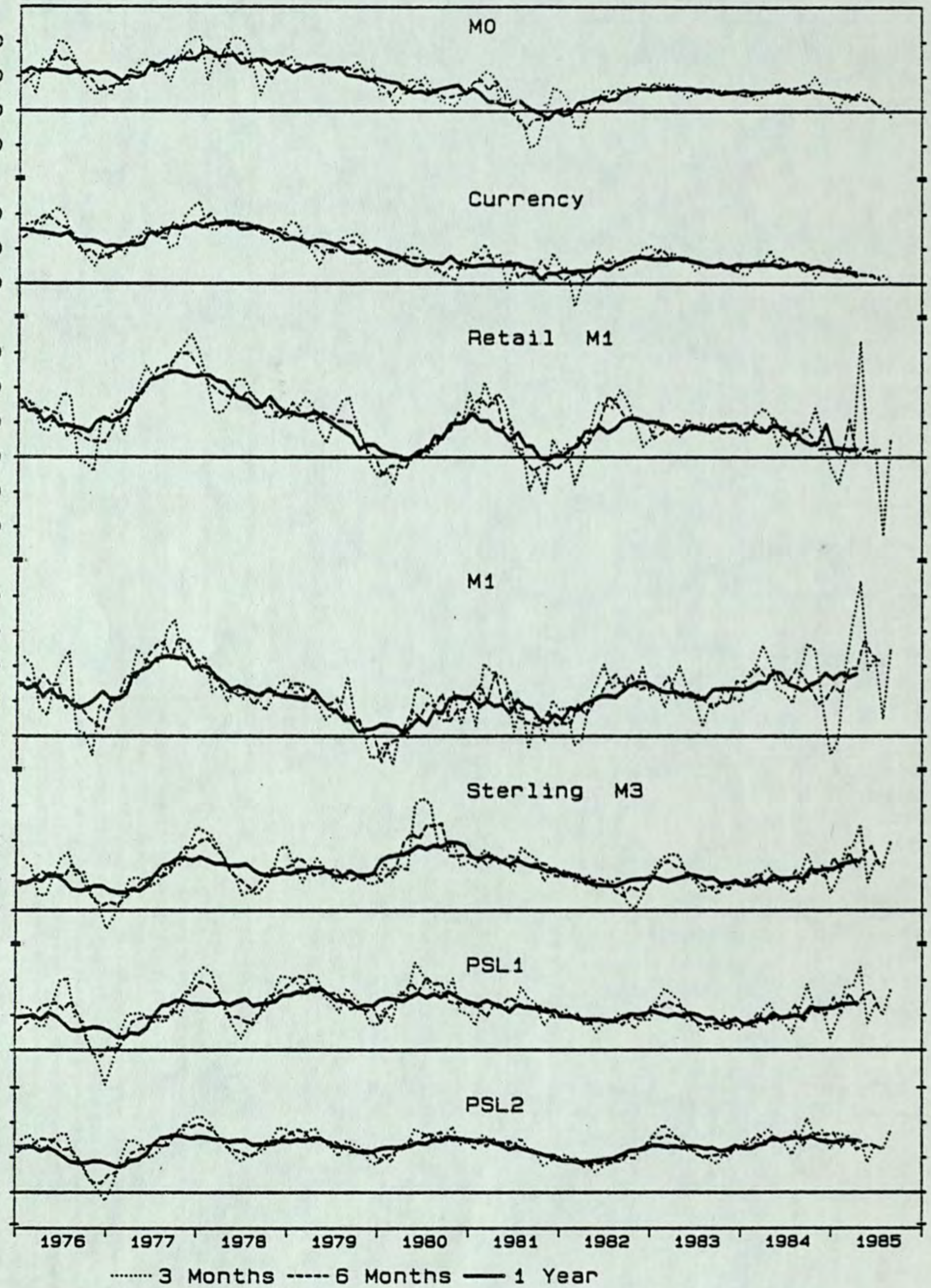


Chart 2 - Monetary Growth in REAL Terms (% p.a.)

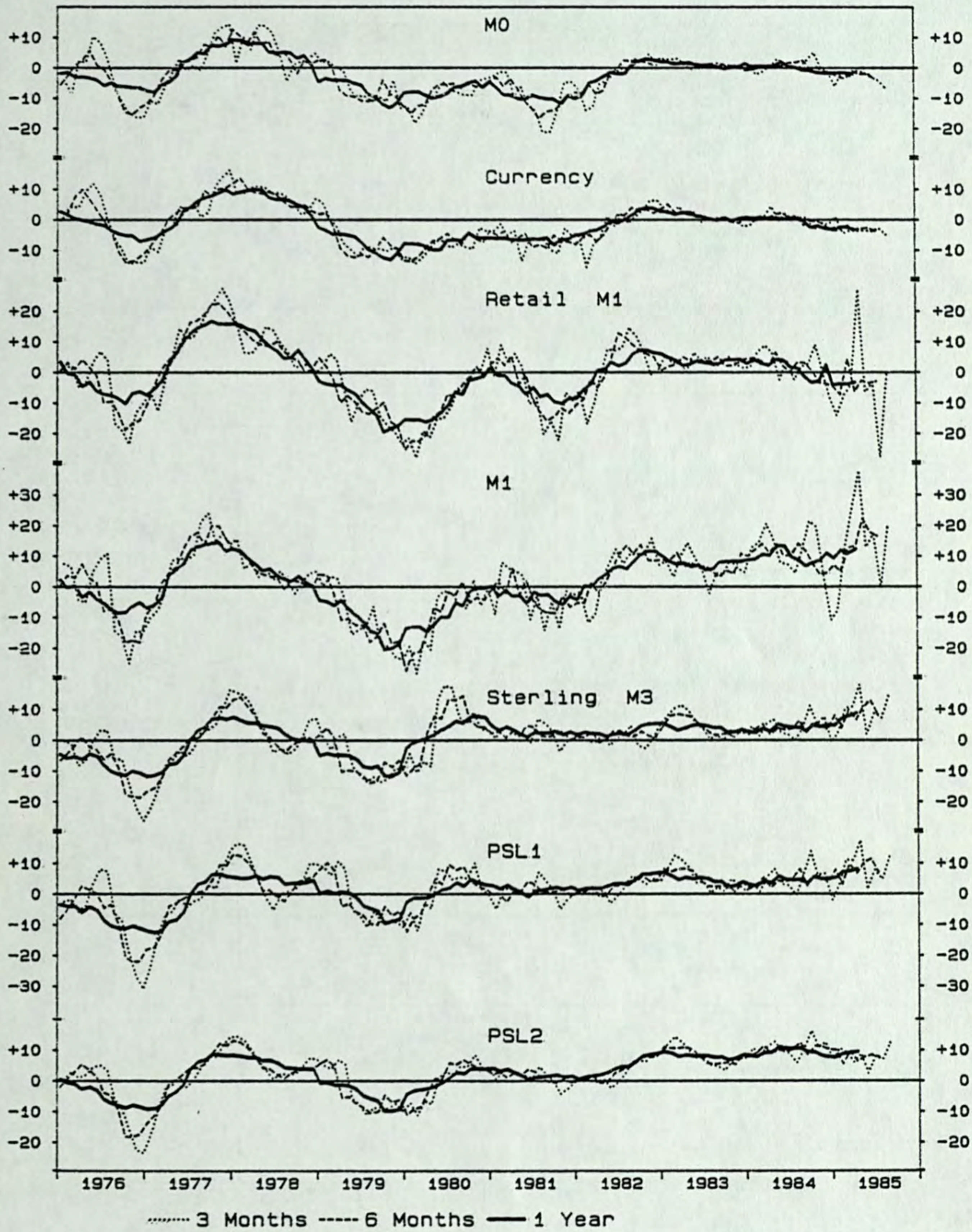
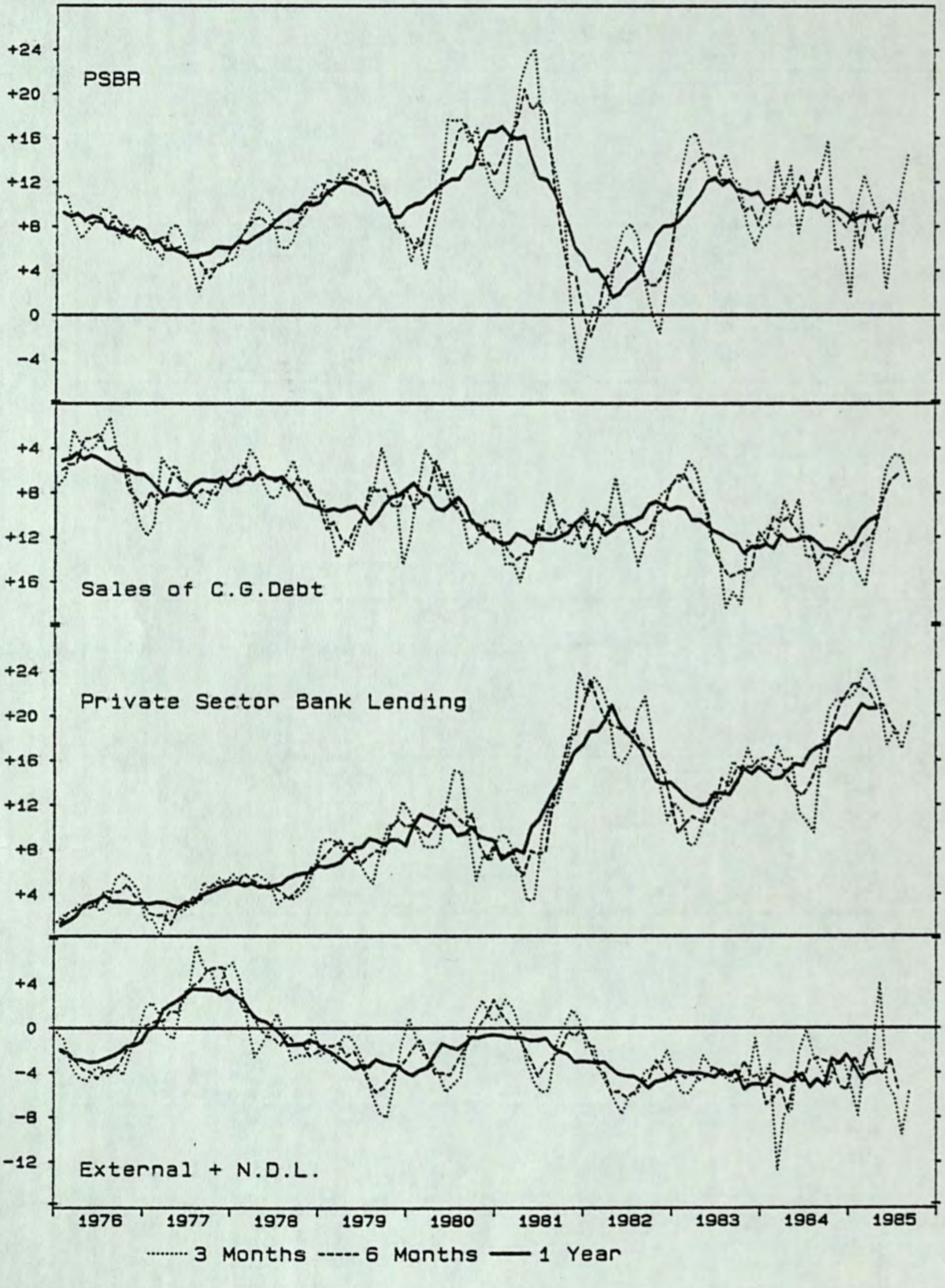


Chart 3 - Components of Monetary Growth (bns)



STATISTICS

reprinted from Bank of England, *Banking Statistics*

Money stock: amounts outstanding

[Table 11.1 in the *Quarterly Bulletin*]

£ millions

	Notes and coin in circulation with public	UK private sector sterling sight deposits: Non-interest-bearing[a]	UK private sector sterling sight deposits: Interest-bearing	Money stock M1[b]: Unadjusted	Money stock M1[b]: Seasonally adjusted	UK private sector sterling time deposits[c]	Money stock £M3[b][d]: Unadjusted	Money stock £M3[b][d]: Seasonally adjusted	UK private sector deposits in other currencies [c]	Money stock M3[b][d]: Unadjusted	Money stock M3[b][d]: Seasonally adjusted
	1	*2*	*3*	*4*		*5*	*6*		*7*	*8*	
Month ended											
1984 Sept. 19[e]	12,102	20,850	14,774	47,726	47,810	57,651	105,377	105,340	17,859	123,236	123,190
Oct. 17	12,115	21,022	15,483	48,620	48,510	57,359	105,979	105,800	17,958	123,937	123,760
Nov. 21	12,186	21,251	16,474	49,911	50,090	58,809	108,720	108,120	18,536	127,256	126,650
Dec. 12[e]	12,641	22,272	16,617	51,530	50,650	58,001	109,531	108,480	19,420	128,951	127,900
1985 Jan. 16	12,113	20,859	16,268	49,240	49,670	60,129	109,369	109,590	20,790	130,159	130,380
Feb. 20	12,210	20,476	16,041	48,727	49,530	60,307	109,034	109,920	21,372	130,406	131,290
Mar. 20[e]	12,322	20,604	16,981	49,907	50,490	59,468	109,375	110,880	20,356	129,731	131,230
Apr. 17	12,435	21,467	18,604	52,506	51,980	61,240	113,746	114,120	18,401	132,147	132,530
May 15	12,441	21,440	19,422	53,303	53,210	60,733	114,036	114,660	18,945	132,981	133,600
June 19[e][f]	12,438	23,496	19,412	55,346	55,370	61,747	117,093	117,270	18,974	136,067	136,230
July 17[f]	12,674	21,250	20,800	54,724	54,300	62,263	116,987	116,390	18,351	135,338	134,740
Aug. 21	12,658	21,169	21,915	55,742	56,030	63,309	119,051	118,570	19,328	138,379	137,900
Sept. 18[e]	12,536	21,253	22,238	56,027	56,070	64,895	120,922	120,720	19,738	140,660	140,450
Oct. 16	12,413	21,574	23,526	57,513	57,400	64,436	121,949	121,670	19,064	141,013	140,740

Money stock: changes[g]

[Table 11.2 in the *Quarterly Bulletin*]

£ millions: *percentages in italics*

	Notes and coin in circulation with public	UK private sector sterling sight deposits: Non-interest-bearing[a]	UK private sector sterling sight deposits: Interest-bearing	Money stock M1[b]		UK private sector sterling time deposits[c]	Money stock £M3[b][d]		UK private sector deposits in other currencies[c]: Transactions	UK private sector deposits in other currencies[c]: Valuation changes[h]	Money stock M3[b][d]	
	1	*2*	*3*	*4*		*5*	*6*		*7*		*8*	
Month ended (unadjusted)												
1984 Oct. 17	+ 13	+ 172	+ 709	+ 894		− 292	+ 602		− 404	+ 503	+ 701	
Nov. 21	+ 71	+ 229	+ 991	+ 1,291		+ 1,450	+ 2,741		+ 845	− 267	+ 3,319	
Dec. 12	+ 455	+ 919	+ 133	+ 1,507		− 1,162	+ 345		+ 468	+ 356	+ 1,169	
1985 Jan. 16	− 528	− 1,413	− 349	− 2,290		+ 2,128	− 162		+ 97	+ 1,273	+ 1,208	
Feb. 20	+ 97	− 383	− 227	− 513		+ 178	− 335		− 34	+ 616	+ 247	
Mar. 20	+ 112	+ 128	+ 940	+ 1,180		− 809	+ 371		− 105	− 921	− 655	
Apr. 17	+ 113	+ 863	+ 1,623	+ 2,599		+ 1,772	+ 4,371		+ 218	− 2,173	+ 2,416	
May 15	+ 6	− 27	+ 818	+ 797		− 552	+ 245		+ 336	+ 208	+ 789	
June 19[f]	− 3	+ 2,056	− 20	+ 2,033		+ 934	+ 2,967		+ 669	− 660	+ 2,976	
July 17[f]	+ 236	− 2,246	+ 1,388	− 622		+ 516	− 106		+ 737	− 1,360	− 729	
Aug. 21	− 16	− 81	+ 1,115	+ 1,018		+ 1,046	+ 2,064		+ 606	+ 371	+ 3,041	
Sept. 18	− 122	+ 87	+ 286	+ 251		+ 1,565	+ 1,816		− 213	+ 612	+ 2,215	
Oct. 16	− 123	+ 321	+ 1,288	+ 1,486		− 459	+ 1,027		+ 160	− 834	+ 353	
Month ended (seasonally adjusted)												
1984 Oct. 17	+ 41	+ 69	+ 590	+ 700	+ *1.5*	− 239	+ 461	+ *0.4*	− 404	+ 503	+ 560	+ *0.5*
Nov. 21	+ 58	+ 630	+ 894	+ 1,582	+ *3.3*	+ 731	+ 2,313	+ *2.2*	+ 845	− 267	+ 2,891	+ *2.3*
Dec. 12	− 47	+ 342	+ 150	+ 445	+ *0.9*	− 547	− 102	− *0.1*	+ 468	+ 356	+ 722	+ *0.6*
1985 Jan. 16	+ 119	− 692	− 411	− 984	− *1.9*	+ 2,077	+ 1,093	+ *1.0*	+ 97	+ 1,273	+ 2,463	+ *1.9*
Feb. 20	+ 46	− 23	− 164	− 141	− *0.3*	+ 458	+ 317	+ *0.3*	− 34	+ 616	+ 899	+ *0.7*
Mar. 20	+ 48	− 166	+ 1,077	+ 959	+ *1.9*	+ 20	+ 979	+ *0.9*	− 105	− 921	− 47	—
Apr. 17	− 16	+ 95	+ 1,416	+ 1,495	+ *3.0*	+ 1,760	+ 3,255	+ *2.9*	+ 218	− 2,173	+ 1,300	+ *1.0*
May 15	+ 80	+ 230	+ 915	+ 1,225	+ *2.4*	− 717	+ 508	+ *0.4*	+ 336	+ 208	+ 1,052	+ *0.8*
June 19[f]	+ 21	+ 2,044	+ 84	+ 2,149	+ *4.0*	+ 394	+ 2,543	+ *2.2*	+ 669	− 660	+ 2,552	+ *1.9*
July 17[f]	− 23	− 2,387	+ 1,338	− 1,072	− *1.9*	+ 234	− 838	− *0.7*	+ 737	− 1,360	− 1,461	− *1.1*
Aug. 21	+ 50	+ 492	+ 1,189	+ 1,731	+ *3.2*	+ 491	+ 2,222	+ *1.9*	+ 606	+ 371	+ 3,199	+ *2.4*
Sept. 18	+ 47	− 356	+ 319	+ 10	—	+ 2,107	+ 2,117	+ *1.8*	− 213	+ 612	+ 2,516	+ *1.8*
Oct. 16	− 96	+ 253	+ 1,167	+ 1,324	+ *2.4*	− 366	+ 958	+ *0.8*	+ 160	− 834	+ 284	+ *0.2*

[a] After deducting 60% of net debit transit items (see additional notes to Table 6 of the *Quarterly Bulletin*).

[b] M1 equals columns 1 + 2 + 3. £M3 equals M1 + column 5. M3 equals £M3 + column 7.

[c] Including certificates of deposit.

[d] Excluding public sector deposits.

[e] Changes in the monthly-reporting population occurred in these months. See also the additional notes to Table 3 in the *Quarterly Bulletin*, and, for June and September 1985, footnotes [b] and [c] respectively to Table H on page 5.

[f] The figures for the banking months of June and July 1985 are heavily distorted by the large flow of funds associated with the oversubscription to the sale of shares in Abbey Life Group p.l.c. These flows probably added substantial amounts to deposits and lending in banking June, but the distortion should have been unwound in banking July.

[g] Changes in the money stock may differ from those which can be calculated by reference to amounts outstanding. (See additional notes to Table 11 of the *Quarterly Bulletin*.) In December 1984, the changes are stated after the exclusion of the bank deposits of British Telecom PLC.

[h] See additional notes to Tables 6 and 11 of the *Quarterly Bulletin*.

An alternative presentation of counterparts to changes in £M3

[See page 529 in the December 1983 *Quarterly Bulletin*]

£ millions

	Public sector borrowing requirement (surplus -)[a]: Central government borrowing requirement	Public sector borrowing requirement: Other public sector contribution / Purchases (-) of public sector debt by UK private sector (other than banks): Other public sector debt	Purchases: Central government debt: British government stocks	Central government debt: Other	External and foreign currency finance of public sector (increase -): Purchases of British government stocks by overseas sector	External and foreign currency finance: Other [b]	Banks' sterling lending to UK private sector [c]	External and foreign currency transactions of UK banks [d]: Sterling deposits from, net of market loans to, banks abroad (increase -)	Other overseas sterling deposits (increase -)	Other sterling lending to overseas sector[e]	Banks' net foreign currency liabilities[f] (increase -)	Net non-deposit sterling liabilities (increase -)	Money stock £M3[a] (columns 1-13)
	1	*2 3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*	*12*	*13*	*14*
Month ended (unadjusted)													
1984 Oct. 17	+ 293	+ 50	- 877	- 580	+ 163	- 28	+ 3,136	- 253	- 637	+ 382	+ 72	- 1,119	+ 602
Nov. 21	+ 1,994	- 478	- 1,035	- 503	- 111	+ 87	+ 1,503	- 269	- 354	- 699	+ 188	+ 64	+ 2,741
Dec. 12	+ 773	- 79	- 501	- 30	+ 35	+ 90	+ 385	+ 177	- 95	+ 268	- 332	- 346	+ 345
1985 Jan. 16	- 2,005	+ 295	- 630	- 344	- 182	- 231	+ 3,012	+ 602	- 487	+ 357	- 384	- 165	- 162
Feb. 20	- 310	+ 93	- 1,552	- 8	- 407	- 252	+ 1,351	- 271	- 56	+ 201	+ 206	+ 670	- 335
Mar. 20	+ 361	+ 57	- 790	- 356	- 265	+ 49	+ 1,838	- 1,712	- 24	+ 164	+ 1,774	- 725	+ 371
Apr. 17	+ 2,785	+ 344	- 767	- 619	- 198	+ 124	+ 2,832	+ 376	- 288	+ 251	- 740	- 1,209	+ 4,371
May 15	+ 495	+ 67	- 586	- 112	- 347	+ 217	+ 873	+ 300	- 67	+ 261	- 468	- 388	+ 245
June 19[g]	+ 2,645	- 434	- 8	- 227	- 722	+ 267	+ 752	+ 415	- 255	- 268	+ 1,231	- 429	+ 2,967
July 17[g]	- 1,156	- 478	- 1	- 415	- 352	- 4	+ 3,104	- 4	- 236	- 407	+ 260	- 417	- 106
Aug. 21	+ 2,325	- 366	- 90	- 183	- 35	+ 49	+ 1,114	+ 282	- 591	- 602	- 170	+ 331	+ 2,064
Sept. 18	+ 1,685	- 319	- 293	- 52	- 59	+ 18	+ 401	+ 422	- 77	- 102	+ 212	- 20	+ 1,816
Oct. 16	+ 540	- 601	- 535	- 525		- 194	+ 3,435	+ 722	- 722	+ 177	+ 366	- 1,636	+ 1,027
Month ended (seasonally adjusted)													
1984 Oct. 17	+ 318	- 9	- 877	- 501	+ 163	- 35	+ 2,087			- 322		- 363	+ 461
Nov. 21	- 1,665	+ 397	- 1,035	- 403	- 111	+ 80	+ 1,691			+ 403		- 374	+ 2,313
Dec. 12	- 1,121	+ 195	- 501	+ 15	+ 35	+ 83	+ 1,581			+ 53		- 442	- 102
1985 Jan. 16	+ 317	+ 84	- 630	- 362	- 182	- 181	+ 2,131			+ 73		- 157	+ 1,093
Feb. 20	+ 819	+ 76	- 1,552	- 109	- 407	- 259	+ 1,698			- 13		+ 64	+ 317
Mar. 20	+ 1,214	+ 3	- 790	- 352	- 265	+ 45	+ 1,810			- 123		- 563	+ 979
Apr. 17	+ 912	+ 128	- 767	- 547	- 198	+ 121	+ 2,575			+ 1,443		- 412	+ 3,255
May 15	+ 389	- 4	- 586	- 121	- 347	+ 213	+ 1,445			+ 176		- 657	+ 508
June 19[g]	+ 769	- 18	- 8	- 269	- 722	+ 263	+ 1,373			+ 1,287		- 132	+ 2,543
July 17[g]	- 86	- 477	- 1	- 444	- 352	- 9	+ 1,528			- 442		- 555	- 838
Aug. 21	+ 2,096	- 355	- 90	- 320	- 35	+ 44	+ 1,757			- 963		+ 88	+ 2,222
Sept. 18	+ 1,973	- 334	- 293	- 15	- 59	+ 13	+ 966			+ 55		- 189	+ 2,117
Oct. 16	+ 890	- 662	- 535	- 477		- 199	+ 2,136			+ 565		- 760	+ 958

[a] Excluding public sector bank deposits.

[b] Including public sector foreign currency bank deposits.

[c] Including holdings of sterling certificates of deposit issued by building societies, and net purchases by the Issue Department of commercial bills and, from February 1985, of promissory notes relating to shipbuilding paper guaranteed by the Department of Trade and Industry.

[d] A seasonally-adjusted breakdown of these transactions is not available.

[e] Including net purchases of ECGD-backed promissory notes by the Issue Department.

[f] Including net non-deposit liabilities in foreign currency. (See the *quarterly Bulletin* for June 1985—page 185.)

[g] See footnote [f] to Table E on page 3.

M0, the wide monetary base

[Table 2 in the *Quarterly Bulletin*]

£ millions: *percentages in italics*

End-banking-month series

	Notes and coin in circulation outside the Bank of England: In circulation with public: Unadjusted	In circulation with public: Seasonally adjusted	Held by banks (till money): Unadjusted	Held by banks (till money): Seasonally adjusted	Bankers' deposits with the Banking Department: Operational deposits: Unadjusted	Cash ratio deposits: Unadjusted
	1		*2*		*3*	*4*
Amount outstanding at						
1984 Sept. 19	12,102	12,131	1,284	1,280	158	533
Oct. 17	12,115	12,172	1,235	1,250	153	533
Nov. 21	12,186	12,231	1,243	1,263	189	582
Dec. 12	12,641	12,184	1,385	1,241	205	582
1985 Jan. 16	12,113	12,304	1,320	1,299	190	582
Feb. 20	12,210	12,351	1,225	1,275	90	582
Mar. 20	12,322	12,400	1,231	1,296	29	582
Apr. 17	12,435	12,384	1,312	1,320	162	582
May 15	12,441	12,464	1,275	1,290	187	628
June 19	12,438	12,486	1,350	1,379	93	628
July 17	12,674	12,464	1,403	1,328	214	628
Aug. 21	12,658	12,514	1,468	1,420	100	628
Sept. 18	12,536	12,561	1,393	1,391	120	628
Oct. 16	12,413	12,466	1,436	1,451	94	628
Change in month ended						
1984 Oct. 17	+ 13	+ 41	- 49	- 31	- 5	—
Nov. 21	+ 71	+ 58	+ 8	+ 13	+ 36	+ 49
Dec. 12	+ 455	- 47	+ 142	- 22	+ 16	—
1985 Jan. 16	- 528	+ 119	- 65	+ 57	- 15	—
Feb. 20	+ 97	+ 46	- 95	- 24	- 100	—
Mar. 20	+ 112	+ 48	+ 6	+ 20	- 61	—
Apr. 17	+ 113	- 16	+ 81	+ 24	+ 133	—
May 15	+ 6	+ 80	- 37	- 30	+ 25	+ 46
June 19	- 3	+ 21	+ 75	+ 88	- 94	—
July 17	+ 236	- 23	+ 53	- 51	+ 121	—
Aug. 21	- 16	+ 50	+ 65	+ 92	- 114	—
Sept. 18	- 122	+ 47	- 75	- 29	+ 20	—
Oct. 16	- 123	- 96	+ 43	+ 60	- 26	—

Monthly-average series

	Notes and coin in circulation outside the Bank of England: Unadjusted	Notes and coin: Seasonally adjusted	Bankers' operational deposits with the Banking Department: Unadjusted	M0 (wide monetary base) (columns 5 + 6): Unadjusted	M0: Seasonally adjusted	
	5		*6*	*7*		
Average amount outstanding in month ended						
1984 Sept. 19	13,471	13,451	139	13,610	13,590	
Oct. 17	13,379	13,479	178	13,557	13,657	
Nov. 21	13,403	13,555	180	13,583	13,735	
Dec. 12	13,804	13,568	356	14,160	13,924	
1985 Jan. 16	14,222	13,701	139	14,361	13,840	
Feb. 20	13,411	13,698	177	13,588	13,875	
Mar. 20	13,542	13,784	144	13,686	13,928	
Apr. 17	13,907	13,864	162	14,069	14,026	
May 15	13,761	13,861	156	13,917	14,017	
June 19	13,888	13,944	178	14,066	14,122	
July 17	13,988	13,962	217	14,205	14,179	
Aug. 21	14,105	13,959	141	14,246	14,100	
Sept. 18	14,031	14,026	133	14,164	14,159	
Oct. 16	13,905	14,003	123	14,028	14,126	
Change in month ended						
1984 Oct. 17	- 92	+ 28	+ 39	- 53	+ 67	*+0.5*
Nov. 21	+ 24	+ 76	+ 2	+ 26	+ 78	*+0.6*
Dec. 12	+ 401	+ 13	+ 176	+ 577	+ 189	*+1.4*
1985 Jan. 16	+ 418	+ 133	- 217	+ 201	- 84	*-0.6*
Feb. 20	- 811	- 3	+ 38	- 773	35	*+0.3*
Mar. 20	+ 131	+ 86	- 33	+ 98	+ 53	*+0.4*
Apr. 17	+ 365	+ 80	+ 18	+ 383	+ 98	*+0.7*
May 15	- 146	- 3	- 6	- 152	- 9	*-0.1*
June 19	+ 127	+ 83	+ 22	+ 149	+ 105	*+0.7*
July 17	+ 100	+ 18	+ 39	+ 139	+ 57	*+0.4*
Aug. 21	+ 117	- 3	- 76	+ 41	- 79	*-0.6*
Sept. 18	- 74	+ 67	- 8	- 82	+ 59	*+0.4*
Oct. 16	- 126	- 23	- 10	- 136	- 33	*-0.2*

Transactions balances and components of M2

[Table 11.1 and 11.2 in the *Quarterly Bulletin*]

£ millions: *not seasonally adjusted*

	Notes and coin in circulation with public	UK private sector sterling non-interest-bearing sight deposits with banks[a]	Non-interest-bearing M1[b]	Other UK private sector sterling retail deposits with banks	UK private sector retail shares and deposits with building societies	National Savings Bank ordinary account	M2[b]	Public sector retail deposits with banks	Overseas retail deposits with banks
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*
Amounts outstanding									
1984 Oct. 17	12,115	21,022	33,137	30,863	64,411	1,749	130,160	1,089	3,289
Nov. 21	12,186	21,251	33,437	31,283	64,828	1,761	131,309	1,177	3,391
Dec. 12[c]	12,641	22,272	34,913	31,043	65,727	1,730	133,413	890	3,399
1985 Jan. 16	12,113	20,859	32,972	31,561	67,263	1,785	133,581	1,087	3,643
Feb. 20	12,210	20,476	32,686	31,815	67,542	1,758	133,801	1,104	3,651
Mar. 20[c]	12,322	20,604	32,926	32,453	67,892	1,762	135,033	1,094	3,753
Apr. 17	12,435	21,467	33,902	32,910	67,710	1,738	136,260	1,033	4,111
May 15	12,441	21,440	33,881	33,291	67,315	1,753	136,240	1,060	4,152
June 19[d]	12,438	23,496	35,934	33,893	68,096	1,751	139,674	1,086	4,186
July 17[d]	12,674	21,250	33,924	34,709	68,293	1,734	138,660	1,015	4,404
Aug. 21	12,658	21,169	33,827	35,004	68,294	1,741	138,866	993	4,452
Sept. 18[c]	12,536	21,253	33,789	35,188	68,783	1,731	139,491	885	4,475
Oct. 16	12,413	21,574	33,987	35,637	69,209	1,737	140,570	1,107	4,541
Changes in month ended [e]									
1984 Nov. 21	+ 71	+ 229	+ 300	+ 420	+ 417	+ 12	+1,149	+ 88	+ 102
Dec. 12	+ 455	+ 919	+1,374	− 240	+ 899	− 31	+2,002	− 287	+ 8
1985 Jan. 16	− 528	−1,413	−1,941	+ 518	+1,536	+ 55	+ 168	+ 197	+ 244
Feb. 20	+ 97	− 383	− 286	+ 254	+ 279	− 27	+ 220	+ 17	+ 8
Mar. 20	+ 112	+ 128	+ 240	+ 638	+ 350	+ 4	+1,232	− 10	+ 102
Apr. 17	+ 113	+ 863	+ 976	+ 457	− 182	− 24	+1,227	− 61	+ 358
May 15	+ 6	− 27	− 21	+ 381	− 395	+ 15	− 20	+ 27	+ 41
June 19[d]	− 3	+2,056	+ 2053	+ 602	+ 781	− 2	+3,434	+ 26	+ 34
July 17[d]	+ 236	−2,246	−2,010	+ 816	+ 197	− 17	−1,014	− 71	+ 218
Aug. 21	− 16	− 81	− 97	+ 295	+ 1	+ 7	+ 206	− 22	+ 48
Sept. 18	− 122	+ 87	− 35	+ 184	+ 489	− 10	+ 628	− 108	+ 23
Oct. 16	− 123	+ 321	+ 198	+ 449	+ 426	+ 6	+1,079	+ 222	+ 66

[a] After deducting 60% of net debit transit items (see additional notes to Table 6 of the *Quarterly Bulletin*).
[b] Non-interest-bearing M1 equals columns 1+2. M2 equals non-interest-bearing M1+columns 4+5+6.
[c] See footnote [e] to Table D on page 3.
[d] See footnote [f] to Table E on page 3.
[e] See footnote [g] to Table E on page 3.

Private sector liquidity, and other deposits

[Summary of Table 12 in the *Quarterly Bulletin*]

£ millions

	'Money'	Other money-market instruments	Savings institution deposits and securities		Certificates of tax deposit		PSL1 (columns 1+2+5)	PSL2 (columns 1+2+3+6)	PSL1	PSL2	Other shares and deposits with building societies	
	Seasonally adjusted	Seasonally adjusted	Seasonally adjusted		Seasonally adjusted		Seasonally adjusted	Seasonally adjusted	Seasonally adjusted change in month [b] [c]	Seasonally adjusted change in month [b] [c]	Unadjusted	
			Total (net)	*of which shares and deposits with building societies* [a]	Issues net of surrenders	Column 5 less building society holdings					Amount outstanding	Change in month
Month ended	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*	*12*
1984 Oct. 17	104,191	3,639	74,930	*71,398*	2,323	2,060	110,153	184,820	+ 864 *+0.8*	+2,340 *+1.3*	18,522	−119
Nov. 21	106,542	3,463	76,564	*72,883*	2,618	2,189	112,623	188,758	+2,467 *+2.2*	+3,932 *+2.1*	18,283	−239
Dec. 12	106,901	3,340	77,247	*73,641*	2,537	2,107	112,778	189,595	− 330 *−0.3*	+ 342 *+0.2*	18,145	−138
1985 Jan. 16	107,982	3,172	79,240	*75,614*	2,681	2,414	113,835	192,808	+1,056 *+0.9*	+3,195 *+1.7*	17,918	−227
Feb. 20	108,238	3,148	80,668	*76,957*	2,695	2,498	114,081	194,552	+ 243 *+0.2*	+1,724 *+0.9*	17,647	−271
Mar. 20	109,143	3,262	81,937	*77,982*	2,840	2,509	115,245	196,851	+1,191 *+1.0*	+2,313 *+1.2*	17,513	−134
Apr. 17	112,390	3,238	81,585	*77,896*	3,081	2,742	118,709	199,955	+3,469 *+3.0*	+3,089 *+1.6*	18,262	+749
May 15	112,924	3,085	81,732	*78,291*	2,975	2,634	118,984	200,375	+ 253 *+0.2*	+ 380 *+0.2*	19,052	+790
June 19[d]	115,488	3,307	82,420	*79,212*	2,900	2,539	121,695	203,754	+2,653 *+2.2*	+3,311 *+1.7*	19,349	+297
July 17[d]	114,569	3,303	83,205	*80,237*	3,062	2,672	120,934	203,749	− 718 *−0.6*	+ 33 *–*	19,485	+136
Aug. 21	116,762	3,080	84,085	*81,379*	2,929	2,530	122,771	206,457	+1,891 *+1.6*	+2,760 *+1.4*	19,647	+162
Sept. 18	118,902	2,961	85,092	*82,635*	2,696	2,296	124,559	209,251	+1,763 *+1.4*	+2,769 *+1.3*	19,375	−272
Oct. 16	119,854	2,935	86,377	*84,117*	2,993	2,537	125,782	211,703	+1,222 *+1.0*	+2,451 *+1.2*	19,003	−372

[a] Including UK non-bank private sector's holdings of certificates of deposit and time deposits issued by building societies.
[b] Percentage changes are shown in italics.
[c] In December 1984, the changes are stated after exclusion of the bank deposits and certain other liquid assets of British Telecom PLC.
[d] See footnote [f] to Table E on page 3.

NW
TF

CDP 11/xi

PRIME MINISTER

JOHNSON MATTHEY

I have spoken this evening to the Chief Whip who has also spoken to the Chancellor of the Exchequer.

The Chief Whip says that neither the Speaker nor the Clerk of the House was in the chamber at the time when Mr. Sedgemore made his allegations. The Clerk has subsequently read the transcript. He will be reporting to the Speaker but has said privately that he can well understand why the Chancellor is upset.

The Chief Whip sees two separate issues:

i) The Parliamentary propriety of accusing a Minister of perverting the course of justice. This is something on which the Speaker should pronounce quickly.

ii) The question whether the Speaker should say something on the lines that he deprecates Members making detailed allegations in the House which could be a matter for criminal proceedings if substantiated, rather than passing their evidence to the appropriate authorities.

The Chief Whip thinks we need to be careful in our public comment not to strengthen the Opposition's hand in calling for an inquiry. This could happen if we talk too much about wild and unsubstantiated allegations. (i.e. they would say that an inquiry was needed to show whether the allegations were wild etc.).

The Chief Whip is trying to get in touch with the Speaker over the weekend and will report to you on Monday.

CDP

MT

C.D. Powell
9 November 1985

GEBG

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

Brian Sedgemore Esq MP
House of Commons

6 November 1985

Brian Sedgemore

NBPM

JMB

Your letter of 25 October suggested that my answer to your questions of the previous day represented an attempt to interfere with the course of justice.

That suggestion is totally unfounded. I told you in my answer that: "If there are any matters for the police to pursue I am confident they will do so".

It is, of course, most important for the pursuit of justice that anyone with information which he believes to be relevant should pass it to the police at the earliest opportunity. I trust you will do just that.

Yours
Nigel

NIGEL LAWSON

EconPol PT 14

Domestic Monetary Policy

CC BG

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
TELEPHONE DIRECT LINE 01-215 5422
SWITCHBOARD 01-215 7877

JU518

Secretary of State for Trade and Industry

5 November 1985

CONFIDENTIAL

David Norgrove Esq
Private Secretary to the
Prime Minister
10 Downing Street
London SW1

Prime Minister 2
To note.
DRN
6/11

Dear David,

ANSBACHER

Please refer to my Secretary of State's minute of 28 October to the Prime Minister on this subject.

I am writing to let you know that the Bank of England have told us that they would prefer not to carry out an enquiry using their Banking Act powers since they do not believe that it would be a proper use of their powers. We have therefore put in hand our own Section 447 enquiry.

I am sending a copy of this letter to Rachel Lomax (HM Treasury) and to Henry Steel (Law Officers' Department).

Yours ever,

Michael

MICHAEL GILBERTSON
Private Secretary

999-1

ECON POL

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PT 14

CONFIDENTIAL

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LOSAN J.

10 DOWNING STREET

From the Private Secretary

SIR ROBERT ARMSTRONG

BUILDING SOCIETIES COMMISSION

Thank you for your minute of 28 October.

The Chancellor's minute was unexpectedly discussed at a meeting yesterday, before the Prime Minister had seen your minute. The Prime Minister agreed the Chancellor's proposals.

I imagine you will wish now separately to pursue your concerns about the definition of the roles and responsibilities of the Commission and the first Commissioner/Registrar.

DAVID NORGROVE

29 October 1985

CONFIDENTIAL

CONFIDENTIAL

flex

10 DOWNING STREET

From the Private Secretary

29 October 1985

ANSBACHER

The Prime Minister was grateful for your Secretary of State's minute of 28 October.

I am copying this letter to Rachel Lomax (H.M. Treasury) and to Henry Steel (Law Officers' Department).

DN

David Norgrove

Michael Gilbertson, Esq.
Department of Trade and Industry.

CONFIDENTIAL

CONFIDENTIAL

2

To note.

DCW

28/10.

PRIME MINISTER

ANSBACHER

At our meeting on 24 September, you asked me to consider, in consultation with the Attorney General, whether to institute an enquiry under Section 447, taking account of a letter which Lord Williams had sent to the Governor about the affair.

2 The Attorney General wrote to me on 27 September, after he had seen the letter that was written to the Governor. He did not consider that it was an adequate explanation and told me that the Director of Public Prosecutions thought that a Section 447 inquiry was the best way to see it. After careful consideration, I have decided that a Section 447 inquiry would be appropriate. From the limited evidence before us at present, there seems reason to believe that an interim statement may have been issued which at least some directors knew to be misleading.

3 I am very conscious, however, that banking supervision is outside my responsibilities. I am therefore exploring whether the Bank of England would prefer to undertake an inquiry using their Banking Act powers. If they are willing to front an inquiry that would be an effective equivalent to the Section 447 inquiry, I can see some advantages in proceeding in this way.

JF5ALW

4 I have considered whether my decision not to mount a Section 432 investigation on JMB might be unfavourably contrasted with action I now believe necessary on Ansbacher. I consider that the two cases are quite different and unconnected. The arguments against such an investigation into JMB - which are set out in my minute of 7 October to you - are quite unaffected.

5 I am copying this minute to Chancellor of the Exchequer, and the Attorney General.

L.B.

L B
28 October 1985

Department of Trade and Industry

JF5ALW

999-49

Econ Pol Pt 14

Domestic Monetary Policy

subject cc Master

CONFIDENTIAL

DCAAVB
cc Lord Chanc.

10 DOWNING STREET

From the Private Secretary

28 October 1985

BANKING SUPERVISION

The Prime Minister today discussed banking supervision with the Chancellor of the Exchequer and the Governor of the Bank of England. The Economic Secretary, Sir Peter Middleton, Mr. Cassell, Mr. Blunden, Mr. Galpin and Professor Brian Griffiths were also present. The meeting had before it the Chancellor's minute to the Prime Minister of 15 October, the Governor's letter of 24 October, your letter to me of 25 October and the Economic Secretary's minute of 25 October reporting his visit to the United States.

The Chancellor said his paper set out proposals for improving banking supervision. The aim was for legislation in 1986/87. He had it in mind to publish a White Paper in December. The starting point for the proposals was that the system of supervision followed in the UK was in many ways superior to that in other countries, but it needed to be strengthened. Action was being taken to strengthen staffing and the system itself needed to become somewhat less informal. The proposals drew on the lessons learned from the JMB affair, but changes would anyway have been needed. There was a wide measure of agreement between the Treasury and the Bank. The only significant difference was on the Treasury's proposal for a Banking Commission.

The meeting then discussed in turn the eight areas described in the Chancellor's minute to the Prime Minister of 15 October.

(i) The role of bank auditors

It was agreed that this was a key area. The present inhibitions on direct contacts between supervisors and auditors should be removed. The exceptional

CONFIDENTIAL

circumstances in which auditors would discuss a bank's affairs with the supervisors without the bank being present, against its wishes or without its knowledge, needed to be further discussed. The Head of the Government Accountancy Service, Mr. Wilson, had this in hand. The result should probably be included in a code of practice rather than in legislation. The Chancellor would report further when, he hoped, agreement had been reached.

(ii) Banking inspection

Agreed.

(iii) Two tier system of supervision

Agreed.

(iv) Reporting requirements

Agreed. It was however recognised that fines for late or inaccurate reporting would not be an alternative to on-site inspection. Fines might be effective in relation to small deposit takers. Visits by supervisors would be more effective against the larger institutions.

(v) Individual large exposures

Agreed.

(vi) Duty of supervisors

It was agreed that the new legislation should impose a more general duty in addition to the protection of depositors which was the basis of the 1979 Act. However the Chancellor and Governor would reconsider the wording of the proposed new duty, perhaps along the lines that the supervisors would "have regard to" the soundness and integrity of the banking system, rather than "maintain" it. The supervisors could not in practice be expected to fulfil so uncompromising an obligation, and to state it in that way could perhaps leave them open to legal action.

(vii) Improving professionalism

Agreed.

(viii) Banking Commission

The Chancellor explained that in many countries the duty of banking supervision was carried out by an organisation other than the central bank. This helped to avoid problems arising from the conflict of objectives. However the Chancellor accepted that it was undesirable to have two separate bodies here and such a change would in the UK context suggest a lack of confidence in the Governor and the Bank. The intention of the proposed Banking Commission was to build upon the existing system, whilst bringing conflicts of objectives fully into the open and giving added weight to the task of banking supervision.

The Governor spoke along the lines of his letter to the Prime Minister of 24 October. He shared the Chancellor's aims. However he was anxious that the proposed Banking Commission would produce too hybrid a system. An advisory body would avoid the blurred lines of responsibility which would be produced by setting up a Banking Commission. There could be difficulty in attracting people of adequate quality to the Commission. The problem of conflicts of objectives was not in practice substantial and indeed the lack of separation of the tasks was helpful, for example in providing a source of understanding of new banking instruments. To set up a Banking Commission would undermine the Bank's international role. It could also, by leading to a more overt system for payment by banks of the cost of supervision, pave the way to legal claims against the Bank when supervision failed. If the Government decided to pursue the proposal it would be necessary to prepare the way by discussions with the British Bankers Association and others.

The Prime Minister suggested that the extent of disagreement between the Treasury and Bank was perhaps not very large. She invited the Chancellor and the Governor to discuss the proposal further with a view if possible to arriving at an agreed view. In the meanwhile drafting on the other matters discussed in the meeting should go ahead with all speed.

The meeting briefly discussed the Chancellor's minute to the Prime Minister of 25 October about the proposal for a Building Societies Commission. The Economic Secretary explained that this was a freestanding proposal, and that the Building Societies would welcome the extension of responsibility for supervision from a single person to a Commission, though this was no reflection at all on the way in which the Registrar had carried out his responsibilities. The Prime Minister agreed that the Chancellor could proceed with an announcement as he had proposed.

Closing the discussion, the Prime Minister said the policy on conveyancing by Building Society solicitors needed to be decided before the Building Society legislation was introduced. The Government had made a clear pledge on this, which should be fulfilled.

I am copying this letter to John Bartlett (Bank of England). cc Lord Cayzer.

(David Norgrove)

Mrs. Rachel Lomax,
HM Treasury.

cc BG
Stehn.

Ref. A085/2726

MR NORGROVE

Building Societies Commission

The Chancellor of the Exchequer proposes in his minute of 25 October a reorganisation of the Registry of Friendly Societies.

2. The reorganisation would not produce a particularly tidy result, with the new Commission and the rump of the Registry between them forming a single non-Ministerial Department and some shared staff under a single head who would be both First Commissioner and Registrar. I have no reason, however, to dispute the Chancellor's judgment that the widening of the powers of supervision of building societies points to the vesting of those powers in a collectivity with relevant experience and expertise rather than in one individual. And no obvious alternative has been identified that would achieve the desired result more neatly.

3. For such an arrangement to work, it will be important that the respective roles and responsibilities of the Commission and the First Commissioner/Registrar, especially as regards accountability to Ministers, are properly thought through and understood by all concerned from the outset. I know that Treasury officials and the current Registrar have already addressed this issue, but it would bear underlining.

4. The Chancellor's minute acknowledges that the proposed Commissioner is likely to be replaced in due course by a single authority to supervise both banks and building societies. The Prime Minister is due to discuss arrangements for banking supervision with the Chancellor on Monday. In that context the current proposals for building societies can be seen as a step

towards a single supervisory authority, but they are not dependent on and do not prejudge the arrangements for banking supervision.

5. The Chancellor would like the establishment of the Commission to be announced on 1 November with other decisions on building societies legislation. I attach a draft minute which the Prime Minister might send approving the proposal.

RA

ROBERT ARMSTRONG

28 October 1985

DRAFT

CONFIDENTIAL

Draft minute from the Prime Minister to the Chancellor of the Exchequer

BUILDING SOCIETIES COMMISSION

Your minute of 25 October set out proposals for a reorganisation of the Registry of Friendly Societies.

I understand why you propose the establishment of a Commission to take on the wider supervisory powers that the Building Societies Bill will introduce. But the split of responsibilities between the Registry and the Commission and between the First Commissioner and the Commission as a collectivity will not be easy to manage in practice. It is therefore vital that all concerned understand at the outset their respective roles and responsibilities and that the arrangements for accountability are spelt out clearly. I understand that your officials with the Registrar have already drawn up an outline for such arrangements. These should be developed into a formal statement of responsibilities which Treasury Ministers can approve.

Subject to that I am content for the proposal to be announced on 1 November as you suggest.

I am copying this to Sir Robert Armstrong.

Prime Minister
Presumably the point is the proposed "Banking Commission."
N.L.W.
28.10

Ref. A085/2727

MR WICKS

I was rung up over the weekend by one of the non-executive directors of the Bank of England about one aspect of the Prime Minister's discussion of banking matters this afternoon.

2. I have not seen the papers, but I understand that there is one point upon which the Governor has put in advice which dissents from that given by the Treasury. The purpose of the call to me was to say that the Governor was supported in his view and advice on this matter by the Court of Directors, and to express the hope that a decision which went against the Governor's advice would not be taken hastily or without further consideration (to which it was no doubt hoped that the members of the Court would have an opportunity to contribute.

RA

ROBERT ARMSTRONG

28 October 1985

28. X.

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CONFIDENTIAL

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

PRIME MINISTER

BUILDING SOCIETIES COMMISSION

We are meeting on Monday to discuss the future supervision of banks. As background to that meeting, and because it is an important issue in its own right, you will want to be aware of the arrangements that I am now proposing for the supervision of building societies.

The Green Paper we published last year made it clear that the wider powers to be given to building societies would not be allowed to put at risk their reputation as a safe home for investors' money. This implies increased recognition by the directors of societies of their responsibility to protect the interests of investors. It also makes it necessary to strengthen prudential supervision.

I am satisfied that the right way to achieve this is to build on the existing supervisory structure. Responsibility for the framework of supervision must continue to rest with Ministers. But there is considerable advantage in separating responsibility for day-to-day supervision, and decisions on individual cases. I therefore rule out any closer direct Ministerial involvement. Nor is self-regulation appropriate. The supervisor of deposit-taking institutions must involve himself not just with standards of behaviour, but also with future commercial plans and viability to an extent which is impossible for a self-regulatory body. No other country has placed this type of supervision with a self-regulatory organisation.

I am, however, seeking to remove constraints on direct competition between banks and building societies. At some point, it will almost certainly make sense to bring their supervision under one authority. But I am satisfied that for an initial period after the new legislation the building societies will have to be supervised separately from banks. They will still be confined to generally less risky assets, and will require a less detailed style of supervision, with different capital adequacy and liquidity criteria.

The timescale for bringing supervision of banks and building societies together must depend in part on the future institutional arrangements for banking supervision, which we are due to discuss on Monday. It will also hinge on how rapidly the building societies themselves change, once the new legislation comes into effect, and on wider developments in financial markets.

The solution we adopt now must therefore make sense to building societies in a critical period of change, and facilitate the subsequent evolution of the supervisory structure for deposit-taking. It makes no sense from either point of view to establish a new quango.

The new Commission

I have therefore decided to leave supervision with what is now the Registry of Friendly Societies, but to make one important structural change.

The wider powers and responsibilities given to the supervisor in the new legislation would be more suitably vested in a body rather than in a single person. Both Parliament and the societies will be reassured that the wider powers will be consistently and fairly used if they are exercised by a group of people with appropriate experience, rather than concentrated on one individual. The Chief Registrar fully supports the proposal that the powers should be vested in a Commission, of which he would be chairman or First Commissioner, rather than in him alone.

The Commission would have, say, three full-time members who would be civil servants, and three or four part-time ones who would not. I would select the part-time members with a view to widening the expertise and experience available: they might include a recently retired building society chief executive, an accountant, a lawyer and possibly a senior banking supervisor. Collectively, well-chosen part-time members would greatly strengthen the supervisory authority.

The new Commission would take on only the supervision of the building societies. For it to assume all the functions of the Registry would both hinder any future reorganisation, and cause needless offence to friendly societies by ending the historic title of Registry of Friendly Societies. The department (at present 125 staff) is too small to split into two. The First Commissioner would therefore also hold the title of Chief Registrar, with statutory responsibility for registration functions, and for the supervision of friendly societies. He would remain Head of Departrment and Accounting Officer. He, and not the Commission, would be responsible for the deployment of the staff resources of the Department.

The Commission would report annually to Parliament. The Building Societies Bill will provide for appeal against the exercise of the Commission's severer statutory powers. All its individual decisions will also, of course, be subject to judicial review. The Commission will report confidentially to Treasury Ministers, in the same way as the Registrar now does.

Financing

I announced in the Green Paper that power would be taken to recover the costs of supervision from societies. The Commission will therefore be self-financing, although the combined Department will still have a Vote to which the normal rules of gross accounting will apply. The Chief Registrar has satisfied me that the Commission will be the most cost-effective way of securing supervision of the required standard, and in particular of securing the essential experience and expertise. Moreover, it could produce a public expenditure saving of some £800,000 in 1986-87, because it will give us reasonable cause to bring in the new charging system some six months earlier than would otherwise have been possible.

An amount that matters to the Treasury's own housekeeping

Staffing

It is increasingly difficult to attract suitably qualified staff to the Registry. This is at least in part due to the Victorian image of the Registry of Friendly Societies, epitomised by its now wholly inappropriate name. I share the Chief Registrar's view that the change proposed in this minute should enhance the status and attractiveness of the Registry as a place to work. This will be important as we seek to recruit supervisors who will take on the more demanding tasks implied by the new legislation.

Conclusion

I should be grateful to know that you are content with the reorganisation of the Registry of Friendly Societies, for which I propose to provide in the Building Societies Bill. This will enable it to perform more effectively the task of supervision of building societies under the new legislation.

It would remain a non-Ministerial department, but the task of supervising building societies would be vested in a Building Societies Commission, rather than in the Chief Registrar of Friendly Societies personally. In view of the tight timetable for the Bill, I have given officials contingent authority to draft instructions for Counsel.

If you are content with this proposal, I should like Ian Stewart to announce it in a speech on Friday 1 November, in which he will also be announcing other decisions which we have taken on the building societies legislation. It will be important for the Chief Registrar to give his staff prior warning of the proposal.

NL.

N.L.
25 October 1985

From Brian Sedgemore MP

HOUSE OF COMMONS
LONDON SW1A 0AA

Dnt to
NL

PC.

x26

25 October 1985

Dear Nigel

BANK OF ENGLAND
JMB

Your PQ answer to me of 24 October is a crude attempt to pre-empt a police enquiry into serious allegations and to interfere with the course of justice. As such you should be ashamed of yourself.

Sir Patrick Mayhew the Solicitor-General has repeatedly told me in letters and to my face that the police are independent of the Executive. How then can that be the case when you are telling the police in Parliamentary Answers that those accused are innocent before the enquiry is under way?

I take the gravest exception to what you have done. It is unworthy of a Cabinet Minister.

In the light of your conduct the only course now that would be seen to be fair would be for an independent enquiry to be set up. I appreciate that such an enquiry would now damage the government gravely but I can see no alternative.

I'm copying this letter to Sir Patrick and to the Prime Minister, both of whom I believe uphold the Rule of Law.

Yours

Brian

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
SW1P 3AG

Copy to: The Rt Hon Margaret Thatcher MP
Sir Patrick Mayhew QC MP

CONFIDENTIAL

CC BG.

For banking supervision meeting folder.

Treasury Chambers, Parliament Street, SWIP 3AG

PRIME MINISTER

25 October 1985

VISIT TO WASHINGTON AND NEW YORK : 22 - 28 SEPTEMBER

As background to your meeting on banking supervision on 28 October, you may find it helpful to have some impressions I formed during a recent visit to the United States.

The purpose of the visit was to study the American system of banking supervision; its place in the broader regulatory framework for financial institutions; and its impact on banks. This is highly relevant as we put the final touches to the Building Societies Bill and consider our policy on banking supervision.

In Washington, I saw Chairman Volcker, and senior officials of the Federal Home Loans Bank Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Treasury, and the Securities and Exchange Commission; and the staff of the House and Senate Committees on Banking. In New York, Hurricane Gloria notwithstanding, ? I called on Merrill Lynch, Burnham Drexel~~l~~ Lambert, Citibank, ? Chemical Bank and J ~~C~~ P Morgan. I also addressed the British-American Chamber of Commerce, and met members of the British banking community.

I am most grateful to the Ambassador and the Consul-General in New York for the full and interesting programme they assembled, and the efficiency of all their arrangements.

There are profound differences between the American and British banking systems, with which I need not trouble you. These stem from our widely different constitutional, political and financial conditions. There are, nevertheless, lessons to be learnt from developments in the United States, which are relevant to our own legislation.

(a) Codification vs flexibility

I was not attracted by the detailed codification of banking supervision practised in the United States. I detected considerable envy of our flexible system, and I remain convinced that we must maintain its fundamental character. An excess of statutory provision merely leads to observance of the letter of the law.

I also felt, however, that there were certain statutory elements which the Americans took for granted, and which we can usefully incorporate into our own legislation. The American supervisors and bankers whom I met were without exception amazed to discover that under our present banking legislation it does not constitute an offence to file late or inaccurate supervisory statistics with the Bank of England supervisors. They were also surprised at the absence from our legislation of a statutory obligation to report to the supervisors large exposures to single and related borrowers. One or two statutory benchmarks of this kind would underline the importance which Parliament attaches to compliance with supervision. They would not impinge materially on the flexible way in which the law is applied to individual institutions.

The Bank particularly do not like this idea

(b) De-regulation v supervision

At the political level in the United States, the use of slogans has led to a damaging conceptual confusion. Under the Reagan administration, "deregulation" has been a prime political objective. This means, of course, removing obstacles to competition, and creating "level playing fields" (a phrase we often hear in this country) for disparate financial institutions.

But Congress has not perceived that increasing freedoms to provide services competitively implies the need for a more effective supervisory system. "Supervision" has been equated with "regulation", and the supervisors have accordingly found it difficult to obtain a political hearing.

The twin problems of over-rapid "deregulation" and inadequate supervision are illustrated by the problems of the savings and loan institutions, or "thrifts", which are the nearest equivalent to our building societies. These institutions suddenly found themselves facing bankruptcy because high market interest rates forced Federal Government to remove the artificial limit on the interest rates payable on deposits, whilst their mortgage portfolios were almost invariably at fixed interest rates which were low compared with those currently prevailing. To help the thrifts make profits from other activities, legislation was rushed through enabling them to provide a wide range of services without adequate prudential checks. As a result, there have been several serious thrift failures, and literally thousands of these institutions are technically insolvent.

I draw two conclusions. First, I am reinforced in the view that our plan to allow only a gradual evolution of the building societies into more sophisticated financial institutions is right. And secondly, it is important - as we are proposing in the Building Societies Bill - that prudential powers should be correspondingly strengthened to cope with greater diversification by the supervised institutions.

(c) The dangers of deposit protection

Almost all banks and savings and loans in the United States must contribute to federal deposit protection funds. All deposits of up to $100,000 are insured, and in many cases protection extends to even larger sums. Brokers in any case split up large deposits into smaller units, so that they are in effect fully protected. There is no reason to think that normally prudent institutions have been tempted into unwise decisions by the existence of 100 per cent deposit protection. But it is undoubtedly true that irresponsible institutions, or those facing possible ruin like certain thrifts, have pursued reckless growth confident that at the end of the day the depositors will not lose out. As a result, the Federal insurance scheme covering thrifts will almost certainly become seriously insolvent, and even the Federal Deposit Insurance Corporation (FDIC) now looks far from sound, particularly since the rescue of Continental Illinois. The Americans see no political possibility of resiling from 100 per cent deposit protection, but strongly impressed upon us the dangers of moving in their direction.

Our own scheme under the Banking Act 1979 provides for up to 75 per cent of a maximum of £10,000 to be protected in the event of a Bank failure. I believe that we should stick to the principle of only partial protection of deposits, and keep the ceiling low, so that the scheme should be confined to its primary function of protecting small depositors. We propose to introduce proposals for building societies very similar to those for banks.

(d) Multiplicity of supervisors

For historical reasons, the responsibility for supervising banks is split amongst a large number of independent supervisory agencies. They have made only moderate progress towards full co-operation with each other, and compete with each other for influence, staff, and other resources. The result is wholly bad. The Americans are well aware of this, and urged us to avoid any unnecessary proliferation of institutions in our new supervisory legislation generally.

(e) Supervision of financial conglomerates

The Americans face the same problem as we do of making sure that financial conglomerate groups can be properly supervised. It is not sufficient for their various activities to be separately supervised by the relevant supervisors. An overall view of the risks faced by the organisation has to be taken. They impressed upon us the need to take advantage of new legislation to make adequate arrangements, and to ensure a central role for the banking supervisor in respect of any group which includes a material deposit-taking business.

(f) Staffing of supervisory bodies

Most of the American supervisors complained of rapid turnover of staff, and of the difficulty of attracting staff of a calibre adequate to keep pace with new financial instruments and with much more highly qualified commercial bankers, who were very substantially better remunerated. I was also struck by the frankness with which top management in the banks we visited admitted to not understanding fully the risks involved in many of the new off-balance sheet instruments.

We too face the problem of finding enough suitable human resources for our supervisory agencies. Both the Banking Supervision Division and the Registry of Friendly Societies are taking active steps to overcome it.

Inspection

The American supervisors found it astonishing that our own arrangements for banking supervision made no provision for on-site inspection. They all found this an invaluable aid to understanding how a bank worked, and forming a view of its reliability and financial standing. I was not persuaded that a fullscale system of inspection on the American model was efficient or desirable. But I was persuaded that our own supervisors should conduct considerably more on-site visits than they have done in the past.

I am copying this minute to Leon Brittan, in view of his interest in supervisory questions, to Her Majesty's Ambassador in Washington, and to the Governor of the Bank of England.

IS

IAN STEWART

25. X. 95

010

VR24

cc BG
B/UP.

CONFIDENTIAL

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

25 October 1985

David Norgrove Esq
10 Downing Street
London SW1

Dear David

STRUCTURE OF BANKING SUPERVISION

I attach a further note by officials explaining in more detail the proposal for a Banking Commission outlined in paragraph 56 of the main paper for the Prime Minister's meeting on Banking Supervision on Monday.

I am copying to John Bartlett (Bank of England).

Yours ever
Rachel.

RACHEL LOMAX

13/11.ms

CONFIDENTIAL

STRUCTURE OF BANKING SUPERVISION

Note by the Treasury

This note supplements the paper attached to the Chancellor's minute to the Prime Minister of 15 October. It sets out in more detail a possible model for a separate Board which would be charged with statutory responsibility for banking supervision. For convenience we have so far called this a "Banking Commission".

Background

2. Our objective is to improve the structure of supervision, while leaving responsibility for banking supervision with the Governor and day to day operation of supervision as at present with the staff of the Bank of England's banking supervision division.

3. The aims are:-

(a) to provide a clearer distinction between banking supervision and the other responsibilities and functions of the Governor and Bank, making any conflicts between them more explicit;

(b) to redress the balance of power between the supervisors and the rest of the Bank, enhancing the role of supervision and giving the supervisors a more independent role; and

(c) to make this clear in public.

It is recognised that the Court of the Bank of England is not, with its present membership, well suited to the task of overseeing banking supervision. The logic of the arguments would point to establishing a new and completely separate organisation for supervision. The present proposal is designed to achieve the advantages while avoiding administrative upheaval, new bureaucracy and any risk of undermining the authority of the Governor.

Responsibilities and Powers

4. The new Banking Bill would confer on the Board the responsibilities for protection of depositors, and authorisation and supervision of banks, currently given to the Bank of England under the 1979 Banking Act. If desired, it should be possible to establish a "shadow" Board in advance of the legislation.

5. The structure could open the way in time to bring the responsibilities for supervision of building societies and banks under one body.

6. The Board's powers would be those proposed for the banking supervisors in the main Treasury paper. It would, however, need a further power to permit mutual exchanges of supervisory information with the Bank of England as well as with other supervisors.

Division of responsibility between the Board and Bank of England

7. The Board would be responsible only for banking supervision. The Court would retain all of its other responsiblities, including its responsibility for decisions in potential rescue cases.

8. The Governor at present has two distinct roles. This structure would distinguish them further: as Governor of the Bank and as Chairman of the Board responsible for banking supervision. Where conflicts emerged - for example with monetary policy or policy on international debt - the Board would give

a clear expression of the supervisors' point of view. In some cases the Governor himself might be able to resolve such conflicts. In other cases it is right that they should be discussed more widely within Government.

Composition

9. The Governor would be ex-officio Chairman of a Board of, say, six or at most eight. The Deputy Governor and the Bank of England Director responsible for banking supervision would also be members. There would be broad balance between in house "Bank" members, and outsiders. The outsiders should not be "representative" of particular interest groups, but people with experience of banking business, former bankers and accountants.

10. We suggest that appointment should be by the Chancellor with the agreement of the Governor.

11. There is a need to maintain continuity, and demonstrable freedom from political interference. Terms of office might be of five years, with the first appointments staggered to avoid a complete change of personnel after the first five years. It should be difficult to dismiss members. This might perhaps be achieved by making dismissal possible only by the Chancellor with the agreement of the Governor, on demonstrable grounds that the member concerned is no longer "fit and proper".

Accountability

12. At present, the Bank of England is required, under the Banking Act 1979, to report annually to the Chancellor on its actions under the Act. The new Board would report directly and annually to Parliament. The Chancellor would continue to answer Parliamentary questions on the general policy of banking supervision, but would not be answerable to Parliament on the handling of individual cases.

Finance and Accounts

13. The statutorily distinct Board would produce separate accounts. As with the proposed Financial Services and Building Societies legislation, supervision would be self-financing, and paid for by the supervised institutions. The cost could either be met by fees or, as at present, from the profit the Bank of England makes from holding compulsory interest-free deposits from the major banks.

Relationship with responsibilities of the Court

14. The Governor and Bank already carry out functions that are not the responsibility of the Court. The Bank provides services to the Treasury on the note issue, gilt edged operations, and the operation of the foreign exchange reserves. The relationship with the new Board would be somewhat similar. In particular:-

(a) If we had a system of fees paid to the Board, the Bank could charge the Board for the services of the Supervision Department in the same way as the Treasury is now charged for services provided to it.

(b) Staffing of the Supervision Division would primarily be a matter for the Bank (and ultimately the Court), taking into account the views of members of the Board. The Supervision Division would be mainly staffed by career Bank of England staff who would continue to have wide career opportunities in the Bank. But it would also be important to provide for a proportion of inward secondees.

25 **October** 1985

CONFIDENTIAL

25 October 1985

PRIME MINISTER

BANKING SUPERVISION

The purpose of the Seminar on Monday should be to arrive at decisions regarding the substance of the forthcoming White Paper on Banking Supervision.

The papers by the Chancellor and the Governor raise four major issues:

a. the responsibility of auditors to report to supervisors;

b. the terms of reference for the supervisory body;

c. the method of supervision (inspection, staffing, disclosure, statutory requirements, reporting);

d. the organisation of supervision.

A fifth subject, which is mentioned en passant but not developed, is:

e. the prosecution of fraud.

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The Need for Perspective

It is important to remember that, by and large, banking supervision in London has a good record, and is greatly favoured by international banks over systems in other countries, largely because it is flexible and participative (variously described by George Blunden in the mid-Seventies as comparable to the Catholic confessional or marriage guidance counselling!). JMB revealed the system to be too casual and too dependent on the goodwill of individual bank management. Changes are needed, but the danger is to over-respond with too rigid and bureaucratic an approach.

Two useful tests which should be applied to any proposed change are:

1. If it had been in place at the time of JMB, how would the outcome of that affair have been different?

2. Would the proposed change drive business away from London?

The Proposals for Change

a. Responsibility of Auditors to report to Supervisors

Legal restriction on communication between auditors and supervisors must be removed. But if auditors are required to report to supervisors without the presence (and knowledge?) of management, there is the real danger that a lack of frankness might develop between auditors and management. **Perhaps auditors should be given initial responsibility to report matters to the banking clients' Audit Committee of Non-Executive Directors before reporting to the supervisors. How are the exceptional circumstances in which dialogue between auditors and supervisors should take place to be defined?**

b. Terms of Reference for the Supervisory Body

The proposal is to change this from "the protection of depositors" to "maintain the soundness and integrity of the banking system". The former is precise and readily understandable; the latter is general and vague and open to many different interpretations. **I should press the Chancellor as to why it needs to be changed.**

If, as I suspect, it may be to cover other non-deposit institutions, they should be included specifically, rather than by changing the terms of reference.

c. Methods of Supervision

The changes concerning banking inspection, two-tier system of supervision, individual large exposures, and

CONFIDENTIAL

improving professionalism of this supervision all seem reasonable.

Imposing fines for late reporting seems rather petty. Why not send supervisors to the institution concerned with power of inspection or, for repeated lateness, revoke the licence?

d. Organisation of Supervision

On this subject, I believe that the Chancellor's proposal is half-baked and messy, as well as a step on the road to a fully independent Banking Commission, which would some day include supervision of the building societies.

The reason for separating the monetary policy side from the banking supervision side of the Bank of England is a presumed conflict of interest. You may ask that these conflicts of interest should be elaborated, and examples given of when they have produced inadequate supervision.

If there are fundamental conflicts of interest, they will not be removed by organisational change. The only difference will be a change in the individual or body resolving the matter. Under the present system, the conflict is resolved by the Court of the Bank, which means in practice the Governor. If the Banking Commission were to be independent of the Bank, then it would be the Chancellor. If, as is proposed, supervision is the responsibility of the Commission, but the Governor is the Chairman of the Commission, then the conflict will still be resolved by the Governor. In other words, the changes do not achieve their intended result.

Most of the benefits of the proposed Banking Commission (raising the status of supervision and giving greater responsibility and power to outsiders) could be achieved just as well in the Bank's proposal for a Banking Supervision Advisory Board or Council, provided:

a. it had a majority of non-Bank members; and

b. if the Court chose to overrule the recommendations of the Commission, then the matter would automatically be reported to the Chancellor.

e. **Prosecution of fraud**

Great damage is done to the City, the market economy and the Government's image by fraud. Is there any evidence that the Fraud Investigation Group is proving a success? **Press the Treasury and Bank to be more** positive and less relaxed about this matter. There used to be (I think) a special court in the City of London dealing with complex financial matters, with a jury drawn from the City. Could this be resuscitated?

Conclusions

I would recommend the following:

Responsibility of Auditors to report to Supervisors

1. Auditors should be given initial responsibility to report matters to the banking clients' Audit Committee before reporting to the supervisor.

2. Press the Chancellor to define in the White Paper "the exceptional circumstances" in which dialogue between auditors and supervisors should take place.

Terms of Reference for the Supervisory Body

3. Press the Chancellor as to why the terms of reference need to be changed.

4. In place of fines, get supervisors sent to the institution concerned if it is late in reporting.

5. Reject the Treasury Banking Commission. Accept the proposed Banking Supervision Advisory Board, provided

   a. it has a majority of non-Bank members; and

   b. if the Court chooses to overrule the recommendations of the Commission, then the matter would automatically be reported to the Chancellor.

Fraud

6. Press the Treasury and the Bank to be more positive and less relaxed about fraud.

Brian Griffiths

BRIAN GRIFFITHS

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PRIME MINISTER

BANKING SUPERVISION

You are meeting the Chancellor and Governor on Monday afternoon at 1630 for two hours to discuss banking supervision. The Economic Secretary, Sir Peter Middleton, Frank Cassell and Messrs. Blunden and Galpin will also be present, with Brian Griffiths.

Papers are:-

Flag A	Brief by Brian Griffiths
Flag B	Paper by the Treasury under a covering minute by the Chancellor
Flag C	Supplementary note by the Treasury on the proposal for a Banking Commission
Flag D	Letter and paper from the Bank of England on the proposal for a Banking Commission
Flag E	Report by the Economic Secretary on his visit to the US
Flag F	Minute by the Chancellor on proposal for a Building Societies Commission

You might first invite the Chancellor and Governor to speak on the general approach being taken, which is based on a decision not to look for radical institutional change but instead to build on the present system, codifying some aspects. Is it accepted that this is the right approach?

Thereafter, the agenda is usefully set by the discussion of eight key areas starting on page 3 of the Chancellor's covering minute (Flag B).

I understand that of the changes discussed in the Treasury paper the Bank are primarily concerned about the proposals to introduce a statutory duty to provide statistical returns (!) and that for a Banking Commission. The second of these is of course by far the more important. The Bank are also discussing with the Treasury the proposal for a statutory duty to be placed on auditors. I understand that Mr. Wilson, the Accountancy Adviser to the Treasury, is chairing a group which involves both Treasury and Bank and there is a reasonable prospect of agreement being reached on this.

At the end of the meeting it would be worth having also some discussion of the proposal for a Building Societies Commission. it would be interesting to have the Governor's view of this (though it does not fall at present within his responsibilties and he has not seen the proposal in detail). However, I suggest you reserve judgement on this until Brian Griffiths has had a chance to look at it.

DN

DAVID NORGROVE

25 October 1985

cc BG Gretton pol.

cc DMcN

CONFIDENTIAL

Bank of England
London EC2R 8AH

The Governor

24 October 1985

The Rt Hon Margaret Thatcher MP
10 Downing Street
London SW1

Dear Prime Minister,

with DRN?

BANKING SUPERVISION

The Chancellor has sent you a note covering a paper by the Treasury ahead of the meeting scheduled for 28 October to discuss banking supervision. As he says, my officials and I have been consulted in the preparation of these papers and I am happy to say I am content with their broad thrust and most of the individual proposals. There are still a number of differences between us which I hope we can resolve in further discussion either between us or at your meeting. But there is a major point on which I wanted to write to you ahead of the meeting.

I fully share the Government's desire to improve, and in many ways tighten, the supervision of the banking system. The Review Committee set up by the Chancellor in the wake of the JMB affair, which I chaired, made a number of recommendations to this end which are incorporated in the present Treasury paper. As the paper points out, we are also engaged in a major increase in and enhancement of our supervisory resources in the Bank; and we are actively seeking to increase the professionalism of our supervisors by inward and outward secondments, more training etc. So much is common ground. But it is important that, in all this endeavour, a fundamental point is not lost. This is that the JMB affair, though extremely damaging, was an isolated event. It revealed a number of shortcomings in our supervision to which it is right and necessary for us to react. But equally it is important that we do not overreact to this isolated failure. The Bank of England's supervision of the banking system in London is widely regarded, by those who have experience of other more dirigiste regimes, as better than that practised anywhere else.

Our supervisory approach is certainly one of the reasons why the world's best banks continue to be attracted to do business in London. The main reason for the success of the present supervisory system would probably be regarded as its participative nature. The essence of the Bank's approach has always been to involve the banks themselves in responsibility for the supervisory process. A striking testimony to the effectiveness of this approach is that over the past two years, non-scheduled interviews with our supervisors - that is to say, interviews at the instigation of the institution itself rather than the Bank - have been as frequent as the regular scheduled interviews. Were the banks to stop coming to us to discuss proposed actions and developments, and simply wait until we could prove they had transgressed our regulations, our system would be greatly weakened. We should be much less well placed to identify potential problems before they had become actual.

This means that tightening regulations, introducing penalties and more statutory obligations will not necessarily bring unambiguous improvements in supervision. One must take account of the risk of a deterioration in the underlying relationship between the supervisor and the supervised; and of the risk that the supervised will be more inclined to stand on the letter of the law rather than comply with its spirit. This concern underlies a number of our differences with the Treasury paper. Some of these are only of emphasis, but one is of such importance that I have felt it necessary to put to you a separate submission on it.

This is the proposal for a Banking Commission. I sympathise with a number of the aims that underly the proposal; but I believe that, as formulated, it is fundamentally misconceived. It would trench on the authority of the Court; would blur lines of executive responsibility; and would detract, internationally as well as domestically, from the standing of the Bank and of the supervisors themselves. As we have indicated in the attached paper, it would be possible to achieve the Chancellor's main objectives by the creation of a body which was advisory rather than executive.

Yours ever,

Robin

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THE PROPOSAL FOR A BANKING COMMISSION

1 A number of things might be looked for from a Banking Commission: increased practitioner involvement in the supervisory process at the top level; greater public visibility and clearer accountability for banking supervision; and some degree of separation of the supervisory function from the other activities of the Bank of England.

2 The first two aims have the Bank's strong support. On the third, different views can be held in principle. It is certainly possible to carry out banking supervision through an organisation quite separate from the central bank. This is the practice in a number of important industrial countries where it does not lead to insuperable difficulties - though equally it has not led to better results than our present approach. There can in principle be conflicts between the demands of monetary policy, or macro-economic policy generally, and the obligations of the supervisors. In practice, however, these conflicts are less frequent and less difficult than is often thought. Moreover, our experience in this country and our observation of others suggests that any such conflicts are resolved better in a debate within the central bank rather than between different institutions.

3 There have, in our view, been a number of important advantages in having banking supervision as an integral part of the Bank of England. In the operation of monetary policy and the assessment of the significance of overall monetary developments we benefit greatly from the detailed knowledge of the banking system that comes from the supervisors. At the same time, the supervisors draw on the authority and standing of the Bank. The high regard for the Bank of England in this field has meant that we have from the start held the vital role of Chairman of the leading group of

supervisors and have provided from our staff or ex-staff the Secretary of the group. As a result, on matters of great importance for the coherent supervision of international banking such as parental responsibility and the consolidation of accounts throughout banking groups, our views have carried the day. With Chairmen and Secretaries from other countries, much less might have been done. If the Bank were dismissed as the supervisory agency here, our influence internationally would be bound to diminish.

4 There is also the practical point that, whether or not we should wish to set up a separate supervisory organisation if we were starting from scratch, we have to start from where we are. We have a large cadre of banking supervisors within the Bank of Engand and none outside. Any new body would have to be predominantly staffed by the people who do it now. For all these reasons we and the Treasury are in agreement that it would be wrong to try to take the whole of banking supervision out of the Bank.

5 If this is accepted, the question arises whether it would be possible to get some of the perceived benefits of separation from setting up a new executive banking commission to whom the existing supervisory staff would in some way be responsible. We believe the answer to this question is no.

6 A statutory executive supervisory commission of the kind suggested would result in a damaging, if not administratively impracticable, blurring of lines of responsibility. It is not clear to us what could be the relationship between this body and the Court on the one hand and Banking Supervision Division on the other. If commissioners were appointed with executive responsibility for supervisory policy decisions, they would have to concern themselves with the whole business of supervision - including the staffing and management of Banking Supervision Division. It is hard to see how a part-time body could properly fulfil that function; or to see how the Governor could be chairman of both Court and the commission without reinstating the

conflict of interest which it is the objective of the proposal to remove. The commission would in some sense be in charge of an important section of Bank of England staff up to and including the level of Executive Director; but that is a responsibility of the Court which they cannot waive while the supervisors remain an integral part of the Bank of England's staff. They would be required to serve two masters.

7 While we therefore oppose the creation of a new statutory executive supervisory body, we share the Treasury wish for greater senior practitioner involvement in, and a greater public visibility of, the supervisory function.

8 We believe these aims could be furthered by a new body which was advisory rather than executive. A Banking Supervisory Advisory Board or Council could be set up (and this could of course be done straight away without waiting for legislation). The membership would be much as envisaged in the Treasury paper: Governor as Chairman, Deputy Governor and the Executive Director in charge of supervision as ex officio members, and say up to six other members, two of whom would be a lawyer and an accountant. The others would be recently retired commercial bankers or former executives who were now non-executive members of their bank's board or its parent's board. This number would allow for experts from other fields to be co-opted if at any time there were accretions to the types of business for which Banking Supervision was required to take responsibility.

9 This body would meet regularly - perhaps monthly - and would review such matters as:

(a) all the policy initiatives and documents that were to be put out by the Bank of England on supervisory questions;

(b) regular reports on problem cases, developments in particular areas of the banking system and so on;

(c) the procedures and techniques, training and recruitment etc of Banking Supervision Division.

On all such questions the other members of the Council would tender the advice to the Governor. The advice would not be binding; but if the Governor decided not to accept it the question would have to be put to the Court for a final decision.

10 In this way there would be both in substance and in presentation a major input of experienced practitioner views on the whole range of supervisory questions. But the lines of responsibility for staff, management and decisions would clearly run through up to the Governors and the Court.

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SECRET

Prime Minister

JV
21/10

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

18 October 1985

Charles Powell Esq
10 Downing Street
London SW1

Dear Charles,

GOLD, JMB AND SOUTH AFRICA

Further to my letter of 4 October and your reply of 7 October, the Bank of England have now reported that an agreement has been reached under which, while JMB will not participate in the new gold swap now being negotiated, other members of the syndicate will be ready to allow JMB to participate once it is under new ownership. In effect, this extends the position that has obtained since last October's rescue without any of the repercussions on JMB's sale value which complete exclusion might have brought. Thus, commercially as well as diplomatically, a satisfactory compromise has been reached. It is not intended to disclose these arrangements publicly.

I am copying this letter to Len Appleyard (FCO).

Yours ever
Rachel

RACHEL LOMAX

Econ. Pol. Domestic Monetary Policy

Pt 14.

PRIME MINISTER

BANKING SUPERVISION

The Treasury's paper below is a good and rigorous piece of work.

General

The Chancellor's proposals would take UK banking supervision towards the formal regulation of other major banking centres. Even so, UK supervision would still be rather less stringent. No harm in that since London's position as a major banking centre owes much to the informality of our supervision. Nevertheless, it is difficult to avoid the impression that the Chancellor's proposals are only a stepping stone towards an even more regulated regime, which will gradually be forced on the authorities in the years ahead.

If that prognosis is right, the obvious question is - why not move straight away to a tougher regulatory environment, in the hope of avoiding some future banking scandals? The answer, it seems to me, is that we neither have the regulatory experience nor expertise to introduce, at this stage, a more developed regulatory system without falling into the trap of erecting an over-rigid structure - which inhibits legitimate banking enterprise.

The Chancellor's step-by-step approach therefore looks to be the right one, provided it is appreciated that it does not provide a water-tight system and that it will need development in the light of experience.

Bank Auditors

On the role of bank auditors, the Chancellor proposes that the legal inhibitions on their communication with banking supervisors should be removed. He is surely right in resisting the opposition to this from some large banks and

/ accountants.

accountants. If the auditors are not enlisted fully into the supervisory process, the alternative would have to be the establishment of a full-scale bank inspectorate. Highly expensive (costs would have to be borne by the banks), cumbersome and probably lacking in the right expertise.

The Banking Commission

Despite the Chancellor's protestation to the contrary, the proposed Banking "Commission" within the Bank of England does represent quite a major change in the organisation of banking supervision. It may well be seen as the first step towards taking supervision away from the Bank.

No need to object on those grounds. Indeed, it may be helpful to create in due course a body, separate from Government and the Bank of England, which can carry the can for the occasional banking failure, which is inevitable in a free market system.

Notification of Large Exposures

On the more detailed point of the notification of individual large exposures to the supervisors (point 5 of the Chancellor's minute and paragraphs 44-47 of the paper), you will want to consider the proposal that banks would have to justify to the supervisors loans that exceed 25 per cent of a bank's capital base. This could so easily become a system whereby responsibility for decisions on difficult loans is transferred from a bank's management to the supervisors.

N.L.W

Nigel Wicks

18 October 1985

CONFIDENTIAL

Prime Minister
To read if you have time - ready for the meeting on 28th October.
??
pp. DRN.
15/10.

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

PRIME MINISTER

BANKING SUPERVISION

We are to discuss banking supervision on 28 October, together with the Governor. I attach a note prepared by Treasury officials, with help from the Bank of England, as background for that discussion. I have discussed the note with the Governor.

This is, I am afraid, quite long, as it has to be to deal with what are complex issues. It describes the existing system of banking supervision and systems in operation in other countries. It also sets out the main proposals for change. We agreed the broad lines of these in the summer, before I made my statement to the House on 20 June.

As you know, following the rescue of Johnson Matthey Bankers, we carried out a substantial review of banking supervision, in a committee under the Governor's chairmanship. This review has been published. I told the House on 20 June that we would act as swiftly as possible to bring forward new legislation to improve banking supervision. This is involving intensive work by Treasury and Bank officials, and we are consulting widely.

The timetable is extremely tight. Our aim is to publish a White Paper at the end of this year, with a view to introducing a Bill in 1986. This will not be easy, but I believe we can achieve it, so long as we now take a few key decisions quickly. The proposals in the White Paper will not be set in concrete. In practice there is likely to be a continuing process of consultation. But it will be difficult to introduce important proposals later on which are not mentioned in the White Paper. Although most of the proposals are agreed between the Treasury and Bank, there are two or three issues on which the Governor and I have not yet reached final agreement. We will need to settle these at, or very soon after, your meeting if we are to stick to our timetable.

In many ways I believe our relatively flexible and informal system of banking supervision has served us well over the years. The Bank attach great importance to the active and willing co-operation they receive from the banks, and would not want to make any changes that inhibit this. Experience in other countries has been that systems of banking supervision based on detailed statutory rules have not prevented banking problems. Too much statutory prescription can encourage banks to follow the letter of rules, and not their spirit, and to operate right up to the maximum permitted limits. It tends to inhibit enterprise and undermine management responsibility. The fundamental principle should be that it is not the supervisor's task to manage banks, but rather to ensure that bank managements are doing their job in identifying and controlling risk.

Nevertheless, it is clear that arrangements hitherto have been too flexible. The JMB affair has made reform necessary and urgent. We need to introduce a greater degree of formality and to tighten up supervisory procedures. We need to increase the professionalism of banking supervisors and bring in more people, at all levels, with practical banking experience and a feel for the assessment of credit risk which is where things so often go wrong. I also see advantage in recognising in new legislation that the supervisory authority's responsibilities extend more widely than simply the protection of depositors. And I would wish to take the opportunity of legislation to build on and formalise some of the changes in the organisation of supervision recently announced by the Governor, and to achieve a greater separation between banking supervision and the Bank of England's central banking functions.

I see eight key areas where we need to make changes:-

(i) The role of bank auditors. Without a large scale inspectorate of the kind that exists in some other countries, the supervisors have to look to bank auditors to bring matters of concern to attention. I would not want to go as far as to make bank auditors directly responsible to the supervisors. This would be inconsistent with the general position and role of auditors under UK law. But we must remove legal inhibitions on communication between a bank's auditors and the banking supervisors, and provide a basis for a regular dialogue between the two that can in exceptional circumstances take place without the presence of the bank's management. This proposal has come in for some criticism from the large banks and some accountants, on the grounds that it could compromise the auditor-client relationship. But I am certain that it is essential.

(ii) Banking inspection. I am not proposing to develop a fully-fledged banking inspectorate. But I see clear advantages in the supervisors making regular visits to banks, and being in a position to make spot checks.

CHANCELLOR OF THE EXCHEQUER

(iii) Two-tier system of supervision. We have decided to abolish the two-tier system of banking supervision, with its distinction between banks and licensed deposit takers. It is clear that all deposit-taking institutions need to be supervised with equal care. This means that the term 'bank' will come to be used by a wider group of institutions; but at the same time, we will be raising minimum capital requirements for authorisation, and tightening up on the use of misleading banking names.

(iv) Reporting requirements. Returns made by banks to the supervisors are at present provided on a voluntary basis. I see prompt and accurate reporting as of sufficient importance for the obligation to be laid down in statute. The legislation should also provide for a system of fines that the supervisors could levy for late or inaccurate reporting. We need to have penalties available other than the ultimate weapon of revocation of a licence.

Visits by supervisors invited

(v) Individual large exposures. Such exposures have proved to be of particular importance in many bank failures. I propose, therefore, that there should be specific statutory rules for the notification of such exposures to the banking supervisors. I have in mind that loans exceeding 10 per cent of a bank's capital base (normally a little under 1 per cent of a bank's total lending) should automatically be reported and that loans that exceed 25 per cent of a bank's capital base, normally around 2 per cent of a bank's total lending, would only be permitted in exceptional circumstances, which would have to be justified to the supervisors. I believe that these percentages are consistent with banking prudence. ? if at all

(vi) Duty of supervisors. The only basis of the 1979 Act is the protection of depositors. In practice, it is a purpose of supervision also to guard against risks that could spread more widely in the banking 'system. I am proposing that the new legislation should impose a duty on the supervisors to maintain the soundness and integrity of the banking system, as well as the protection of depositors.

Small depositors

?? ?? More specific.

(vii) Improving professionalism of the supervisors. This is crucial. I welcome the steps the Governor is taking, in particular to arrange secondments to bring people with practical experience of banking and credit assessment into the Bank's supervision department.

(viii) A Banking Commission. I do not wish to propose major changes in the organisation of banking supervision. But I do see considerable advantage in achieving a greater separation between supervision and the Bank's other functions, to reduce the risk of internal conflicts of interest, if that can be achieved without unnecessary administrative upheaval. I am therefore much attracted by the creation by statute of a Banking "Commission" - in effect a board to oversee the work of the Bank of England's banking supervision department. I envisage that as well as a few full-time officials of the Bank, a Commission would include a number of outside members with relevant background and expertise. This is a way of bringing outside practical experience to bear at the highest level. The Commission should be chaired by the Governor. The legislation would confer the duties and powers of supervision on the Commission, rather than on the Governor and Court of the Bank of England. I believe this proposal would also serve to improve the status of the supervisors, and to give a new and better focus of public accountability for banking supervision.

What are the conflicts of interest?

Doesn't this mean that the Governor is supervising himself?

The Governor is still considering the proposal for a Banking Commission. He and I have asked officials urgently to work up in more detail what the constitution, and responsibilities of such a Commission might be. I understand he also wishes to discuss further whether there is a need to place a statutory duty on auditors to co-operate with the banking supervisors.

NL

N.L.
15 October 1985

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CONFIDENTIAL

BANKING SUPERVISION

I INTRODUCTION

This paper describes the present arrangements for banking supervision and discusses the main alternatives, with overseas comparisons. It also sets out the main proposals made for change, both administrative and statutory, the broad lines of which were agreed in the summer and set out in the Chancellor's statement to the House on 20 June.

II HISTORY OF PRESENT SYSTEM

2. Until the Banking Act 1979, supervision of the major UK banks was conducted on an informal basis by the Bank of England, without statutory powers. The Bank of England had no separate Supervision Division. There was a separate rudimentary system of licensing by the DTI for the smaller, or fringe banks, for which the Bank of England accepted no responsibility. After the fringe banking crisis of 1974 it was clear that more systematic and comprehensive supervision was needed. It was also necessary to develop formal, statutory, authorisation procedures to conform with the EC Credit Institutions Directive of 1977. It was decided that the Bank of England should undertake the supervision of all banks, and a separate supervisory division was formed.

3. The subsequent consultation led to the Banking Act 1979, passed by the Labour Government. Its principal purpose is to protect depositors. It gives the Bank of England a range of discretionary powers enabling it to authorise deposit-taking institutions, and to revoke authorisation. It established two categories of authorised institution, recognised banks and licensed deposit-takers. Broadly speaking, only the former are allowed to call themselves banks. Most of the Bank's powers relate to licensed deposit-takers since the Act was passed on

the basis that the informal supervision of the primary banking sector (ie the recognised banks), which had not been called into question by the 1974 crisis, would continue. The Act does not apply to institutions that take deposits only in wholesale markets. It established a deposit protection scheme.

4. Most countries with developed financial systems are reviewing or have recently reviewed their present methods of supervision. Financial markets, and the nature of banking itself are changing rapidly. New financial techniques are being developed; technological change is rapid; and financial businesses are becoming more and more international and multi purpose. These developments pose new risks, outrun legislation and complicate the task of supervision.

5. The regulatory framework has to keep pace with the rapid changes taking place in our financial system. Before the planned legislation on banking supervision is introduced, Bills will have been introduced early in the coming session to regulate investment businesses (the Financial Services Bill) and to permit a controlled evolution of building societies (the Building Societies Bill).

Review of the 1979 Act

6. During the period since the Act was passed, the Bank has raised a number of issues arising from its administration of the Act with a view to making improvements in the legislative framework for supervision when there was an opportunity for new legislation. The rescue of Johnson Matthey Bankers and rapidly changing markets have now made review an urgent priority.

7. The Chancellor announced in a Statement on 17 December 1984 that it was "clear that the [JMB] case raises important issues about our present procedures of banking supervision, and the legislative framework within which it is conducted". A Review Committee was established, under the Governor's chairmanship, and comprising senior officials of the Bank and Treasury, including Sir Peter Middleton. Its work was greatly assisted by the inclusion of Mr Derek Vander Weyer, a distinguished former

commercial banker. The Committee's report was published on 20 June 1985. Its main recommendations are described in Section IV below and in Annex 1.

8. In view of the urgency of its task, the group did not examine in detail the possibility of changing to a basically different system; but they concluded "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". In his Statement on 20 June, the Chancellor said that he had "accepted the report as a basis for immediate consultation", but would be "considering the Committee's proposals carefully". He also made it clear that although the Review Committee had addressed itself to supervisory lessons to be learnt from the JMB affair, officials were continuing with a thorough review of the whole of the Banking Act 1979. The Chancellor announced that a White Paper would be published later this year, with the intention of bringing a Banking Bill before the House as soon as possible.

The objectives of supervision

9. UK legislation is couched in terms of depositor protection. But in practice supervision protects the integrity and soundness of the financial system. At the same time it needs to permit efficient competitive banking. A good system of banking supervision is an important element in London's position as a major international banking centre.

10. The Chairman of the Federal Reserve Board, Mr Paul Volcker, recently described the objectives of supervision in the following terms:-

> "The most prominent among these is commonly referred to as 'safety and soundness'. That goal is directly related to protecting individual depositors but also has profound implications for the operation of the financial system and the economy as a whole. Commercial banks, in particular, are custodians of the largest share of the money supply, liquid assets and the

payments system. The stability of one part of the banking system rests increasingly on the soundness of the whole as the interrelationships among institutions become even more complex. In the last analysis, prospects for growth and stability in the economy as a whole must be premised on a strong and stable financial system."

11. No supervisory system guarantees against bank failures, and it would be wrong to seek to do so. Like the UK, other countries have had significant banking problems. Indeed it is fair to say that there have been more problems in other countries than in the UK, with the possible exception of France (though this probably owes more to fact that the French banking system is nationalised than to the supervisory arrangements). Banking necessarily involves taking risk with depositors' funds. In a free enterprise system depositors, managers and shareholders of banks must be free to take some risks, and, on occasion, suffer the consequences of wrong decisions. The partial (75 per cent of £10,000 maximum) cover given UK depositors by the statutory deposit protection scheme recognises this principle.

Too wide

12. Nor is it the job of the supervisor to manage the banks he supervises; or, indeed to duplicate the work of the external auditors. The supervisor's task is rather to make sure that management is doing its job in identifying and controlling risk.

13. Good supervision certainly should reduce the opportunities for fraud, for example, by keeping unfit people away from managing savings institutions. But it would be wrong to think that enhancing supervision is the answer to the problem of professional fraud. The Fraud Investigation Group (FIG) was established in January, with increased resources, to improve the police's ability to pursue serious fraud cases. This is important. There is no doubt that the City's reputation has suffered from alleged criminal activities at Lloyds and, in particular, by the absence of prosecutions for financial fraud.

III ACTION SO FAR AND LEGISLATIVE TIMETABLE

14. QL Committee has allocated a provisional firm place for

a Banking Bill in the Parliamentary programme for 1986/87. To meet the timetable the bulk of Parliamentary Counsel's instructions will have to be completed by the end of January 1986. A joint Treasury/Bank working group is now meeting regularly under Treasury chairmanship to prepare policy papers for Treasury Ministers.

15. The Bank of England has issued three consultative documents: on the legislative proposals which may feature in the White Paper; the relationship between auditors and supervisors; and on large exposures. The Bank is consulting the main banking associations and the auditing profession, and will shortly report the outcome. Because of the tight timetable, it is clear that consultation will in effect continue through to next year. It is intended that the White Paper published in December should contain firm recommendations; but there will have to be scope for modification in the light of representations.

16. Meanwhile action that need not wait for legislation is being pursued. On 25 September the Governor announced a range of moves designed to strengthen the Bank's supervisory capability. In addition to the senior staff appointments and an increase in the Bank's supervisory staff, inward and outward secondments are being stepped up, particularly with commercial banks and accountancy firms. The Governor has also appointed Mr Sid Procter, who is shortly to retire as Group Managing Director of the Royal Bank Group, as adviser on supervisory matters. The aim is to create a supervisory apparatus with, to quote Mr Volcker again, a "high degree of continuity, consistency, independence and professionalism".

17. The Bank is also seeking, ahead of legislation, to initiate a dialogue with the auditors of supervised institutions. It is taking further steps to ensure that the banks have effective internal control systems, and encouraging them to appoint finance directors and audit committees. Visits to bank premises by the supervisors are being stepped up. The supervisors are insisting on comfort letters from all significant shareholders in United Kingdom banks, and monitoring more closely the ability

of parent companies and other large shareholders to honour their undertakings.

IV SYSTEMS OF SUPERVISION

18. The British system is characterised by its flexibility and the part played by the voluntary co-operation of banks. Apart from the process of authorisation, under present legislation the Bank has no clear statutory duty to supervise. The prudential ratios and other controls prescribed by the Bank of England are agreed with institutions individually, and are not specified in statute. Though deriving from the Bank's statutory authority, they do not have statutory force. Statistical returns are made voluntarily. The supervisory process depends on a continuing relationship between the management of an institution and the supervisors. It depends heavily on mutual trust.

19. There are, of course, other ways of supervising banks. The table at Annex 2 sets out the key elements of supervisory systems operated in France, Germany, Switzerland and the United States. National systems have evolved in widely different ways, reflecting differences in historical development, institutions and legal systems. Whilst some aspects of overseas practice may look attractive, they would not necessarily transplant easily.

20. An important differentiating feature amongst supervisory systems is the degree to which they rely on specific statutory rules. The UK system probably relies less than any other on specific statutory rules. At the opposite end of the spectrum are the systems based on detailed rules and regulations set out in statute. The French system lays down in regulations risk asset ratio levels; rules for liquidity; and limits on large exposures. The German and Swiss systems are similarly enshrined in detailed legislation. The corollary of detailed prescription is an elaborate system of enforcement and penalties.

21. Although the United States has a large volume of detailed regulation, this has grown up piecemeal over the years, and

partly reflects tensions between different supervisory bodies and between State and Federal supervisors.

22. There are superficial attractions in a heavily regulated system in that if the penalties for breaching the rules are severe enough, and the supervisory aparatus is doing its job, it should in principle build caution into the system, and reduce the likelihood of failure. In a narrow sense the task of the supervisor is certainly easier, since departures from the prescribed norm are easily identified.

23. But there are dangers in such an approach, which has not avoided problems in other countries. In Germany, Switzerland, Canada and the United States, there have been bank failures and serious problems in recent years. Conformity with the regulations has not guaranteed good decisions by managements. In practice it can have the opposite effect, encouraging both banks and supervisors to abide by the letter of the rules and ignore their spirit and underlying purpose. Specific statutory 'ceilings' may in fact encourage banks, including the less experienced, skilled or substantial organisations, to operate right up to the maximum permitted levels.

24. There are other arguments against detailed statutory prescription. In particular it can inhibit diversity. One of the strengths of the UK system is that it permits prudential guidelines to be tailored to individual cases. This has allowed the development in London of a variety of banks and deposit-taking institutions specialising in different ways. It seems likely that our relatively flexible supervisory regime has been an important positive factor in the growth of London's role as the world's most important international banking centre.

25. However, whilst it is clearly necessary to avoid these dangers, there may be lessons to learn from other countries' systems and some element of statutory prescription in key areas should not be ruled out. There are certain aspects of the supervisory process which may well be of sufficient importance to warrant specific statutory backing. This would serve symbolically to emphasise certain key elements of supervision.

It would also provide a statutory basis for the imposition of fines and penalties for non-compliance in certain key areas, short of the ultimate weapon of revocation of a licence. The Treasury is therefore considering the feasibility of making prompt submissions of accurate statistical returns obligatory, with penalties, in the form of fines, for non-compliance. Because the problem of large and related exposures is at the root of so many bank failures, consideration is also being given to whether this too should not be the subject of statutory provisions. (In this area, it may be possible to avoid the worst problems associated with statutory ceilings by providing statutory requirements for the notification of exposures above a certain size - see paragraph 47.)

26. Considerable care would need to be taken in expressing such statutory requirements and penalties. There are problems of definition. A system of fines would need to allow for special circumstances. This might be achieved by prescribing maximum fines, but leaving discretion with the supervisors about whether to levy a fine, and if so at what level within the maximum, in particular cases. The maxima should relate to the seriousness of the 'offence' and, possibly, to the size of the institution. An appeals procedure would be required. Where necessary, financial penalties would have to be accompanied by appropriate supervisory action, for example a special investigation by the supervisors, or the imposition of conditions which the bank would have to meet to avoid revocation of authorisation.

IV MAIN ELEMENTS OF NEW LEGISLATION

27. Annex 1 sets out the main elements of the proposed legislation, as seen at present. In general these derive from the recommendations of the Review Committee.

28. The present Act is couched in terms of depositor protection. The Review Committee addressed itself to modifications of the present Act, without fundamental reconsideration of its scope. However, as noted earlier, the objectives of supervision include both protection of individual depositors and protection of the system as a whole. There is therefore a strong case for

acknowledging in statute the full role of a supervisory system in maintaining the integrity and soundness of the financial system as well as the protection of depositors. The present Act's concentration on the latter has the effect of putting outside its supervisory controls some institutions which do not take small deposits but which nevertheless have a part in the financial system as a whole - and whose difficulties could pose a threat to that system. At a time of innovation and change in financial markets - and particularly when we are tightening-up on supervision - it may be that more institutions will choose to operate in such a way as to remain outside the scope of a supervisory system aimed at protecting depositors. Whilst the Bank has traditionally sought to monitor and regulate activities in the financial markets overall, in most areas it relies on informal methods not supported by statutory powers and obligations.

29. Since it is likely that the changes to the 1979 Act already proposed are sufficiently extensive to justify a de novo Bill, further consideration is therefore being given to how the basis for the new Act could be extended to encompass the role of supervision in maintaining the soundness of the system, as well as the protection of depositors. It must be recognised, however, that we could not contemplate far-reaching changes in this respect without endangering the present extremely tight timetable for legislation.

30. These issues are also related to the question of the supervision of the increasing number of conglomerate financial institutions. The activities of conglomerates embracing deposit-taking, investment and insurance businesses will be the concern of several supervisory institutions. Problems arising in one area of business may feed across to others and, by contagion, to the wider financial system. The banking system, with its largescale interrelated dealings, would be the main vehicle of contagion; and, with a high level of liquid funds and relying as it does on a high degree of confidence, the banking system is also particularly vulnerable to the effects of such contagion. So the banking supervisors will have a special interest in the supervision of financial conglomerates. In these circumstances,

it will be essential that the different supervisory authorities cooperate with each other and are able to exchange relevant supervisory information. It is therefore proposed that the new legislation should relax existing requirements for the confidentiality of supervisory information to enable co-operation between supervisors.

31. As they now stand, the main features of the proposed legislation are as follows.

Relationship between supervisors and auditors

32. The Review Committee proposed that a mechanism should be established to enable a regular dialogue to take place between the supervisors and banks' auditors. This might include, for example, the auditors making a report to the Bank each year on the effectiveness of banks' internal control systems. The Institutes of Chartered Accountants of England and Wales and of Scotland gave evidence before these recommendations were advanced, and they have the Institutes' broad support.

33. The proposals derive from the fact that in the course of their duties, auditors and supervisors respectively unearth information and make judgments relevant to the effective performance of the other's functions. Both are at present inhibited by statutory or common law restraints from passing information to third parties, without the authority of the institution concerned; the supervisors by the Banking Act 1979, the auditors by the duty of professional confidentiality which they consider they owe to their clients. Although in many cases consent to disclose would be forthcoming and communication procedures would include the client bank, it is in just those cases where contact would be most useful that it is likely to be refused. Hence the need for legislative action to permit a dialogue without the participation or knowledge of the supervised institution in the last resort.

34. In other countries, notably Switzerland and Germany, auditors have a definite responsibility to the banking supervisors. In the UK, such an arrangement might conflict with the statutory duties of auditors, which are owed primarily to the shareholders

What are the statutory duties of auditors?

rather than to the depositors of a bank, and it would also undermine the traditional relationship between the auditors and the management of a client company. Principally, therefore, the proposed new arrangements would allow a dialogue between supervisors and auditors by removing existing constraints rather by introducing new obligations. But in order to make this dialogue effective, it might be necessary to provide for bank auditors to have a duty to co-operate with and to take part in annual meetings with the supervisors. Auditors would be free, but not obliged, to instigate more frequent or 'ad hoc' contact with the supervisors. This additional proposal is therefore also under consideration.

35. Two other proposals are aimed at keeping up the standard of Bank auditors. First that the Bank should be able to require a bank to appoint a second firm of accountants to carry out an investigation covering similar ground to a statutory audit, at the expense of the bank. The Review Committee also recommend that in cases of serious misconduct by a bank auditor, the Bank should be able to provide information to the auditor's professional body, so that it can consider instituting disciplinary proceedings.

36. These proposals mark important and necessary changes in the role of auditors of banks. In his statement of 20 June, the Chancellor strongly endorsed the proposal of a dialogue between auditors and supervisors. The Opposition indicated general support. It is clear, however, from some responses to the Bank of England's consultative paper that some members of the profession and some influential banks have reservations about the changes implied for the traditional relationship between auditors and their clients.

The two-tier system

37. The second major change proposed by the Review Committee was abolition of the distinction between banks and licensed deposit-takers. As already noted, the original intention was to create two categories, distinguished by both status and function. Recognised banks are required to have high reputation, standing, integrity and professionalism, and to provide a wide

range of services, LDTs have to meet a lesser test; to be run prudently by fit and proper persons. Banks have to have minimum net assets of £5m. For licensed deposit-takers the figure is £250,000. The principles underlying this distinction were that the Bank was to continue its traditional informal supervision of the primary banks and, by restricting the use of banking names and descriptions to the senior category, that depositors would in some way be sensible to the increased risk of depositing with an LDT.

38. But in practice, recognised bank status has not always guaranteed prudence and co-operation. The actual administration of the two tier system has required resources out of proportion to the benefits and has in some respects proved counter-prudential. JMB was a recognised bank. If the Bank of England's powers in respect of LDTs had extended to JMB, it is arguable that its problems would have been detected sooner. It is now proposed to introduce a single supervisory regime; a single set of criteria for authorisation; and to establish a minimum figure of £1m net assets, applicable to all authorised institutions.

39. There is wide support for the introduction of such a unitary system of supervision. However, one consequence of a unitary system - that all authorised institutions should be free to use "bank" in their name - has caused concern on the grounds that the popular understanding of the word "bank" would allow certain institutions to attract funds on a misleading basis.

40. But limiting the use of "bank" would inevitably re-introduce a form of two-tier system since the privileged group would have to be distinguished on the basis of prudential criteria relevant to supervision. Nor would it be reasonable to prevent the use by any authorised institution of descriptions of business involving "banking services" or similar phrases, even if banking names were more strictly controlled.

41. The proposed changes address this problem in three ways. First, the overall system of authorisation and supervision is being improved and tightened for all institutions. More than

ever, there should be no question of 'fringe' institutions obtaining authorisation or operating imprudently. Second, it is proposed that the minimum net assets required for authorisation should be raised from £250,000 to £1 million. Third, it is proposed that new powers should be taken to allow the supervisors to prevent the use by individual institutions of banking names which are misleading, for example, with regard to the institutions standing or importance. To take a somewhat extreme example an institution with only one branch would not, for example, be permitted to call itself the "Grand Universal Bank".

The Bank's powers

42. Most of the powers given to the Bank by the 1979 Act apply only to LDTs. It is now proposed to make them applicable to all authorised institutions, and to strengthen certain of the supervisors' powers (see Annex 1 for details).

An Inspectorate?

43. The Review Committee's recommendations fall well short of a fully-fledged inspectorate like the French system. There are however evident advantages in a system which would increase familiarity with banks on their own ground, and which could be used to perform spot checks.

Large exposures

44. The Bank published a consultative paper on large exposures in July. It is based on the conclusions of the Review Committee, which endorsed the Bank's existing policy of monitoring and investigating all exposures in excess of 10 per cent of a bank's capital base* and added that no exposure to an individual borrower (or group of closely related borrowers taken together) should exceed 25 per cent of a bank's capital base, except in the most exceptional circumstances, which would need to be justified to the supervisors.

45. A comparison with foreign practice invites two questions:-

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* For a major UK bank, 10 per cent of capital base is likely to be equivalent to ½-1 per cent of total lending.

(a) Are the figures of 10 per cent and 25 per cent consistent with banking prudence?

(b) Should the trigger of 10 per cent or the ceiling of 25 per cent, or both, be statutory obligations, rather than supervisory requirements without automatic sanction?

46. It seems clear that the answer to the first question is "yes". The overseas comparisons at Annex 2 show that whilst specific rules differ from country to country, those now proposed will be among the most conservative. For example in France the limit is 50%. It may also be of interest that it is proving difficult to reach agreement amongst EC countries on a ceiling as low as 40 per cent. Any more restrictive guideline would put British banks at a serious disadvantage in relation to overseas competitors. And it is necessary to allow for cases where, for example, there is a large exposure but for only a short period of time or where the supervisors can have regard to other factors, such as the resources available to the large parent of a small deposit-taking institution.

47. The answer to (b) is less clear cut. It is certainly true that large exposures lie behind many bank failures, and there is therefore a case, both in terms of enforcement and as a symbol of its importance for statutory rules in this area. But there are difficulties. First there is the problem of defining exposure legally - which will be made worse by the proliferation of new financial instruments and corporate structures. There is also the risk that a formal rule could encourage banks to lend up to the limit. But these arguments would not seem to outweigh the prospects offered by the inclusion in statute, or statutory regulations, of rigorous notification procedures. The Treasury will be considering this point further with the Bank in the light of responses to the Bank's consultative document.

Other legislative proposals

48. The more important of the Review Committee's other proposals are set out in Annex 1.

V ORGANISATION OF SUPERVISION

49. Under the Banking Act 1979, the system of recognition and licensing is entrusted to the Bank of England. The Bank has a duty to report annually to the Chancellor of the Exchequer on its activities in that year in the exercise of its functions under the Act and this report must be laid before Parliament and published. The Chancellor is responsible to Parliament for the legal framework of banking supervision. In practice he is given policy advice by Treasury and Bank of England officials working closely together. On specific supervisory matters, however, the Banking Supervision Division answers only to the Governors and Court of the Bank of England. There is a right of appeal, to the Chancellor, against decisions on authorisation and revocation, when he has the advice of an appointed, independent tribunal.

50. Foreign practice varies. Swiss supervision is conducted by the Federal Banking Commission, which is quite separate from the Central Bank. In Germany, the Federal Banking Supervisory Office, based in Berlin, reports to the Ministry of Finance in Bonn. It is responsible for detailed regulation, but works closely with the Bundesbank, which plays a dominant role in determination of ratios, and collects and processes supervisory data. The United States regulatory apparatus is complex. Different categories of banks are supervised respectively by the Comptroller of the Currency (based in the US Treasury) and by the Federal Reserve. The Federal Deposit Insurance Commission also has supervisory responsibilities. Most of the States also operate their own supervisory bodies. There is competition between the agencies, and divided responsibility tends to blunt the authorities' response to crises. The Belgians have a separate banking commission. In the Netherlands, and Italy the Central Bank is the supervisor. The French have a statutory Banking Commission. This is, however, chaired by the Governor of the Banque de France, and serviced by Banque de France staff. It is supported by separate statutory committees, which respectively determine the rules by which supervision should take place, and decide on questions of authorisation and

revocation. In Canada there is a separate regulatory commission. In Japan the work is done by a division of the Ministry of Finance.

51. In all these countries, however, the Central Bank is closely involved in banking supervision, even where it does not actually carry it out or does not have the direct statutory responsibility. This is not surprising given the historical Central Bank responsibility for a sound monetary and financial system and its role as lender of last resort.

52. In the UK, both supervisory and Central Bank roles are performed by the Bank of England.

53. There is a case for separating these roles. There may sometimes be conflicts of interest between the operation of monetary policy on the one hand and banking supervision on the other. It is at least debatable whether these are best settled privately within one institution. There can also be conflicts of interest between the Central Bank's role as a sponsor of the banking industry and its duties as bank supervisor. These factors argue for an element of independence for the supervisors.

54. It is also legitimate to ask whether the Bank is sufficiently accountable, or seen to be sufficiently accountable, for its considerable statutory powers; whether the present arrangements whereby in practice the Banking Supervision Division reports only to the Governors and the Court is right; and whether some separation of banking supervision from other central bank functions could improve accountability, and the status and professionalism of supervision.

55. These would be arguments for establishing a completely new and separate banking supervisory organisation. But, given the established role of the Bank and its staff in banking supervision, the likely benefits of an entirely new arrangement would not seem sufficient to outweigh the loss of continuity and administrative upheaval this would involve. There are in any event some advantages in maintaining reasonably close links between banking supervision and other matters for which the

Bank of England is responsible.

56. There are however attractions in an arrangement under which there was a separate statutory Commission, with a statutory duty of supervision, but chaired by the Governor, and serviced by Bank of England staff. Such a Commission would be given the responsibility for overseeing the work of the Banking Supervision Department. Some members might be full-time staff of the Bank of England, but others would be outside bankers, accountants or lawyers. It would reflect the importance, and might enhance the status of banking supervision. It would bring outside expertise in at the highest level. It should help encourage the development of a professional expertise in banking supervision. It would clarify and bring into the open any conflicts of interest with the other roles of a central bank - which are not best resolved within the Court - providing a more independent voice for the supervisors. At the same time, the Governor's role and the use of Bank of England staff would provide continuity and continued close relations with the 'central bank'. A Commission would also be more readily seen to be publicly accountable. It would perhaps be given a responsibility to submit annual reports to Parliament in the same way as the Chief Registrar of Friendly Societies. The Treasury and Bank are considering further what the detailed constitution and responsibilties of such a Commission might be, including such matters as the appointment of members and the nature of its accountability to Parliament.

57. It is relevant in this context that development of a banking Commission on these lines might pave the way for an eventual merger with the supervision of building societies. The Government has already announced its intention to move in this direction.

58. The Governor has recently announced important changes which represent a step in this direction. A new high level supervisory committee, under the chairmanship of the Deputy Governor, will take responsibility for supervision. Another variant, which would go further but not as far as a Commission, would be to provide specifically in the Bill for a separate Executive

Committee of the Court, or a statutory Governor's Committee, calling on outsiders, to oversee the Supervision Division.

59. It would be an unnecessary administrative upheaval to seek to establish a new organisation for carrying out supervision. But there are attractions in organisational changes that would achieve some separation of banking supervision from the Bank's other responsibilities, and improve its status and accountability. The recent changes in the administration of supervision that the Governor has introduced are welcome. The question now is whether to take the opportunity of legislation to go further. There would seem considerable advantage in working towards the establishment of a Commission on the lines described in paragraph 56 above.

HM TREASURY
October 1985

CONFIDENTIAL

ANNEX 1

Banking Supervision : Main Proposals

1. Auditors and supervisors

The consultative document proposes the following as the main elements of the dialogue:-

(a) Regular meetings between supervisors and auditors, with representatives of the bank present.

(b) The supervisors to receive a copy of the "management letter" from the auditor.

(c) Supervisors to receive specific information on request from the auditors, e.g. on control systems and bad debts.

(d) The auditor to have access to any written communications from the supervisors to a bank.

(e) Supervisors to require periodic examination by the auditor of prudential returns.

(f) The supervisors to make ad hoc requests to the auditor for information on particular subjects.

(g) The supervisors or the auditor to be able to initiate bilateral meetings in exceptional circumstances where it would not be appropriate for representatives of the bank to be present.

2. Normally, information required by the supervisors from the auditors will be passed through the bank, which will be represented at meetings between supervisors and the auditor. Occasionally, however, it is possible that the auditors and supervisors will need to have direct bilateral contact, e.g. when one or other is concerned about the quality of the management of the Bank).

3. The Review Committee Report contains two further proposals aimed at keeping up the standard of Bank auditors.

4. First, it is proposed that the Bank should have powers to require a supervised institution to appoint a second firm of accountants to carry out an investigation covering similar ground to a statutory audit. This second firm should be chosen by the bank concerned, subject to the Bank's agreement, at the cost of the supervised institution.

5. Secondly, the Review Committee recommend that in cases of negligence or other serious misconduct by a bank auditor, the Bank should be able to provide evidence to the auditors professional body, to enable it to consider instituting disciplinary proceedings. Such evidence would be subject to strict confidentiality safeguards.

The Bank's powers and the two-tier system

6. Some of the powers given to the Bank by the 1979 Act apply only to LDTs. These are principally:-

(i) LDTs must give the Bank written notice of changes in directors, controllers and managers.

(ii) LDTs have to make available copies of their most recent audited accounts in all their deposit-taking premises.

(iii) The Bank can require information of an LDT; an approved accountant's report on that information; and books and papers.

(iv) The Bank can give directions to licensed institutions constraining the use of misleading advertisements for deposits.

7. The Review Committee proposed that the present two-tier system should be replaced by a single authorisation and that in future the above powers should apply to all authorised institutions. It is further proposed that they are extended as follows:-

(i) The Bank should have power to require information not only exceptionally but on a routine basis. (This stops short of a requirement on authorised institutions to submit timely and accurate statistical returns. Late and inaccurate reporting was a major feature of the JMB case, and I have asked officials also to consider in detail the feasibility of a statutory requirement in this area, with serious penalties for failure to conform.)

(ii) A widening of the Bank's powers to require information of holding companies and subsidiaries, and other persons connected with an institution, as well as from the institution itself.

(iii) Power to place restrictions on the conduct of a business. This would in effect be an indefinite extension of the present power to grant a conditional licence for one year only.

(iv) A power to require an institution to inform the Bank in advance of any prospective change of shareholder control; and possibly a requirement for the Bank's prior consent to be obtained to any merger or takeover. This would effectively be a power to stop mergers and takeovers on prudential grounds.

8. The minimum net assets criterion for authorisation under the new, unitary system should be £1 million.

9. Under the new unitary system all authorised institutions should be entitled to use banking names.

Enforcement

10. The Bank should be given powers, analogous to those of the DTI, to investigate suspected cases of illegal deposit-taking.

Confidentiality

11. 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. This is in fact no more than a technical correction to the Banking Act 1979, (although it is clear that it is not seen as such by the banks) which permits the Bank to tell the Treasury in these circumstances, but does not allow it or the Treasury to pass on the information to other departments which might be concerned. It might be, for instance, that a Northern Ireland deposit-taker was in trouble, and that the NIO needed to know. It is easy to imagine similar cases where it would be appropriate to inform the FCO.

Consolidated supervision

12. The Review Committee warn that the relevant Government departments and supervisory authorities should consider carefully the issues raised by the supervision of financial conglomerates.

This work is in hand. It bears directly on our future institutional arrangements between the various supervisors.

Deposit protection

13. The Review Committee recommended that the amount of a protected deposit under the Deposit Protection Scheme should be increased from £10,000 to £20,000 (75 per cent is protected by the scheme).

14. The Committee's recommendation was based on the effects of inflation since the Banking Act was passed, which they calculated would justify an increase to £16,500, and on the desirability of a closer alignment between the arrangements 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.

15. However, consideration also needs to be given to the 'moral hazard' aspects of any deposit protection scheme, which will have a tendency to undermine the proper responsibilities of, on the one hand, depositors who must choose between institutions on the basis of which of them is able to offer the safer or more profitable arrangement; and on the other, of managers whose responsibility it is to conduct the affairs of a bank so as to avoid losses to depositors. The larger the margin of absolute safety offered by a deposit protection scheme, the greater the distortion of decision-taking in these areas.

16. Moreover, the higher the level of 'insurance' the greater will be the strain on the banking system as a whole of meeting payments under a deposit protection scheme. The failure of a substantial deposit-taking institution could in this way threaten the solvency of other institutions connected only by their obligation to contribute to the deposit-protection scheme. This in turn could make it difficult for the system to allow the collapse of an institution which should otherwise be allowed to fail.

17. Ministers have therefore concluded that the current £10,000 level should be retained for banks and should also be applied to the scheme for building societies.

	France	Germany	Switzerland	US
Supervisory authority	1. Banking Commission*: responsible for monitoring compliance with regulations. No staff of its own - relies on central bank to carry out much of the supervision. 2. Committee on Bank Regulation - technical body to establish regulations, ratios, accounting standards etc. 3. Committee on Credit Institutions* - new licences, technical decisions. * Chaired by Governor of central bank. Governor also sits on COBR.	Federal Banking Supervisory Office, reporting to Ministry of Finance: exercises its functions in close collaboration with central bank. FBSO responsible for detailed regulations ; central bank consulted on appropriate ratios, etc, and collects supervisory data.	Federal Banking Commission (separate from central bank which has no formal supervisory responsibilities) is chief supervisor and licensing authority.	Supervision is divided between: 1 Federal Reserve System 2 Office of the Comptroller of the Currency 3 Federal Deposit Insurance Corporation 4 Various state agencies Majority of banks come under both federal and state supervision.
Legislation	Banking Law 1984 set up single supervisory structure.	Banking Law (last amended 1985) defines scope of supervisory system.	Federal Law Relating to Banks and Savings Banks, implemented via the Banking Ordinance.	Federal Law and individual state regulations.
Entry procedure	Criteria set down in Banking Law, covering capital, proposed activity and quality of management. Authorisations granted by CCI.	FBSO sole authority for authorisation; criteria covering minimum capital, proposed activity and quality of management.	Specific regulations governing minimum capital, proposed activity and management quality.	Minimum requirements for capital; approval of management and proposed activity. May vary according to whether the bank is applying for a national or state charter.
Permitted activities for banks	Banking and financially related activities, including securities, underwriting etc.	Banking and financially related activities. Also non-financial activities, eg capital investment in corporate borrowers etc.	Although not restricted by law, mostly financially related. Large volume of fiduciary business (undertaken at customers' risk).	Generally confined to traditional banking activities. With limited exceptions, banks cannot undertake securities business or engage in insurance or commercial activity (vide Glass-Steagall Act).
Capital adequacy	Minimum risk asset ratio levels set by COBR on an individual bank basis. Endowment capital required for branches.	FBSO, in conjunction with central bank, has established certain "Principles". Under one of these, a bank's loans and participations may not exceed eighteen times capital, calculated on a risk asset basis.	Minimum ratios set down under the risk asset approach. FBC can require higher ratios than banks engaged in international lending.	Federal Reserve regulations require separate ratios to be calculated for primary and total capital (on a gearing type basis): current minimum levels are 5.5% and 6.0% respectively.
Liquidity	COBR empowered to set minimum levels. Short-term ratio requires liquid assets of 60% of 3 month liabilities. Medium and long-term assets limited to three times a bank's savings deposits and capital.	FBSO's Principles also cover liquidity; complex formulae covering short, medium and long term liquidity.	Regulations require minimum liquidity based on two stage structure; a measure of liquid assets against short term liabilities (up to 1 month, plus 15% of savings deposits), and a measure of liquid assets and marketable assets against short term liabilities.	No specific requirements although close reviews are undertaken at the time of examinations.
Large loans	No more than 50% of capital allowed in lending to one customer (does not apply to bank or government guaranteed credits). In addition, total of loans exceeding 25% of capital must not be more than eight times own funds.	Loans to any group of related customers not to exceed 50% of capital. Also limit on aggregate of large loans. Special limit for loans to parties connected with lender.	Large loans limited in a range from 20% of capital for unsecured advances, to 160% of capital for Swiss public sector risk.	15% of capital for federally chartered banks. State limits vary between 10 and 25% of capital, depending on State and security held.
Foreign exchange exposures	Exchange controls exist. Specific authorisation required: maximum levels of exposure set by central bank.	Difference between assets and liabilities in foreign currency not to exceed 30% of capital.	Where total foreign exchange exposure exceeds 40% of capital a bank must inform FBC.	Not subject to regulatory limitation, although they are reported monthly to the federal authorities and reviewed during examination.
Country exposure	No specific limits; regular reporting to the commission.	No specific limits but regular reporting and monitoring.	No specific limits, but regular reporting and monitoring. Auditors required to comment on banks' efforts at evaluating country risk.	Quarterly reporting, and disclosure to the public of large exposures to individual countries. No specific supervisory limit.
Provisions	No minimum requirements, but assessed in the light of overall asset quality.	No minimum requirement, but regular assessment. Increases sought where necessary.	Provisions of 20% required for specified developing and newly industrialised countries.	Asset quality reviewed primarily during examination. Under the Allocated Transfer Risk Reserve requirement, "reserves" must be maintained against country risk credits which are classed as value impaired: minimum 10%, or as directed.
Inspection/ audit	On-site inspections by central bank (for a normal bank, every 4/5 years). Commission can refuse appointment of auditors.	FBSO entitled to inspect, with or without particular cause. Inspections take place periodically by public auditors. Auditors appointed by the bank must submit their report to FBSO.	Independent bank auditors are approved by and act as agents for the FBC: they examine compliance with regulations, and the form of their reports follow a guidance note issued by FBC.	Comprehensive on-site examination: for chartered banks this takes place at least once every three years. Also, limited interim examinations. Supervisory authorities tend to rely on their own examinations rather than on external auditors.

NB This matrix has been prepared on the basis of up-to-date information but in a highly simplified form. Some of the simple entries in the table need substantial expansion in order to permit sound comparisons between countries to be made.

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Monetary Bulletin

No. 177 October 1985

In his Mansion House speech the Chancellor not only formally downgraded £M3 but also declared that its recorded growth will no longer be controlled by systematic overfunding. As long as other indicators, such as Mo and sterling, are not giving cause for concern, excessive growth of £M3 is unlikely to trigger corrective action.

This bulletin raises the concern that at some time in the future when there are signs from these other financial indicators that liquidity is being spent, short term interest rates, the Chancellor's chosen control mechanism, may not be able to cope effectively.

Monetary Policy after the Mansion House Speech

The Chancellor has now stated categorically that the authorities are no longer seeking to control the growth of £M3. They may return to such a policy sometime in the future and the Chancellor will probably still announce a new target range for £M3 in the next Budget but the aggregate has been downgraded to become an indicator that may be useful in some circumstances.

In our view the Chancellor had no option but to take this position. The height of real interest rates, the shape of the yield curve and the possibilities for bill arbitraging have combined to make £M3 virtually unusable, even as an approximate indicator of monetary conditions. This is not to deny some concern about growth rates of 18½% p.a. and 14% over the last six and twelve months respectively, and the implied build up of liquidity, but it is simply not possible to establish how real that concern should be. It is certainly not clear, for example, that the authorities should urgently take steps to mop up the liquidity and risk the economic contraction that could thereby be implied. The most judicious expression of the present dilemma came in the Governor's speech the same evening, when he said "In policy terms this means that the faster the growth of broad money generally, taking £M3 alongside the other broad aggregates, the greater the reassurance we need to find in the other available indicators before accepting that monetary conditions remain appropriately firm and that policy is continuing to have its intended counter-inflationary effect".

Policy Implementation

The Chancellor's new apparatus for controlling monetary conditions has four principal elements. First, he aims to sell that amount of public sector debt (i.e. gilt-edged stock plus national savings) which will just fund the PSBR, after allowing for external flows. This last qualification mainly refers to foreign buying of gilt-edged stock plus changes in the country's foreign exchange reserves. Foreign purchases of gilt-edged stock were extremely heavy during the first half of 1985. Under the new funding policy, sales to foreigners have the same value as sales to domestic investors. Their impact on £M3, however, can be very different.

Under the new funding policy, if, for example, a foreigner sells some of his holdings of gilt-edged stock to a domestic investor, funding requirements are obviously unchanged but £M3 will grow less fast. Allowing for external flows also means that if the Bank engages in foreign exchange intervention, for example by helping to depress the dollar, the need for domestic debt sales would be reduced.

The new funding policy does two things. First, it means that the Government will not print money directly. This emphatically does not mean that £M3 will necessarily be controlled, because the private sector's behaviour can be sufficient to cause it to expand rapidly. But it does mean that the Government is committed to not exacerbating any such expansion. The second consequence of the new funding policy is that the overfunding of the last four years will now end. Table I shows the pattern of over and underfunding since 1980. The pressures on markets will now be different.

Table I - Overfunding since 1980

£bn	1980/1	1981/2	1982/3	1983/4	1984/5	Six months to mid-Sept.
PSBR	12.7	8.6	8.9	9.7	10.3	5.1*
less Domestic Debt Sales						
to non-banks: Gilts	-8.9	-7.1	-4.6	-9.8	-9.2	-1.7
Other	-1.9	-4.2	-3.8	-2.8	-3.3	-1.7
less Public external finance	-0.1	-1.0	-2.3	-1.3	-2.2	-1.2
Overfunding (-)	+1.7	-3.7	-1.9	-4.1	-4.4	+0.5

*less sales of non-central government debt to non-bank private sector.

The second element in the Chancellor's new apparatus of control is the increased importance of Mo. Apart from downgrading £M3, the Chancellor emphasised that Mo was relatively undistorted and has stayed comfortably within its target range. He also claimed that it was an early warning signal of higher spending. He acknowledged that Mo has not yet acquired many friends in the City but again tried to broaden its appeal by likening it to the target aggregate in the Federal Republic of Germany. He perhaps overstated its appeal as an early warning signal. Mo figures lead the publication of retail sales figures by less than a month; it is better to see Mo as a concurrent than as a leading indicator. Further, although it may be a good guide to developments in an important part of the economy, Mo is not an aggregate that is susceptible to more than very rough and belated control under our present arrangements. In particular, the third element in the new control apparatus, short term interest rates, have a tenuous and distant impact on Mo. The growth of Mo might suggest that something needed to be done, but it would not indicate with any precision how much needed to be done, nor could there be any confidence for some considerable time after action had been taken that enough had been done.

Mo is only one of the factors specified by the Chancellor as influencing short term interest rate policy. It is obvious that forecasts of inflation and of money GDP growth will also play a part. In practice, these are usually pretty accurate over six to nine months, but for longer than that they become increasingly speculative. One of the virtues of broad money was that it was a relatively reliable longer leading indicator of inflation. It is no longer that and there is nothing that adequately replaces it. The Government's interest rate policy is thus becoming explicity more short run in its orientation.

Finally, and this is a factor which probably reinforces the last point, a central aspect of the new control apparatus is the behaviour of sterling, which the Chancellor described, alongside Mo, as "the other good and early guide to changing financial conditions" (emphasis added). The announced policy tool to control exchange rate movements are, as over the last year, short term interest rates.

Implications

The new emphasis on Mo as an indicator and short term interest rates as the policy tool might suggest that the Chancellor is edging ever closer to fully fledged monetary base control. Certainly he is implying more volatile short term interest rates. In our view, such a move is not imminent. The best interpretation of last Thursday's speech is not that the Chancellor is stealthily pursuing a policy of monetary radicalism. Instead, he was jettisoning, perhaps temporarily, an aggregate that was unreliable and had become an embarrassment. The Chancellor is still left with a major problem, however. He has no policy tool which will reliably control a build up of liquidity. In seeking to establish the pedigree of his underlying funding policy, the Chancellor quoted from his Mansion House Speech of 1983. His quote omitted a passage which asserted that a policy of just funding the PSBR would "provide a basic control of the growth of liquidity, however measured". This is manifestly not the case. The Chancellor has virtually abandoned any attempt to restrain the build up of liquidity and he is apparently relying on short term interest rates to control the situation when any build up begins to be spent.

It is, in our view, wrong, and certainly premature, to accuse the Chancellor of covertly engineering a reflationary and permissive policy. Such a policy may be irresistible by Budget time but it is not apparent yet. Many commentators have been anticipating a U-turn, some of them for a considerable time. But it is unwise to forget the astonishing tenacity with which the Conservatives have stuck to the core of their policy since 1979. Whether they have been wise to be so tenacious is a different question, but the fact of it is indisputable. Crudely expressed, the Chancellor's argument on Thursday was '£M3 is dead, long live monetarism!'

Specific analysis which supports the view that the Chancellor still places overwhelming priority on reducing inflation is as follows. The growth rate of Mo is falling; our provisional estimate for the month to mid-October implies six and twelve month growth rates of only 2% p.a. and 3¾% respectively. The exchange rate, as the Chancellor himself observed, is close to its average level of the past two and a half years. Finally, inflation is officially forecast to be below 4% by the middle of next year. Nevertheless, a cautious approach continues to be indicated for short term interest rates. This is not self-evidently the action of a Chancellor keen to engineer additional reflation.

The principal doubt about the new policy emphasis is rather different. While the Chancellor may not be actively pursuing reflation, liquidity is undoubtedly building up. It is not at all clear that his new control mechanism can cope with this effectively. If the crunch comes at an inopportune time, the Chancellor may have neither the will nor the political support to use the only mechanism he has allowed himself.

Monetary Growth in the Month to Mid-September

The seasonally adjusted data for the four weeks to 18th September are shown in Table II.

Table II
Changes in the Month to mid-September

	£m	pa
Mo	59	5%
Currency	47	4%
Retail M1	-309	-11%
M1	10	-
Sterling M3	2,142	22%
PSL1	1,788	17%
PSL2	2,632	15%
Bank lending in sterling to private sector	986	9%

The pattern over the longer term, together with our estimates of the underlying trend over the last six months, are shown in Table III. Our estimates of the underlying trend make no allowance for the high relative level of short term interest rates nor for the recent move away from overfunding.

Table III
Monetary Growth in the Longer Term

		4 months	6 months		One Year	
		Published	Published	Underlying	Published	
		% p.a.	% p.a.	% p.a.	%	Notes
Narrow money:	Mo	3.1	3.3	4	4.2	1
	Currency	2.3	2.6	3	3.5	
	Retail M1	-1.6	1.7	7	2.1	2
	M1	16.7	23.1	12	16.9	3
	M2	n.a.	n.a.	8	7.5	4
Broad money:	Sterling M3	16.7	18.5	15	14.1	5
	PSL1	14.8	16.9	14	13.6	5
	PSL2	13.7	12.8	14	14.3	6

Notes.
1. Revised upwards because of abnormally low banker's balances in September.
2. Revised upwards because of a switch from current accounts to high interest chequing accounts.
3. Revised downwards because of the newly available high interest chequing accounts and the greater use of overnight deposits by Other Financial Institutions.
4. 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.
5. The downward adjustment is to allow for arbitraging and the increase in high interest chequing accounts where funds have not come from other bank deposits.
6. The adjustment for changes in term shares of building societies is now upwards; it is partially offset by a downward adjustment to allow for arbitraging.

Apart from M1 the underlying growth of the narrow aggregates has been subdued. In particular, Mo continues to grow more slowly than the mid-point of the target range. A deceleration is continuing. Banker's balances fell further in banking October to an exceptionally low level, and Mo is estimated to have been broadly unchanged. Its six and twelve month growth rates are forecast to have dropped to 2% p.a. and 3¾% respectively.

The broader aggregates have continued to be buoyant even if they are adjusted downwards to allow for the lack of sales of gilt-edged stocks. Table IV shows that average sales of gilt-edged stocks in the four banking months to mid-September were £600m below the monthly average in the previous twelve months. This decline is more than accounted for by the drop in purchases by non-bank domestic investors. Although there are indications that these were much higher in the month to mid-October, overall sales in the five months since mid-May have probably averaged some £500m a month less than in previous months.

Table IV
Net Purchases of Gilt-edged Stocks

£m Monthly Averages	Non-bank domestic	Foreign	Non-bank dom. & foreign	Banks & discount houses*	Total
May 1984 to Dec. 1984	717	-2	715	156e	871e
Dec. 1984 to May 1985	865	280	1,145	23e	1,167e
May 1984 to May 1985	779	115	894	100e	994e
May 1985 to Sep. 1985	91	308e	398e	-6e	393e

* adjusted for repos with the Bank
e estimate

The impact on £M3 of low purchases of gilt-edged stock has been very large in the last four months. Table V compares the published growth of £M3 and PSL2 with growth after making allowances for both our normal adjustments, as in Table II, and abnormally low sales of gilt-edged stock. The four month rather than three month rates are shown because of the distortion at mid-June.

Table V
Adjusted Broad Monetary Growth

	Published	Adjusted Underlying
Sterling M3:		
One Year	14.1%	12%
Six Months	18.5% p.a.	11% p.a.
Four Months	16.7% p.a.	9% p.a.
PSL2:		
One Year	14.3%	12%
Six Months	12.8% p.a.	11% p.a.
Four Months	13.7% p.a.	9½% p.a.

Bank lending rose more slowly in banking September, and its underlying monthly rate of increase in the last three months is now more than £300m below the average in the previous three months. It was expected that the changed provisions for capital allowances, announced in the 1984 Budget, would first raise and then lower the bank lending figures. The rise was duly observed around the end of the financial year in March, and the fall now seems to have arrived, somewhat later and smaller than anticipated.

Table V
Bank Lending in Sterling to the Private Sector

	£m	Published	Bills Outside	Adj Total	3 Month Av
1984	Oct	2,087	111	2,198	1,610
	Nov	1,691	62	1,753	1,823
	Dec	1,581	-49	1,532	1,828
1985	Jan	2,131	-154	1,977	1,754
	Feb	1,698	-4	1,694	1,734
	Mar	1,810	117	1,927	1,866
	Apr	2,575	-54	2,521	2,047
	May	1,445	-250	1,195	1,881
	June	1,373	192	1,565	1,760
	July	1,528	-17	1,511	1,424
	Aug	1,758	212	1,970	1,682
	Sep	986	-188	798	1,426

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MONETARY GROWTH
In Nominal Terms

Percentage Annual rates		Mo	Currency	Retail M1	M1	M2	Sterling M3	PSL1	PSL2
Changes in year to:									
1984	Oct.	5	6	7	15	12	8	9	13
	Nov.	6	6	9	18	13	10	11	15
	Dec.	7	5	9	18	11	9	9	14
1985	Jan.	5	5	7	15	10	9	10	15
	Feb.	5	6	7	14	10	10	10	15
	Mar.	5	6	5	13	10	9	10	15
	Apr.	6	4	4	15	9	12	13	15
	May.	5	5	4	16	8	12	12	14
	June.	5	4	10	18	9	12	12	14
	July.	5	4	3	16	7	12	12	14
	Aug.	4	4	3	18	7	13	13	14
	Sep.	4	4	2	17	8	14	14	14
Changes in 6 months to:									
1985	Apr.	5	3	2	14		15	15	17
	May.	4	4	0	12		11	11	12
	June.	3	5	11	19		17	16	15
	July.	5	3	0	19		13	13	12
	Aug.	3	3	3	28		16	16	13
	Sep.	3	3	2	23		19	17	13
Changes in 3 months to:									
1985	July.	4	3	0	19		8	8	8
	Aug.	2	2	2	23		14	13	13
	Sep.	1	2	-22	5		13	10	11

In Real Terms

		Mo	Currency	Retail M1	M1	M2	Sterling M3	PSL1	PSL2
Changes in year to:									
1984	Oct.	0	1	2	10	7	3	4	8
	Nov.	1	1	4	13	8	5	6	10
	Dec.	2	0	4	14	7	5	5	10
1985	Jan.	0	0	2	10	5	4	5	10
	Feb.	0	0	1	9	5	4	5	10
	Mar.	-1	0	-1	7	4	3	4	9
	Apr.	-1	-2	-3	8	2	5	6	9
	May.	-2	-2	-3	9	1	5	5	7
	June.	-2	-3	3	11	2	5	5	7
	July.	-2	-3	-4	9	0	5	5	7
	Aug.	-2	-2	-4	12	1	7	7	8
	Sep.	-2	-2	-4	11	2	8	8	8
Changes in 6 months to:									
1985	Apr.	-2	-4	-5	7		8	8	9
	May.	-3	-3	-7	5		4	3	5
	June.	-4	-1	5	13		10	10	9
	July.	-1	-3	-6	13		7	7	6
	Aug.	-2	-3	-3	22		11	10	7
	Sep.	-2	-3	-3	18		13	12	8
Changes in 3 months to:									
1985	July.	-2	-3	-6	13		2	2	2
	Aug.	-3	-4	-3	17		9	9	7
	Sep.	-4	-3	-27	0		7	5	6

Chart 1 - Monetary Growth in NOMINAL Terms (% p.a.)

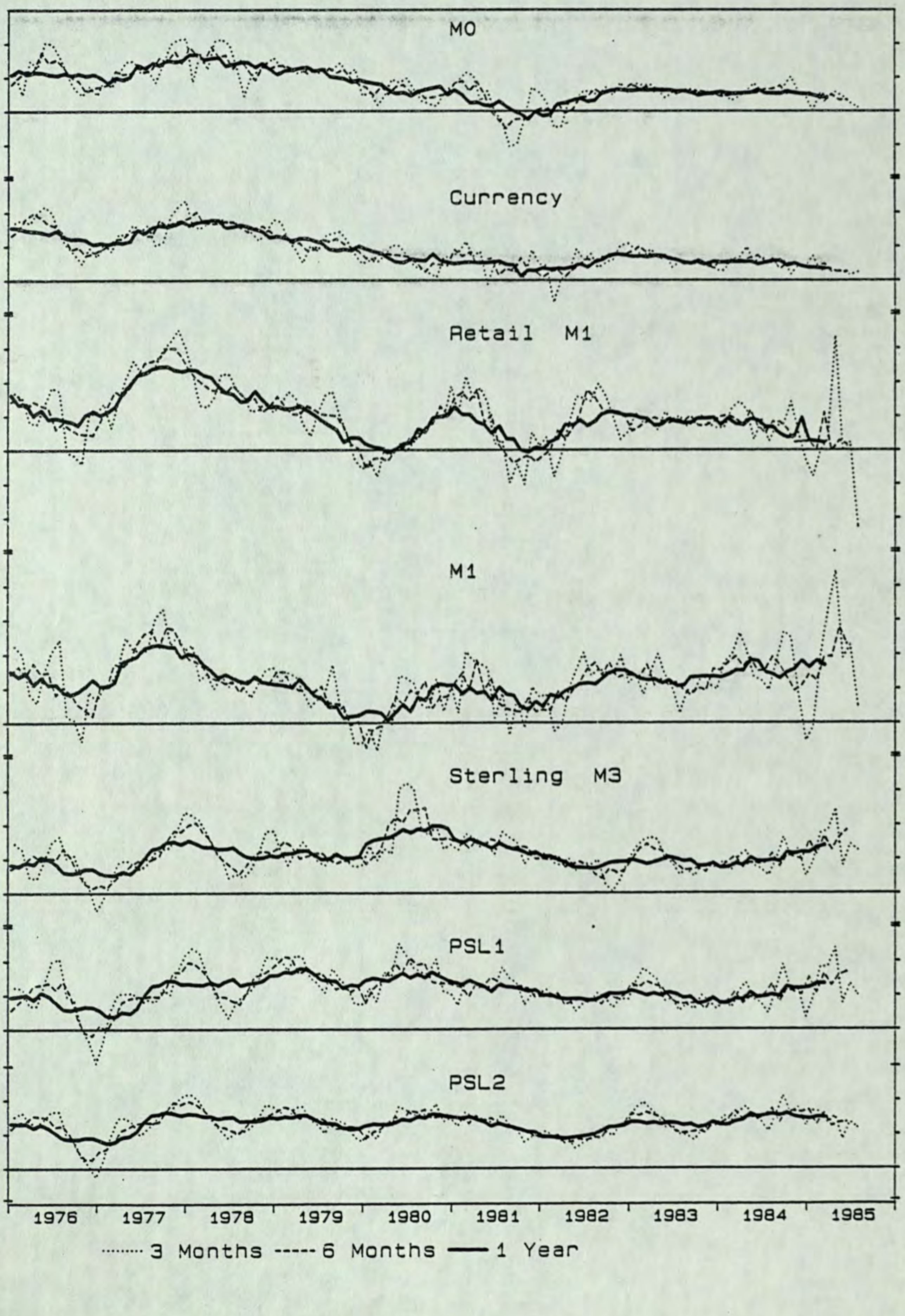


Chart 2 - Monetary Growth in REAL Terms (% p.a.)

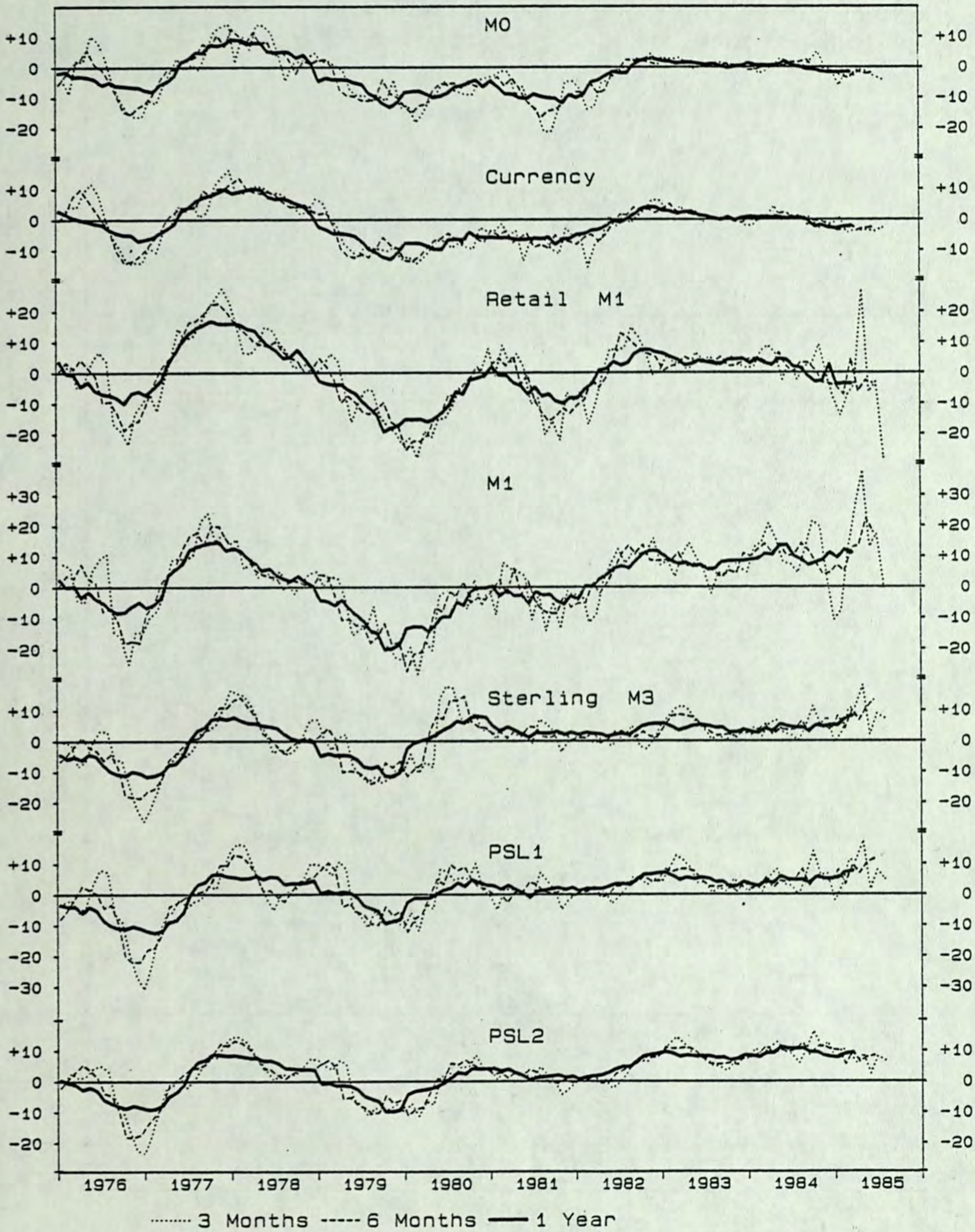
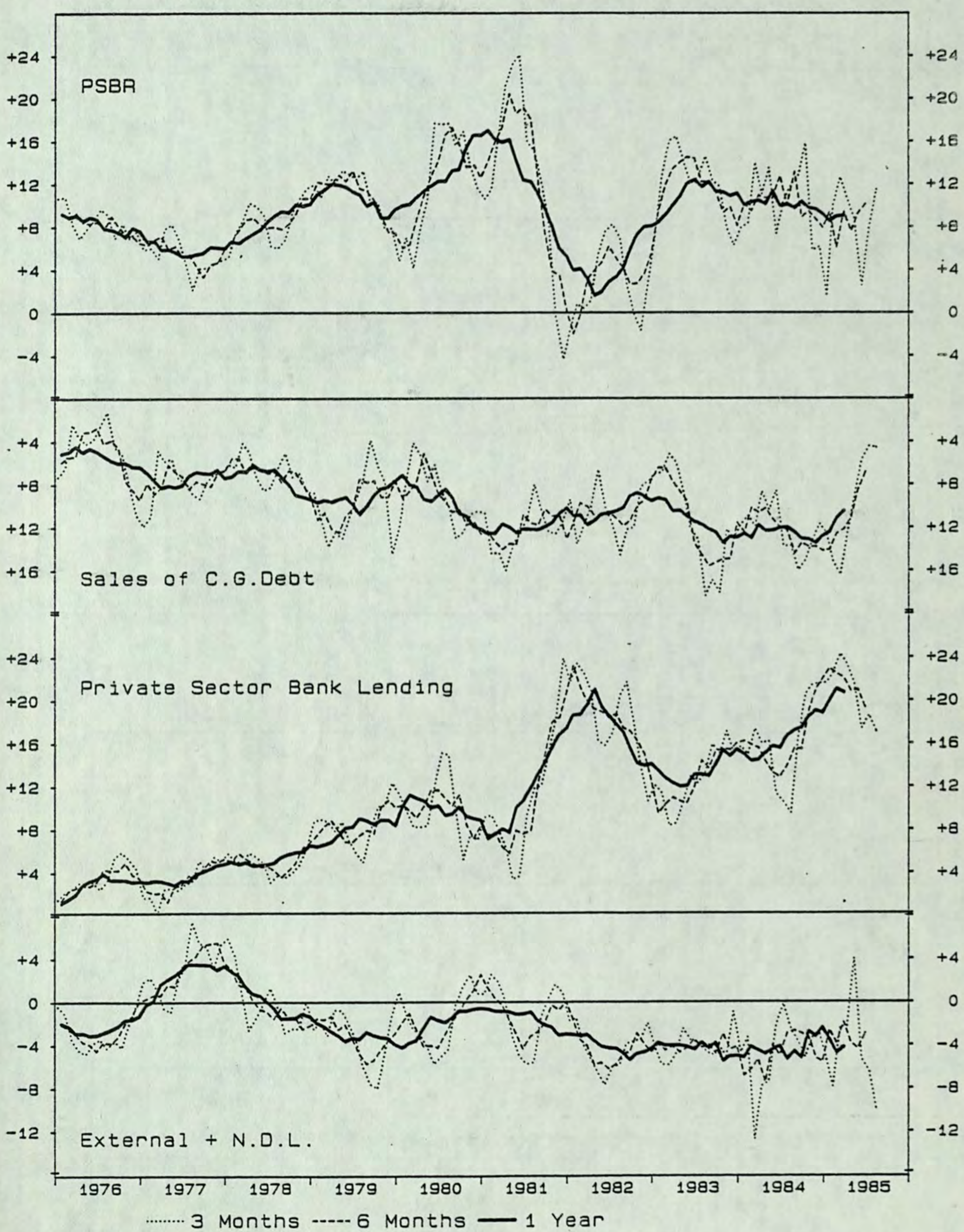


Chart 3 - Components of Monetary Growth (bns)



STATISTICS

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[**Table 11.1** in the *QuarterlyBulletin*]

Money stock: amounts outstanding

£ millions

Month ended	Notes and coin in circulation with public	UK private sector sterling sight deposits		Money stock M1[b]		UK private sector sterling time deposits[c]	Money stock £M3[b][d]		UK private sector deposits in other currencies [c]	Money stock M3[b][d]	
		Non-interest-bearing[a]	Interest-bearing	Unadjusted	Seasonally adjusted		Unadjusted	Seasonally adjusted		Unadjusted	Seasonally adjusted
	1	*2*	*3*	*4*		*5*	*6*		*7*	*8*	
1984 Aug. 15	12,156	20,981	14,035	47,172	47,230	57,141	104,313	104,050	16,468	120,781	120,520
Sept. 19[e]	12,102	20,850	14,774	47,726	47,810	57,651	105,377	105,340	17,896	123,273	123,230
Oct. 17	12,115	21,022	15,483	48,620	48,510	57,359	105,979	105,800	17,995	123,974	123,790
Nov. 21	12,186	21,251	16,474	49,911	50,090	58,809	108,720	108.120	18,573	127,293	126,690
Dec. 12[e]	12,641	22,272	16,617	51,530	50,650	58,001	109,531	108,480	19,474	129,005	127,960
1985 Jan. 16	12,113	20,859	16,268	49,240	49,670	60,129	109,369	109,590	20,844	130,213	130,440
Feb. 20	12,210	20,476	16,041	48,727	49,530	60,307	109,034	109,920	21,426	130,460	131,350
Mar. 20[e]	12,322	20,604	16,981	49,907	50,490	59,468	109,375	110,880	20,388	129,763	131,270
Apr. 17	12,435	21,467	18,604	52,506	51,980	61,240	113,746	114,120	18,433	132,179	132,560
May 15	12,441	21,440	19,422	53,303	53,210	60,733	114,036	114,660	18,977	133,013	133,630
June 19[e]	12,438	23,496	19,412	55,346	55,370	61,747	117,093	117,270	19,006	136,099	136,270
July 17	12,674	21,250	20,800	54,724	54,300	62,263	116,987	116,390	18,383	135,370	134,770
Aug. 21	12,658	21,169	21,915	55,742	56,030	63,309	119,051	118,570	19,360	138,411	137,930
Sept. 18[e]	12,536	21,253	22,238	56,027	56,070	64,920	120,947	120,740	19,769	140,716	140,510

[**Table 11.2** in the *QuarterlyBulletin*]

Money stock: changes[f]

£ millions: *percentages in italics*

Month ended	Notes and coin in circulation with public	UK private sector sterling sight deposits		Money stock		UK private sector sterling time deposits[c]	Money stock		UK private sector deposits in other currencies [c]		Money stock	
		Non-interest-bearing[a]	Interest-bearing	M1[b]			£M3[b][d]		Trans-actions	Valuation changes[g]	M3[b][d]	
	1	*2*	*3*	*4*		*5*	*6*		*7*		*8*	
(unadjusted)												
1984 Sept. 19	– 54	– 131	+ 739	+ 554		+ 505	+ 1,059		+ 397	+ 1,026	+ 2,482	
Oct. 17	+ 13	+ 172	+ 709	+ 894		– 292	+ 602		– 405	+ 504	+ 701	
Nov. 21	+ 71	+ 229	+ 991	+ 1,291		+ 1,450	+ 2,741		+ 846	– 268	+ 3.319	
Dec. 12	+ 455	+ 919	+ 133	+ 1,507		– 1,162	+ 345		+ 484	+ 357	+ 1,186	
1985 Jan. 16	– 528	– 1,413	– 349	– 2,290		+ 2,128	– 162		+ 93	+ 1,277	+ 1,208	
Feb. 20	+ 97	– 383	– 227	– 513		+ 178	– 335		– 36	+ 618	+ 247	
Mar. 20	+ 112	+ 128	+ 940	+ 1.180		– 809	+ 371		– 126	– 922	– 677	
Apr. 17	+ 113	+ 863	+ 1,623	+ 2,599		+ 1,772	+ 4,371		+ 222	– 2,177	+ 2,416	
May 15	+ 6	– 27	+ 818	+ 797		– 552	+ 245		+ 336	+ 208	+ 789	
June 19	– 3	+ 2,056	– 20	+ 2,033		+ 934	+ 2,967		+ 670	– 661	+ 2,976	
July 17	+ 236	– 2,246	+ 1,388	– 622		+ 516	– 106		+ 739	– 1,362	– 729	
Aug. 21	– 16	– 81	+ 1,115	+ 1,018		+ 1,046	+ 2,064		+ 606	+ 371	+ 3,041	
Sept. 18	– 122	+ 87	+ 286	+ 251		+ 1,590	+ 1,841		– 215	+ 613	+ 2,239	
(seasonally adjusted)												
1984 Sept. 19	+ 70	– 259	+ 774	+ 585	+ *1.2*	+ 682	+ 1,267	+ *1.2*	+ 397	+ 1,026	+ 2,690	+ *2.2*
Oct. 17	+ 41	+ 69	+ 590	+ 700	+ *1.5*	– 239	+ 461	+ *0.4*	– 405	+ 504	+ 560	+ *0.5*
Nov. 21	+ 58	+ 630	+ 894	+ 1,582	+ *3.3*	+ 731	+ 2,313	+ *2.2*	+ 846	– 268	+ 2,891	+ *2.3*
Dec. 12	– 47	+ 342	+ 150	+ 445	+ *0.9*	– 547	– 102	– *0.1*	+ 484	+ 357	+ 739	+ *0.6*
1985 Jan. 16	+ 119	– 692	– 411	– 984	– *1.9*	+ 2,077	+ 1,093	+ *1.0*	+ 93	+ 1,277	+ 2,463	+ *1.9*
Feb. 20	+ 46	– 23	– 164	– 141	– *0.3*	+ 458	+ 317	+ *0.3*	– 36	+ 618	+ 899	+ *0.7*
Mar. 20	+ 48	– 166	+ 1,077	+ 959	+ *1.9*	+ 20	+ 979	+ *0.9*	– 126	– 922	– 69	– *0.1*
Apr. 17	– 16	+ 95	+ 1.416	+ 1,495	+ *3.0*	+ 1,760	+ 3,255	+ *2.9*	+ 222	– 2,177	+ 1,300	+ *1.0*
May 15	+ 80	+ 230	+ 915	+ 1,225	+ *2.4*	– 717	+ 508	+ *0.4*	+ 336	+ 208	+ 1,052	+ *0.8*
June 19	+ 21	+ 2,044	+ 84	+ 2,149	+ *4.0*	+ 394	+ 2,543	+ *2.2*	+ 670	– 661	+ 2,552	+ *1.9*
July 17	– 23	– 2,387	+ 1,338	– 1,072	– *1.9*	+ 234	– 838	– *0.7*	+ 739	– 1,362	– 1,461	– *1.1*
Aug. 21	+ 50	+ 492	+ 1,189	+ 1,731	+ *3.2*	+ 491	+ 2,222	+ *1.9*	+ 606	+ 371	+ 3,199	+ *2.4*
Sept. 18	+ 47	– 356	+ 319	+ 10	–	+ 2,132	+ 2,142	+ *1.8*	– 215	+ 613	+ 2,540	+ *1.8*

[a] After deducting 60% of net debit transit items (see additional notes to Table 6 of the *QuarterlyBulletin*).

[b] M1 equals columns 1 + 2 + 3. £M3 equals M1 + column 5. M3 equals £M3 + column 7.

[c] Including certificates of deposit.

[d] Excluding public sector deposits.

[e] Changes in the monthly-reporting population occurred in these months. See also the additional notes to Table 3 in the *QuarterlyBulletin*. and, for June and September 1985, footnotes [b] and [c] respectively to Table H on page 5.

[f] Changes in the money stock may differ from those which can be calculated by reference to amounts outstanding. (See additional notes to Table 11 of the *QuarterlyBulletin*.) In December 1984, the changes are stated after the exclusion of the bank deposits of British Telecom PLC.

[g] See additional notes to Tables 6 and 11 of the *QuarterlyBulletin*.

An alternative presentation of counterparts to changes in £M3

[See page 529 in the December 1983 *Quarterly Bulletin*]

£ millions

	Public sector borrowing requirement (surplus–)[a]		Purchases (–) of public sector debt by UK private sector (other than banks)			External and foreign currency and finance of public sector (increase–)		Banks' sterling lending to UK private sector [c]	External and foreign currency transactions of UK banks [d]				Net non-deposit liabilities (increase–)	Money stock £M3[a] (columns 1-13)
	Central government borrowing requirement	Other public sector contribution / Other public sector debt	Central government debt: British government stocks	Central government debt: Other		Purchases of British government stocks by overseas sector	Other [b]		Sterling deposits from, net of market loans to, banks abroad (increase–)	Other overseas sterling deposits	Other sterling lending to overseas sector[e]	Banks' net foreign currency deposit liabilities[+] (increase–)		
	1	*2* *3*	*4*	*5*		*6*	*7*	*8*	*9*	*10*	*11*	*12*	*13*	*14*
Month ended (unadjusted)														
1984 Sept. 19	+ 1,180	+ 141	- 86	- 756		- 360	- 228	+ 973	- 547	+ 111	+ 826	- 363	+ 168	+ 1,059
Oct. 17	+ 293	+ 50	- 877	- 580		+ 163	- 28	+ 3,136	- 253	- 637	+ 382	+ 72	- 1,119	+ 602
Nov. 21	+ 1,994	+ 478	- 1,035	- 503		- 111	+ 87	+ 1,503	- 269	- 354	+ 699	+ 188	+ 64	+ 2,741
Dec. 12	+ 773	- 79	- 501	- 30		+ 35	+ 90	+ 385	+ 177	- 95	+ 268	- 332	- 346	+ 345
1985 Jan. 16	- 2,005	+ 295	- 630	- 344		- 182	- 231	+ 3,012	+ 602	- 487	+ 357	- 384	- 165	- 162
Feb. 20	- 310	+ 93	- 1,552	- 8		- 407	- 252	+ 1,351	- 271	- 56	+ 201	+ 206	+ 670	- 335
Mar. 20	+ 361	+ 57	- 790	- 356		- 265	+ 49	+ 1,838	- 1,712	- 24	+ 164	+ 1,774	- 725	+ 371
Apr. 17	+ 2,785	+ 353	- 767	- 619		- 198	+ 115	+ 2,832	+ 376	- 288	- 251	+ 740	- 1,209	+ 4,371
May 15	+ 496	+ 67	- 586	- 113		- 347	+ 217	+ 873	+ 300	- 67	+ 261	- 468	- 388	+ 245
June 19	+ 2,644	- 434	—	- 226		- 730	+ 267	+ 752	+ 415	- 255	- 268	+ 1,231	- 429	+ 2,967
July 17	- 1,156	- 425	- 1	- 415		- 352	- 57	+ 3,104	- 4	- 236	- 407	+ 260	- 417	- 106
Aug. 21	+ 2,325	- 366	- 76	- 183		- 49	+ 49	+ 1,115	+ 282	- 591	- 602	- 171	+ 331	+ 2,064
Sept. 18	+ 1,685	- 318	- 285	- 52		- 42		+ 421	+ 422	- 77	- 103	+ 213	- 23	+ 1,841
Month ended (seasonally adjusted)														
1984 Sept. 19	+ 1,467	+ 118	- 86	- 864		- 360	- 235	+ 1,365			- 249		+ 111	+ 1,267
Oct. 17	+ 318	- 9	- 877	- 501		+ 163	- 35	+ 2,087			- 322		- 363	+ 461
Nov. 21	+ 1,665	+ 397	- 1,035	- 403		- 111	+ 80	+ 1,691			+ 403		- 374	+ 2,313
Dec. 12	- 1,121	+ 195	- 501	+ 15		+ 35	+ 83	+ 1,581			+ 53		- 442	- 102
1985 Jan. 16	+ 317	+ 84	- 630	- 362		- 182	- 181	+ 2,131			+ 73		- 157	+ 1,093
Feb. 20	+ 819	+ 76	- 1,552	- 109		- 407	- 259	+ 1,698			- 13		+ 64	+ 317
Mar. 20	+ 1,214	+ 3	- 790	- 352		- 265	+ 45	+ 1,810			- 123		- 563	+ 979
Apr. 17	+ 912	+ 137	- 767	- 547		- 198	+ 112	+ 2,575			+ 1,443		- 412	+ 3,255
May 15	+ 390	- 4	- 586	- 122		- 347	+ 213	+ 1,445			+ 176		- 657	+ 508
June 19	+ 768	- 18	—	- 268		- 730	+ 263	+ 1,373			+ 1,287		- 132	+ 2,543
July 17	- 86	- 424	- 1	- 444		- 352	- 62	+ 1,528			- 442		- 555	- 838
Aug. 21	+ 2,096	- 355	- 76	- 320		- 49	+ 44	+ 1,758			- 964		+ 88	+ 2,222
Sept. 18	+ 1,973	- 333	- 285	- 15		- 47		+ 986			+ 55		- 192	+ 2,142

[a] Excluding public sector bank deposits.
[b] Including public sector foreign currency bank deposits.
[c] Including holdings of sterling certificates of deposit issued by building societies, and net purchases by the Issue Department of commercial bills and, from Fe'ruary 1985, of promissory notes relating shipbuilding paper guaranteed by the Department of Trade and Industry.
[d] A seasonally-adjusted breakdown of these transactions is not available.
[e] Including net purchases of ECGD-backed promissory notes by the Issue Department.
[f] Including net non-deposit liabilities in foreign currency. (See the *quarterly Bulletin* for June 1985_page 185.)

M0, the wide monetary base

[Table 2 in the *Quarterly Bullet*

£ millions: *percentages in italics*

End-banking-month series

	Notes and coin in circulation outside the Bank of England: In circulation with public		Notes and coin in circulation outside the Bank of England: Held by banks (till money)		Bankers' deposits with the Banking Department: Operational deposits	Bankers' deposits with the Banking Department: Cash ratio deposits
	Unadjusted	Seasonally adjusted	Unadjusted	Seasonally adjusted	Unadjusted	Unadjusted
	1		*2*		*3*	*4*
Amount outstanding at						
1984 Aug. 15	12,156	12,061	1,277	1,239	50	533
Sept. 19	12,102	12,131	1,284	1,280	158	533
Oct. 17	12,115	12,172	1,235	1,250	153	533
Nov. 21	12,186	12,231	1,243	1,263	189	582
Dec. 12	12,641	12,184	1,385	1,241	205	582
1985 Jan. 16	12,113	12,304	1,320	1,299	190	582
Feb. 20	12,210	12,351	1,225	1,275	90	582
Mar. 20	12,322	12,400	1,231	1,296	29	582
Apr. 17	12,435	12,384	1,312	1,320	162	582
May 15	12,441	12,464	1,275	1,290	187	623
June 19	12,438	12,486	1,350	1,379	93	628
July 17	12,674	12,464	1,403	1,328	214	628
Aug. 21	12,658	12,514	1,468	1,420	100	628
Sept. 18	12,536	12,561	1,393	1,391	120	628
Change in month ended						
1984 Sept. 19	- 54	+ 70	+ 7	+ 41	+ 108	—
Oct. 17	+ 13	+ 41	- 49	- 31	- 5	
Nov. 21	+ 71	+ 58	+ 8	+ 13	+ 36	—
Dec. 12	+ 455	- 47	+ 142	- 22	+ 16	- 49
1985 Jan. 16	- 528	+ 119	- 65	+ 57	- 15	
Feb. 20	+ 97	+ 46	- 95	- 24	- 100	—
Mar. 20	+ 112	+ 48	+ 6	+ 20	- 61	—
Apr. 17	+ 113	- 16	+ 81	+ 24	+ 133	—
May 15	+ 6	+ 80	- 37	- 30	+ 25	—
June 19	- 3	+ 21	+ 75	+ 88	- 94	+ 46
July 17	+ 236	- 23	+ 53	- 51	+ 121	
Aug. 21	- 16	+ 50	+ 65	+ 92	- 114	—
Sept. 18	- 122	+ 47	- 75	- 29	+ 20	—

Monthly-average series

	Notes and coin in circulation outside the Bank of England		Bankers' operational deposits with the Banking Department	M0 (wide monetary base) (columns 5 + 6)		
	Unadjusted	Seasonally adjusted	Unadjusted	Unadjusted	Seasonally adjusted	
	5		*6*	*7*		
Average amount outstanding in month ended						
1984 Aug. 15	13,478	13,333	164	13,642	13,497	
Sept. 19	13,471	13,451	139	13,610	13,590	
Oct. 17	13,379	13,479	178	13,557	13,657	
Nov. 21	13,403	13,555	180	13,583	13,735	
Dec. 12	13,804	13,568	356	14,160	13,924	
1985 Jan. 16	14,222	13,701	139	14,361	13,340	
Feb. 20	13,411	13,698	177	13,588	13,875	
Mar. 20	13,542	13,784	144	13,686	13,928	
Apr. 17	13,907	13,864	162	14,069	14,026	
May 15	13,761	13,861	156	13,917	14,017	
June 19	13,888	13,944	178	14,066	14,122	
July 17	13,988	13,962	217	14,205	14,179	
Aug. 21	14,105	13,959	141	14,246	14,100	
Sept. 18	14,031	14,026	133	14,164	14,159	
Change in month ended						
1984 Sept. 19	- 7	+ 118	- 25	- 32	+ 93	*+0.7*
Oct. 17	- 92	+ 28	+ 39	- 53	+ 67	*+0.5*
Nov. 21	+ 24	+ 76	+ 2	+ 26	+ 78	*+0.6*
Dec. 12	+ 401	+ 13	+ 176	+ 577	+ 189	*+1.4*
1985 Jan. 16	+ 418	+ 133	- 217	+ 201	- 84	*-0.6*
Feb. 20	- 811	- 3	+ 38	- 773	+ 35	*+0.3*
Mar. 20	+ 131	+ 86	- 33	+ 98	+ 53	*+0.4*
Apr. 17	+ 365	+ 80	+ 18	+ 383	+ 98	*+0.7*
May 15	- 146	- 3	- 6	- 152	- 9	*-0.1*
June 19	+ 127	+ 83	+ 22	+ 149	+ 105	*+0.7*
July 17	+ 100	+ 18	+ 39	+ 139	+ 57	*+0.4*
Aug. 21	+ 117	- 3	- 76	+ 41	- 79	*-0.6*
Sept. 18	- 74	+ 67	- 8	- 82	+ 59	*+ 0.4*

Transactions balances and components of M2

[Table 11.1 and 11.2 in the *Quarterly Bulletin*]

£ millions: *not seasonally adjusted*

	Notes and coin in circulation with public	UK private sector sterling non-interest-bearing sight deposits with banks[a]	Non-interest-bearing M1[b]	Other UK private sector sterling retail deposits with banks	UK private sector retail shares and deposits with building societies	National Savings Bank ordinary account	M2[b]	Public sector retail deposits with banks	Overseas retail deposits with banks
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*
Amounts outstanding									
1984 Sept. 19[c]	12,102	20,850	32,952	30,677	64,101	1,741	129,471	972	3,357
Oct. 17	12,115	21,022	33,137	30,863	64,411	1,749	130,160	1,089	3,289
Nov. 21	12,186	21,251	33,437	31,283	64,828	1,761	131,309	1,177	3,391
Dec. 12[c]	12,641	22,272	34,913	31,043	65,727	1,730	133,413	890	3,399
1985 Jan. 16	12,113	20,859	32,972	31,561	67,263	1,785	133,581	1,087	3,643
Feb. 20	12,210	20,476	32,686	31,815	67,542	1,758	133,801	1,104	3,651
Mar. 20[c]	12,322	20,604	32,926	32,453	67,892	1,762	135,033	1,094	3,753
Apr. 17	12,435	21,467	33,902	32,910	67,710	1,738	136,260	1,033	4,111
May 15	12,441	21,440	33,881	33,291	67,315	1,754	136,241	1,060	4,152
June 19[c]	12,438	23,496	35,934	33,893	68,097	1,752	139,676	1,086	4,186
July 17	12,674	21,250	33,924	34,709	68,292	1,736	138,661	1,015	4,404
Aug. 21	12,658	21,169	33,827	35,004	68,295	1,744	138,870	993	4,452
Sept. 18[c]	12,536	21,253	33,789	35,188	68,634	1,734	139,345	885	4,475
Changes in month ended [d]									
1984 Oct. 17	+ 13	+ 172	+ 185	+ 186	+ 310	+ 8	+ 689	+ 117	− 68
Nov. 21	+ 71	+ 229	+ 300	+ 420	+ 417	+ 12	+1,149	+ 88	+ 102
Dec. 12	+ 455	+ 919	+1,374	− 240	+ 899	− 31	+2,002	− 287	+ 8
1985 Jan. 16	− 528	−1,413	−1,941	+ 518	+1,536	+ 55	+ 168	+ 197	+ 244
Feb. 20	+ 97	− 383	− 286	+ 254	+ 279	− 27	+ 220	+ 17	+ 8
Mar. 20	+ 112	+ 128	+ 240	+ 638	+ 350	+ 4	+1,232	− 10	+ 102
Apr. 17	+ 113	+ 863	+ 976	+ 457	− 182	− 24	+1,227	− 61	+ 358
May 15	+ 6	− 27	− 21	+ 381	− 395	+ 16	− 19	+ 27	+ 41
June 19	− 3	+2,056	+ 2053	+ 602	+ 782	− 2	+3,435	+ 26	+ 34
July 17	+ 236	−2,246	−2,010	+ 816	+ 195	− 16	−1,015	− 71	+ 218
Aug. 21	− 16	− 81	− 97	+ 295	+ 3	+ 8	+ 209	− 22	+ 48
Sept. 18	− 122	+ 87	− 35	+ 184	+ 339	− 10	+ 478	− 108	+ 23

[a] After deducting 60% of net debit transit items (see additional notes to Table 6 of the *Quarterly Bulletin*).

[b] Non-interest-bearing M1 equals columns 1+2. M2 equals non-interest-bearing M1+columns 4+5+6.

[c] See footnote [e] to Table D on page 3.

[d] See footnote [f] to Table E on page 3.

Private sector liquidity, and other deposits

[Summary of Table 12 in the *Quarterly Bulletin*]

£ millions

	'Money'	Other money-market instruments	Savings institution deposits and securities		Certificates of tax deposit		PSL1 (columns 1+2+5)	PSL2 (columns 1+2+3+6)	PSL1		PSL2		Other shares and deposits with building societies	
	Seasonally adjusted	Seasonally adjusted	Seasonally adjusted		Seasonally adjusted		Seasonally adjusted	Seasonally adjusted	Seasonally adjusted change in month [b] [c]		Seasonally adjusted change in month [b] [c]		Unadjusted	
			Total (net)	*of which shares and deposits with building societies* [a]	Issues net of surrenders	Column 5 less building society holdings							Amount outstanding	Change in month
Month ended	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*		*10*		*11*	*12*
1984 Sept. 19	103,745	3,631	73,436	*69.817*	1,913	1,665	109,289	182,477	+ 1,480	*+1.4*	+2,358	*+1.3*	18,641	−125
Oct. 17	104,191	3,639	74,930	*71,398*	2,323	2,060	110,153	184,820	+ 864	*+0.8*	+2,340	*+1.3*	18,522	−119
Nov. 21	106,542	3,463	76,564	*72,883*	2,618	2,189	112,623	188,758	+2,467	*+2.2*	+3,932	*+2.1*	18,283	−239
Dec. 12	106,901	3,340	77,247	*73,641*	2,537	2,107	112,778	189,595	− 330	*−0.3*	+ 342	*+0.2*	18,145	−138
1985 Jan. 16	107,982	3,172	79,240	*75,614*	2,681	2,414	113,835	192,808	+1,056	*+0.9*	+3,195	*+1.7*	17,918	−227
Feb. 20	108,238	3,148	80,668	*76,957*	2,695	2,498	114,081	194,552	+ 243	*+0.2*	+1,724	*+0.9*	17,647	−271
Mar. 20	109.143	3,262	81,937	*77,982*	2,840	2,509	115,245	196,851	+1,191	*+1.0*	+2,313	*+1.2*	17,513	−134
Apr. 17	112,390	3,238	81,587	*77,898*	3,081	2,742	118,709	199,957	+3,469	*+3.0*	+3,091	*+1.6*	18,260	+747
May 15	112,924	3,085	81,739	*78,294*	2,975	2,634	118,984	200,382	+ 253	*+0.2*	+ 385	*+0.2*	19,049	+789
June 19	115,488	3,307	82,427	*79,216*	2,900	2,539	121,695	203,761	+2,653	*+2.2*	+3,311	*+1.7*	19,345	+296
July 17	114,569	3,303	83,210	*80,241*	3,062	2,672	120,934	203,754	− 718	*−0.6*	+ 31	—	19,481	+136
Aug. 21	116,762	3,080	84,096	*81,386*	2,929	2,530	122,771	206,468	+1,891	*+1.6*	+2,766	*+1.4*	19,640	+159
Sept. 18	118,927	2,961	84,941	*82,483*	2,696	2,296	124,584	209,125	+1,788	*+1.5*	+2,632	*+1.3*	19,590	−50

[a] Including UK non-bank private sector's holdings of certificates of deposit and time deposits issued by building societies.

[b] Percentage changes are shown in italics.

[c] In December 1984, the changes are stated after exclusion of the bank deposits and certain other liquid assets of British Telecom PLC.

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10 DOWNING STREET

From the Private Secretary 14 October 1985

JMB

The Prime Minister was grateful for your Secretary of State's minute of 7 October, reporting that he has decided against launching a Section 432 inquiry into JMB at the present time. She has noted the line he would intend to take in public if he is asked about this.

I am copying this letter to Rachel Lomax (HM Treasury) and Henry Steel (Attorney General's office).

(DAVID NORGROVE)

John Mogg, Esq.,
Department of Trade and Industry.

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Prime Minister 2
To note the proposed public line to take, over.
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PRIME MINISTER

JMB

At our meeting on 24 September, you invited me to consider further whether or not to institute an inquiry into JMB's collapse under Section 432 of the Companies Act 1985. After reflecting on this further, I have decided against launching such an enquiry at the present time.

In reaching this decision, I have taken account of all the various points made during our discussion. It is clear that the affairs of JMB have already been investigated in great depth. Remedial action has been taken by those responsible at each of several levels: management changes at JMB itself; strengthening banking supervision arrangements at the Bank of England; and a review recommending more fundamental changes in the supervisory system. The adequacy of all these measures is, of course, the responsibility of others but I have no reason to question it. I also recognise the force of the Governor's view that a Section 432 inquiry would risk disturbing the progress being made in restoring JMB to health and might thereby damage the interests of the bank and its customers. So far as the suspicions of fraud are concerned, Police enquiries are in train. I shall of course be ready to help the Police at any stage through the use of my Section 447 powers if this would be useful.

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If I am asked publicly to use my powers or to explain my decision not to appoint inspectors under Section 432, I would say that I believe a Section 432 inquiry could add very little to the extensive inquiries that have already taken place and the Police enquiries now in train. I would explain that the most appropriate way in which my powers could be used would be in assisting the Police if they believe it would help. I should also say that if fresh evidence came to light suggesting that a Section 432 would be appropriate, I would be ready to reconsider the position.

I do not doubt that certain Opposition Members will continue to try to oblige the Government to mount some kind of public inquiry into the affair because they scent political advantage in accusing the Government of a "cover-up". No doubt these calls will be renewed if it is eventually decided that there is insufficient evidence to bring prosecutions. Faced with these demands, we agreed that there might be some advantage in publishing an edited version of the Price Waterhouse Report. I hope that the Governor will proceed quickly with the preparation of a suitable version, so that we can consider whether or not its publication would be in the public interest.

I am copying this letter to the Chancellor of the Exchequer and the Attorney-General. I shall also be informing the Governor of the Bank of England of my decision as soon as possible.

L.B.

L B

7 October 1985

Department of Trade and Industry

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10 DOWNING STREET

From the Private Secretary

7 October 1985

GOLD, JMB AND SOUTH AFRICA

Thank you for your letter of 4 October.

The Prime Minister agrees that JMB should be allowed to take part in a new swop if they can but that the Bank of England should be discouraged from bringing pressure to bear on other members of the gold market to agree to JMB's participation.

I am copying this letter to Len Appleyard (Foreign and Commonwealth Office).

(Charles Powell)

Mrs. Rachel Lomax,
H.M. Treasury.

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Prime Minister

Agree
- to let JMB take part in a new swap if they can; but
- to discourage the Bank of England from bringing pressure to bear on other members of the gold market to allow this.

Yes

Yes not

CDP

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

Charles Powell Esq
10 Downing Street
London SW1

4 October 1985

Dear Charles,

GOLD, JMB AND SOUTH AFRICA

There is a long-standing agreement between the members of the London gold market (including Johnson Matthey Bankers) and the South African Reserve Bank to swap South African bullion for US dollars, the members of the gold market in effect providing a dollar loan against the security of gold held in London. The agreement was last renewed in 1981 and is due to come up for re-negotiation this month. At the time of JMB's rescue last October JMB's commitment was effectively taken over by another gold market member, but on a private and temporary basis.

This is potentially awkward. On the one hand there is the Prime Minister's assurance of 3 September to Mr Kinnock that "there is no question of the Bank of England giving financial support, directly or indirectly, to the South African Government in present circumstances", and JMB's status as a wholly-owned Bank subsidiary. On the other hand, it is not our policy to impose economic sanctions on South Africa.

JMB's management feel they are in a financial position to take part in a new swap. Moreover the Bank are clear that, from a commercial point of view, JMB's status as a full gold market member in good standing makes participation in any re-negotiated swap desirable. JMB's market standing, and therefore sale value, could be slightly diminished by exclusion. No doubt for very similar reasons, other gold market members have now expressed some resistance to JMB's participation in a new swap.

The Foreign Secretary has been consulted. I understand he agrees that it would be wrong for the Bank in any way to seek to prevent JMB from participating in a swap, on the basis that this is a commercial decision, and that the new swap would be a continuation of an existing arrangement. This is the same approach that we took to the newly signed contract between BNFL and the South African Nuclear Fuel Corporation. The Chancellor fully agrees.

However the Bank have now proposed that, for the reasons given in paragraph 3 above, they should actively seek to persuade the other gold market members to agree to JMB's participation in a new swap. The Chancellor thinks this would certainly become public knowledge and that it would be bound to be misinterpreted as the Bank giving active help to the South Africans (and inconsistent with the letter to Mr Kinnock).

Subject to the Prime Minister's views, therefore, the Chancellor thinks that the Bank should be asked not to seek to bring its formidable pressure to bear on the other members of the gold market; but that if JMB manage to persuade the other members of the market to let them participate in a new swap, then they should of course be allowed to do so.

Whatever the outcome, the right presentation would seem to be to treat this as a purely commercial matter between the parties concerned, and (if JMB's participation is agreed) as a continuation of an existing arrangement.

I am copying this letter to Len Appleyard (FCO).

Yours ever
Rachel

RACHEL LOMAX
Principal Private Secretary

SECRET

25

PRIME MINISTER

GOLD - JMB AND SOUTH AFRICA

As the Treasury letter below implies, it is arguable that the course of action proposed

- JMB taking part in a new swap; but
- discouraging the Bank of England from bringing pressure to bear on other members of the gold market,

is inconsistent with your assurance in your letter to Mr Kinnock that

"there is no question of the Bank of England giving financial support, directly or indirectly, to the South African Government under present circumstances".

After all, JMB is wholly owned by the Bank, its Chairman (David Walker) is a Director of the Bank, and its Board are appointed by the Bank.

None of this is to argue against Treasury and FCO advice, which I support. If the transaction became public knowledge (Treasury tell me that Dr Owen has good sources within the gold market) we can argue that:

- JMB is undertaking a commercial transaction.

- which is exactly the same as other members of the bullion market.

Therefore agree

- to let JMB take part in a new swap if they can,
- to discourage the Bank of England from bringing pressure to bear on other members of the gold market to allow this?

Yes mt

N.L.W

NIGEL WICKS

4 October 1985

MONTHLY ECONOMIC INDICATORS

MORGAN STANLEY

FORECAST — SEPTEMBER/OCTOBER 1985

MONDAY	TUESDAY	WEDNESDAY	THURSDAY	FRIDAY
23	24 CONSUMER PRICE INDEX (8:30) DURABLE GOODS ORDERS (8:30) Real Earnings*	25 TREASURY BUDGET 10-Day Auto Sales*	26	27 MERCHANDISE TRADE BALANCE (8:30)
30 LEADING INDICATORS (8:30)	1 CONSTRUCTION EXPENDITURES (8:30)	2 MANUFACTURERS' SHIPMENTS, INVENTORIES, AND ORDERS (10:00) Single-family Home Sales*	3 Monthly Auto Sales*	4 UNEMPLOYMENT RATE (8:30)

Report Date	Indicator	Amount of Change	Comment
9/24	Consumer Price Index (August)	+0.2%	Relative stability in quotes of food, energy, and apparel should hold the CPI at its May to July pace; there is a downside risk to this estimate because of discount financing of new cars.
9/24	Durable Goods Orders (Advance, August)	+0.7%	A reversal of plunges in defense and nondefense capital goods orders should partially recoup July's decline in hardgoods bookings.
9/25	Treasury Budget (August)	-$25.1-billion	The deficit should widen more than expected as a sluggish economy is causing receipts to fall short of OMB targets.
9/27	Merchandise Trade Balance (August)	-$12.0-billion	A rebound in most categories of imports -- following the sharp declines in July -- should bring the trade deficit nearly back to its second quarter average.
9/30	Leading Indicators (August)	+0.4%	An upturn in the factory workweek and continued rapid growth in the money stock should be partly offset by a weakening stock market, faster declines in commodity prices, and slower vendor performance.
10/1	Construction Expenditures (August)	+0.5%	A rebound in nonresidential building outlays, together with further gains in residential spending, should push overall construction outlays up for the second consecutive month.
10/2	Manufacturers' Shipments, Inventories, and Orders (August)	+0.5% -0.1% +0.7%	While orders are expected to improve a bit, August's fractional increase in output in the face of rising shipments should produce a slight further drop in factory inventories.
10/4	Unemployment Rate (Civilian, September)	7.2%	A substantial jump in the labor force, particularly among young persons whose participation inexplicably dropped in August, should cause the overall jobless rate to retrace some of the August decline; nonfarm payroll employment is expected to rise by 180,000 workers.

*Items due for release but not included in the forecast. In many instances, release dates and times are subject to change by issuing agencies or offices.

MORGAN STANLEY

POSTMORTEM WEEK ENDED SEPTEMBER 20, 1985

Date	Indicator	Forecast
9/16/85	Business Inventories (July)	Actual: 0.0% Projected: -0.2%

Most manufacturers and retailers have managed to keep their inventories under reasonably good control despite sluggish shipments and sales since last spring. Only merchant wholesalers appear to be carrying excess stocks, and those overhangs are not widespread. In short, there is little evidence in the July figures of either emerging imbalances or of aggressive actions to build stocks in anticipation of strength in future sales.

9/17/85	Consumer Credit (July)	Actual: +\$6.25-billion Projected: +\$6.50-billion

The slowing of net credit extensions during June and July compares with explosive gains of almost \$8 1/2-billion per month earlier in the year. Most of the slowdown has come from much smaller increases in revolving credit, as consumers have curtailed their spending on discretionary items other than autos. Despite smaller increases recently, the ratio of outstanding credit relative to disposable income has soared over the past year and is at its highest level since 1979.

9/18/85	Housing Starts (August)	Actual: 1.75-million units Projected: 1.75-million units

As expected, total starts bounced back somewhat from the reduced level of recent months, as multi-family units returned close to the elevated levels recorded this past spring; single-family starts, however, were up just slightly. To date, lower mortgage rates have provided considerably less impetus to housing activity than normally is the case, and as a result, the housing sector should provide only a moderate stimulus to GNP growth this quarter.

9/19/85	Personal Income (August)	Actual: +0.3% Projected: +0.5%

The shortfall of income growth was accompanied by a somewhat stronger-than-expected gain in personal consumption that drove the saving rate down to a post-war low of 2.8% last month. Over 70% of the rise in spending was concentrated in automotive purchases where demand continues to be bloated by aggressive financing incentives. However, with Detroit keeping assembly schedules fixed -- despite rising sales -- this report has little bearing on GNP growth this quarter; the personal spending numbers do suggest that the auto sector's contribution to GNP this quarter will be reflected in more rapid final demand and less inventory than we had previously estimated. If anything, the incredibly low level of the personal saving rate reinforces our view that consumer consolidation is now an essential precondition for a resumption of balanced expansion.

9/20/85	Real GNP (Flash, QIII)	Actual: +2.8% Projected: +3.1%

As implied by the August personal spending report, the flash appears to be consistent with stronger final demand and less inventory investment than we had been expecting. Our calculations suggest that the flash report implies real final demand could be growing in the 3 1/2% to 4% range in the current period -- almost a full percentage point faster than expected but considerably slower than the 4.6% gain in the second quarter. The Government's characterization of little change in capital spending, residential construction, and net exports is essentially consistent with our expectations. To the extent that current quarter consumption growth is being spurred by special incentive pricing of new cars, we continue to maintain that income-constrained consumers will promptly enter a period of consolidation that will keep the economy growing slowly through at least year-end.

Robert S. Gay
Stephen S. Roach
September 20, 1985

SECRET

24

Prime Minister   per

MR NORGROVE

24 September 1985

FUNDING POLICY

The Prime Minister's monetary policy meeting in mid July decided to stop over-funding of the PSBR. At today's regular Treasury meeting on funding policy, it was reported that net sales of gilts to all sectors were a modest £600 million or so in the banking months of August and September combined - considerably below the PSBR. So the total stock of money market assistance fell dramatically from a peak of almost £17.5 billion in late July to around £14 billion now.

Because we raised so much less from the gilts market, Sterling M_3 grew rapidly. It has grown at an annual rate of well over 13%, compared with a target range of 5-9%.

It would be very worrying if the underlying position were as bad as the Sterling M_3 figures suggest. But there are reasons for believing they are misleading. Some of the increase in Sterling M_3 is accounted for by long-term interest-bearing savings, which will not be spent but will nevertheless fall within our definition of broad money. M_0 is within its target range. More widely, the PSBR seems to be reasonably well on track; interest rates are still high; inflation is at last coming down; and the City doesn't seem particularly jittery. But a plummetting oil price, or any

SECRET

suggestion of weakening resolution on public expenditure and the PSBR, could change all that. The Treasury are still cautious about cutting interest rates.

The forecast for the next few months envisages a slight improvement in the performance of Sterling M_3 - maybe growing at 1% a month. The hope is that the massive bill mountain may shrink further over the next couple of months.

Meanwhile, the relative stability in the domestic financial markets, and our low gilt sales, are bringing gilt yields down towards 10%. The 20-year gilt yield has not fallen below 10% under this Government. It would be very good news if it did fall below this crucial psychological barrier, though - as often in the City - there are signs of resistance whenever we approach it.

David Willetts

DAVID WILLETTS

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file

10 DOWNING STREET

From the Private Secretary

24 September 1985

Dear Rachel,

JMB and Ansbacher

The Prime Minister today discussed with the Chancellor of the Exchequer, the Governor of the Bank of England, the Secretary of State for Trade and Industry and the Attorney General proposals for Companies Act inquiries into the affairs of JMB and Ansbacher. Mr. David Walker was also present. The meeting had before it papers by the Treasury and the Bank of England and a letter from Mr. Robin Broadley of Baring Brothers.

Introducing the discussion, the Chancellor said he saw the question whether there should be a Companies Act inquiry into JMB essentially as turning on an assessment of the effect on the Government's position in the House. The attack on the affairs of JMB would re-emerge with renewed force after Parliament returned. The Lord Privy Seal had said he saw no way of avoiding a debate. There would be accusations of a cover up. Though unjustified these would be difficult to handle.

Continuing, the Chancellor said there was no assurance that the police would feel able to bring prosecutions. If there were to be no prosecutions, no report would be made public, without an inquiry. There would certainly, in any case, be demands for a Companies Act inquiry under Section 432. So far the demands had been for a public inquiry under the terms of the 1921 Act, which the Government had refused. But inevitably the demands would soon turn to the Companies Act, and the Secretary of State for Trade and Industry would need to be able to respond. In the absence of an inquiry under Section 432, there would also probably be an inquiry by the Treasury Committee. This would be highly undesirable. The Chancellor had concluded that an inquiry under Section 432 offered the best way ahead, subject to the agreement of the Secretary of State for Trade and Industry.

The Governor had put forward essentially one argument against an inquiry, the Chancellor said, namely that this would make JMB more difficult to sell and reduce its price. The Chancellor questioned how far this was a real fear. Potential buyers already knew of the police inquiries and

JB

the Chancellor was sceptical about how much extra deterrent would be created by a Companies Act inquiry. However, even if the Governor's analysis were correct about the financial costs, this was not an argument which could or should be used by the Secretary of State in deciding whether to appoint an inquiry; nor could it be used in Parliament. The Chancellor expressed gratitude that the Governor had offered the publication of an edited version of the report by Price Waterhouse. This warranted consideration. The Chancellor questioned, however, whether to publish this would be a desirable precedent and he also doubted whether it would satisfy Parliamentary pressures, since it would need to be heavily edited and might well have been overtaken by events.

The Prime Minister drew a distinction between a police inquiry and a Companies Act inquiry: the one was against persons, the other was an inquiry into the company. A Companies Act inquiry into a bank which was a going concern would be unprecedented. To appoint a Companies Act inquiry could kill JMB. The Prime Minister was also concerned that an inquiry would do great harm to the reputation of the City. The cause of the present difficulties was the absence of an effective fraud and prosecution service.

The Secretary of State for Trade and Industry noted that the decision on whether to hold an inquiry was at his discretion. An inquiry would cover the events leading up to the rescue. The fact that there had been no inquiry into a bank which was operating as a going concern, and the civil actions should not be seen as obstacles. He would prefer to avoid an inquiry. But if prosecutions were unlikely or there was no prospect of a reasonably full report otherwise being published, an inquiry was the only way of achieving a public account of events. The Secretary of State noted the Chancellor's view that the continuing criticism of the JMB affair was itself damaging the City's reputation.

The Governor of the Bank of England drew attention to the substantial improvements in JMB's position. The loan book had been cut from £500m to £400m; loan provisions were down from £68m to £45m; the balance sheet had been reduced from £2bn to £1.3bn; and the exposure to Nigeria had been reduced from £120m to £90m. There was serious interest from buyers, who were not being deterred by the police investigation. The tone of newspaper comment had changed in recent months from attacking the past to commenting on the way in which the company was being restored to health. JMB had succeeded in holding on to its customers, who included central banks. Customers recognised that a fraud squad investigation was directed ad personam. However, they might see an inquiry under Section 432 as risking bringing their affairs under investigation. The Governor was also concerned about the effect on the new Board, who had taken on the task out of a sense of duty to the City. The Governor was not sure that they would stay with JMB if they had to face another inquiry.

The Governor further drew attention to the investment by the Bank of England and the indemnities of £140 - £150m. If a forced sale of JMB took place, the receipts might amount to £80m or less. This would be a heavy price to pay for what might prove to be a not terribly effective answer to Parliamentary pressure. There might also be a further cost in terms of lower receipts from the sale of JMB, reflecting expectations of the lower outcome of the case against Arthur Young, which might be weakened by publication of an inquiry report.

Continuing, the Governor said that the Price Waterhouse report, even edited, might result in disclosures as far reaching as those which might be put out in a Companies Act report: that too would have to be edited (though the Governor acknowledged that editing the Price Waterhouse report might well have to be substantial). The Price Waterhouse investigations were virtually complete and the work for the statement of claim against Arthur Young might be ready in one to two months. The Governor noted that prosecutions stemming from Lloyds scandals were being held up by a Companies Act inquiry. (The Attorney General later disputed this, explaining that they were being held up by the difficulty of obtaining evidence and witnesses from overseas). In the case of JMB, the shareholders did not want a Companies Act inquiry and there were no creditors at risk. To hold a Companies Act inquiry into JMB would therefore be outside the usual scope of such matters.

The Attorney General described the state of affairs over the decision on whether to prosecute. The prosecution would arise from the unusual exposures at JMB, which had arisen in relation, for the most part, to people associated with the bank. There were missing documents, and the poor reporting to the Bank of England was also suspicious. A decision would be taken probably within two months on whether to bring in the fraud investigation group, but prima facie evidence of criminal activity was needed for this. The Attorney General hoped that a decision on whether or not to prosecute would be made by next Spring. The Attorney General was concerned that to publish the Price Waterhouse report, even heavily edited, would amount to a breach of faith and create a damaging precedent. The information made public at the time of the prosecution would be much more limited than a publication either of an edited Price Waterhouse report or a report of an inquiry under the Companies Act, and so less damaging to JMB.

The Prime Minister reiterated her concern that a Companies Act inquiry into JMB would be unprecedented and would result in damage to the Treasury, to indemnitors, to the City, and in the longer run to the Government.

In response to the Prime Minister, Mr. Walker described his perceptions of the reactions of likely buyers. From his experience with two or three of them, in his judgement they would be keen that allegations of fraud at JMB should be followed up. However, they would not wish the management of a company which they had bought to be subjected to an inquiry under Section 432, with no assurance about what would be published about the business in two or three years' time, when they would hope JMB would be operating well. It would cut little ice that the inquiry would be directed at events before the rescue: it was part of the achievement of the past year that existing customers had been retained after the rescue. It might be argued that an inquiry would focus on the banking business, but the management of the banking business and the bullion business was integrated and it would not seem credible to potential buyers to try to distinguish between them.

Reinforcing this assessment, the Governor said that an inquiry would introduce further uncertainty into the affairs of the company. He doubted that JMB would hold together if an inquiry was instituted and the result could well be a forced sale or liquidation. It was the worst of all worlds for a central bank to carry out a rescue and then to see the company fail.

The Chancellor noted that a decision on whether to hold an inquiry would fall to the Secretary of State for Trade and Industry and he would have to defend his decision. If he decided against, this would greatly increase the probability of an inquiry by the Treasury Committee. The Bank would then have to consider the possibility of publishing the edited Price Waterhouse report. Indeed, it might be impossible to prevent publication without a vote on the floor of the House. Even if it were published, the Treasury Committee might still decide to hold its own inquiry.

The Prime Minister invited the Secretary of State for Trade and Industry to consider, in the light of the discussion, whether or not to institute an inquiry into JMB under Section 432. The Prime Minister invited the Governor to set in hand the production of an edited version of the Price Waterhouse report with a view to publication if the Secretary of State decided against a Companies Act inquiry. Editing should be carried out by Price Waterhouse themselves. It might be possible to get permission from those who had given evidence to release more of the information in the report: this release would need to be freely given if the risk of setting damaging precedents was to be reduced. Price Waterhouse might wish to include an addendum bringing the report up to date. (The Chancellor believed this was already in hand.) Preparations would need to be made so that action could be taken quickly if necessary.

The meeting briefly considered the possibility of an inquiry into Ansbacher under Section 447. The Secretary of State for Trade and Industry said there were indications of deliberate concealment of information, but as yet insufficient evidence for a prosecution. If there were to be an inquiry under Section 447, it would not necessarily be announced. The Attorney General said that the Director of Public Prosecutions hoped for an inquiry under Section 447 in order to gather material to establish whether there was a basis for prosecution.

The Prime Minister recognised that if it became public knowledge an inquiry into Ansbacher would increase pressure for an inquiry into JMB. She invited the Secretary of State for Trade and Industry to consider, in consultation with the Attorney General, whether to institute an inquiry under Section 447. This should take account of a letter which Lord Williams had sent to the Governor about the affair. The Chancellor undertook to circulate this letter to the Secretary of State for Trade and Industry and the Attorney General.

I am copying this letter to the Private Secretaries to the Governor of the Bank of England, the Secretary of State for Trade and Industry and the Attorney General.

Yours sincerely,

David.

(David Norgrove)

Mrs. Rachel Lomax,
HM Treasury

Ref

File

10 DOWNING STREET

From the Principal Private Secretary

24 September, 1985

Thank you for sending me a copy of the Bank of England's draft of 23 September in which they announce certain measures to strengthen and improve supervision of banks and other institutions. You subsequently telephoned me to say that the Bank wished to amend the draft by replacing the first sentence in the third paragraph with the following:-

"In the area of banking supervision there will be a number of changes."

I have shown this draft press notice to the Prime Minister who is very content with it. It is, in her view, a great improvement on the earlier edition which she discussed with the Chancellor over the weekend.

I am also taking an opportunity of sending you a copy of the draft press notice which we are planning to issue at 11 am tomorrow announcing the new Deputy Governor of the Bank.

NW

Mrs. R. Lomax,
HM Treasury.

Prime Minister

This is much better.

N.L.

CHANCELLOR OF THE EXCHEQUER

Appointments in confidence.

Nigel

As agreed between the Chancellor & the Governor at the airport on Sunday.

KL.

24/9

SECRET

22

DRAFT (23. 9.85)

cc N Tower.

The Bank of England today announces a number of measures to strengthen and improve the supervision of banks and other financial institutions. These involve substantial increases at all levels in the resources devoted to the supervision of individual institutions, to supervisory policy, and to co-ordination between different supervisors internationally and domestically.

A new high-level supervisory committee is being set up under the Chairmanship of the Deputy Governor with Messrs Cooke, Galpin, George and Walker as members. This committee will be ultimately responsible under the Governor for all decisions on supervisory policy, especially its evolution, and for monitoring and minimising underlap and overlap between the Bank's supervisory responsibilities and those of other supervisory bodies.

In the area of Banking Supervision there will be a number of changes. ~~the full range of responsibilities hitherto handled by Mr Cooke will be split between him and Mr Galpin.~~ Mr Galpin, an Executive Director hitherto in charge of Operations and Services in the Bank and Chairman of Johnson Matthey Bankers will relinquish these duties and take over the overall responsibility at Director level for the supervision of banking institutions. Mr Cooke will have responsibility for the increasing workload involved in supervisory co-ordination internationally, most notably through his Chairmanship of the Basle Committee of Supervisors.

Mr Quinn, as Head of the Banking Supervision Division, will report to Mr Galpin on all questions involving individual institutions and to Mr Cooke on international supervisory issues. The Banking Supervision Division is being expanded. Staff numbers have been increased in the last six months and arrangements made for a continuing programme of outward and inward secondments to develop expertise in commercial banking and accounting skills. There will shortly be additional increases in the managerial and supervisory staff of the Banking Supervision Division and, as previously announced, Mr Sidney Procter will join the Bank on 1 October as an Adviser to the Governor on banking supervisory matters. Improvements have also been introduced in the organisation and working procedures to make clearer the lines of responsibility and communication in the expanded Division.

Under Mr George, the Gilt-Edged Division, which will continue to be headed by Mr Plenderleith, is being significantly expanded in numbers to handle its additional responsibilities arising from the change in the structure of the gilt-edged market. These additional responsibilities include a new supervisory function being set up under Mr Jennings with an initial team of four supervisors working to him, to supervise the new gilt-edged market-makers, the Stock Exchange money brokers and the inter-dealer brokers. Most of the new people within the Division as a whole are coming from elsewhere in the Bank but in addition Mr McConnaichie, previously with the Inland Revenue, has been recruited as a Senior Manager. Supervision of the Discount Market will continue to be carried out by the Money Markets Division, headed as before by Mr Coleby.

Under Mr Walker the functions of corporate and industrial finance and of securities and general supervision are being brought together under Mr C J Farrow. Mr Jonathan Charkham, currently on secondment from the Bank as Director of PRO NED, is to become a Chief Adviser with responsibilities in this area. Mr Walker and Mr Farrow will continue the Bank's liaison work with the DTI, the SIB and the various City markets.

Mr Galpin's responsibilities for the operations and services of the Bank - including Banking Department, Registrar's Department, Corporate Services Department and the Printing Works, will be assumed by Mr Dawkins who becomes an Associate Director.

Mr Galpin will resign as Chairman of JMB on assuming his responsibility for the supervision of banks. Mr Walker will become Chairman of JMB, in addition to retaining his other responsibilities. Mr Alan Lord, a non-Executive Director of the Bank, will also be joining the Board of JMB as a non-Executive member.

All these moves will take place on 1 October, except that of Mr Charkham who will join the Bank in November.

19 September 1985

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APPOINTMENTS IN CONFIDENCE

File Lomax

BM

10 DOWNING STREET

From the Principal Private Secretary

23 September 1985

BANKING SUPERVISION: APPOINTMENTS

The Prime Minister discussed with the Chancellor on the telephone on Saturday his minute of 18 September to which was attached a draft press notice, which the Governor intends to issue next Tuesday, on changes to the staffing of the Banking Supervision Department.

The Prime Minister recognises that this is a matter of internal Bank organisation and she appreciates the personnel considerations which have led the Governor to the arrangements described in the draft. Nevertheless, she is very strongly of the view that it is absurd to split responsibility for banking supervision between Galpin, who would be responsible for all individual banking institutions, and Cooke, who would be responsible for general policy on Banking Supervision and international supervisory co-ordination. Cooke has to bear, in the Prime Minister's view, substantial responsibility for the Johnson Matthey debacle. It would therefore be quite wrong, in her view, for him to retain responsibility for general policy and preparation of the new Banking Act, though she would not object to his continued involvement in the international aspects of supervisory co-ordination.

The Prime Minister therefore would like the Chancellor to persuade the Governor to change his dispositions so that Cooke loses responsibility for general policy as well as for individual banking cases. He should make clear that the significance of these personnel dispositions went far beyond the Bank's own internal organisation. Unless the Bank Supervisory Authority was held in high esteem, the reputation of the City of London, and ultimately the Government itself would suffer. The Chancellor undertook to discuss this with the Governor on the flight to New York on Saturday evening.

NLW

Mrs. Rachel Lomax,
HM Treasury

APPOINTMENTS IN CONFIDENCE

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APPOINTMENTS IN CONFIDENCE

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

23 September 1985

Nigel Wicks Esq
Principal Private Secretary
10 Downing Street
London SW1

Dear Nigel,

BANK OF ENGLAND: DEPUTY GOVERNOR

As the Prime Minister knows, the Governor would like Mr George Blunden to succeed Mr Christopher McMahon as Deputy Governor of the Bank of England. I understand Mr Blunden has already been sounded out and would be happy to accept. The Chancellor agrees with the Governor's advice and hopes that the Prime Minister will feel able to recommend Mr Blunden to the Queen.

Yours ever
Rachel

RACHEL LOMAX

PRIME MINISTER   23 September 1985

JMB AND ANSBACHER

As all sides are now lining up for a DTI inspection, may we suggest that a High Court Judge be appointed as one of the inspectors? This should defuse any suggestion that this exercise is a Whitehall cover up. Secondly, as you saw with the interminable planning enquiry at Sizewell where the Inspector was Sir Frank Layfield QC, silks have rarely developed the judicial skill in cutting out duplication or irrelevant evidence. Judges more frequently have this facility. Lastly, it might be more appropriate for a senior Judge to quiz the Bank of England than a QC.

DTI inspections take between 9 months and 5 years, according to David Hobson of the Policy Unit, who was an inspector in the case of London and County Securities Group in 1974 with Andrew Leggatt QC (now Mr Justice Leggatt).

We also suggest that any announcement stresses that this DTI investigation will go further than the police enquiry, and therefore is not a duplication of police work.

HB

HARTLEY BOOTH

Baring Brothers & Co., Limited
8 Bishopsgate, London EC2N 4AE
TELEPHONE: 01-283 8833
TELEX: 883622

STRICTLY PRIVATE & CONFIDENTIAL

23rd September, 1985

The Governor
The Bank of England
Threadneedle Street
London EC2

Dear Mr Governor

It may be helpful if I confirm the views which I expressed on Thursday when you told me that discussions were being held about the possibility of a DTI Inquiry into Johnson Matthey Bankers.

The Bank's objective is to sell JMB as soon as possible to a private sector buyer on terms which recoup the commitment which has been made by the Bank and the Indemnitors to the greatest extent possible. In my view the establishment of a DTI Inquiry will prejudice this objective.

Discussions which I have so far had with potential buyers have shown that they are already concerned that, notwithstanding a change in ownership, JMB would continue to be exposed to investigation by the Fraud Squad and involved in extensive litigation against Arthur Young. However, I continue to believe that they are sufficiently interested in the bullion business of JMB to accept that as the Bank wishes to sell JMB as a whole, they must continue with the work of recovery from the disasters incurred by its general banking business prior to 30th September 1984 as a necessary part of the continuing business and activities of JMB, and will not be deterred by the Fraud Squad investigation or the litigation against Arthur Young. However, I am convinced that a DTI Inquiry would involve a degree of uncertainty and potential disruption for the business both in relation to the bullion business and the general banking business that would make it impossible for any of those parties who have indicated a potential interest in JMB to justify any continuing interest. The consequences to the Bank and the Indemnitors in being forced to maintain their current commitment to JMB will materially increase the risks of greater loss when either JMB is finally sold or other steps are taken to terminate or reduce its range of business.

.../...

The Governor 23rd September, 1985

Given that Price Waterhouse have already reported on JMB any increase in the Indemnitors' risk arising from the institution of a DTI Inquiry could significantly affect the relations between the Bank and the Indemnitors.

Furthermore, I believe that to involve JMB in the detailed scrutiny and investigation which would come with a DTI Inquiry, could have a material effect on the confidence of those customers who are currently undertaking bullion banking business with JMB. The assumption by the Bank of England of ownership of JMB last October, with the Bank's expressed commitment as to banking confidentiality, has seen a maintenance of customer dealings. I believe that there is a significant risk that such business would be lost in the event of the imposition of an Inquiry, which customers would see as putting at risk the banking confidentiality on which they rely. Loss of business would again expose the Bank and the Indemnitors to the risk of greater financial loss.

Again an Inquiry would surely prejudice JMB's action against Arthur Young.

Finally, I must confirm my concern that the institution of a DTI Inquiry could significantly erode the confidence and commitment which JMB has received both from the new Board which has been recruited for JMB and from the lower levels of management who have been retained by JMB since the events of last September. The fragile loyalty of those who work at JMB - other than perhaps the commitment of the Board which is more to the Bank of England than to JMB - requires the transfer of JMB to a commercial owner as soon as possible in order to maintain their interest and the viability of the business. It is my view that the institution of a DTI Inquiry could seriously prejudice this position.

Yours sincerely

Robin Broadley

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PRIME MINISTER

JMB AND ANSBACHER

You are meeting tomorrow with the Chancellor, Governor, Secretary of State for Trade and Industry, and the Attorney General to discuss JMB and Ansbacher. David Walker will be accompanying the Governor. The papers are:

- Paper by the Treasury, reflecting comments by the DTI (Flag A);

- Paper by the Bank of England (Flag B);

- Letter from Baring Brothers (Flag C);

- Letter from Nigel Wicks reporting your conversation with the Governor in Scotland (Flag D);

- Note by the Policy Unit (Flag E).

The material in the papers is mostly familiar. The letter from Baring Brothers simply reinforces the Bank's arguments that the viability of JMB would be damaged by an inquiry.

The two main factors which have not so far been discussed in a general meeting are the Treasury's recognition that the action against Arthur Young would delay publication of an interim report of an inquiry, and the statement that the Bank would be prepared for Price Waterhouse to publish an edited report.

You might start the meeting by noting that the action against Arthur Young means that the interim report "could not become public in less than a year and then only if we had by that time given up all hope of prosecutions and saw no complications for the civil action (paragraph 20 of the

Treasury paper). This clearly makes it worthwhile to consider alternatives to an inquiry.

You might then turn to paragraph 4 of the Bank paper.

On paragraph 4(a), how much of the Price Waterhouse material might be publishable, when, and would the Chancellor after Parliament returns would be able to promise that a Price Waterhouse report would be published?

On paragraph 4(b), when is a decision about a full police investigation likely to be made (paragraph 2 of the Treasury paper)?

On paragraph 4(c), it is true that the Treasury Committee give Chancellors a harder time than Governors, but if the Governor is willing to appear surely the Chancellor ought to be less reluctant than he seems to be (paragraph 19 of the Treasury paper)?

I understand that the Secretary of State for Trade and Industry is inclined to go for a Section 447 inquiry into the Ansbacher affair. This will also need to be discussed.

DLN

DAVID NORGROVE

23 September 1985

SLHAGS

SECRET

20 cc BG/UP

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

23 September 1985

David Norgrove Esq
10 Downing Street
London
SW1

Dear David

JMB INQUIRY

When we spoke earlier today, you said that the Prime Minister would be ready to accept, among the papers to be considered at tomorrow's meeting, a submission from Mr Robin Broadley, a Director of Baring Brothers. As I mentioned to you, Barings are advising the Bank on the sale of JMB to the private sector.

Accordingly, I enclose a letter which Mr Broadley has today written to the Governor. I am copying this letter and enclosure to Rachel Lomax (Treasury), Michael Gilbertson (DTI) and Henry Steel (Law Officers' Department).

Yours ever

John

John Bartlett
Private Secretary
to the Governor

10 DOWNING STREET

It would be right to receive a paper from Robin Broadley on his part of the Governor's case not

Prime Minister

You might like to have a first glance at these papers (brief to follow on Monday). See final sentence of para 4 of the Treasury paper in particular.

The Governor was allowed himself + 1 (to be David Walker). He also wants to have Robin Broadley, a director of Barings, who is handling the sale of JMB, for at least part of the meeting. The Treasury know and are strongly against. I agree – it looks bad for the Governor himself. No one else is bringing anyone.

Refuse Broadley?

DRN 20/9

VR62

SECRET

19

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

20 September 1985

David Norgrove Esq
10 Downing Street
London SW1

File with PM

Dear David

JOHNSON MATTHEY BANKERS

I now attach the paper commissioned in Nigel Wicks' letter to me of 6 September, for discussion at the Prime Minister's meeting next Tuesday morning. It reflects comments by the DTI. The Bank also saw a copy in draft, but did not comment; instead, I understand that the Governor may submit a separate paper.

I am sending a copy of this letter to John Mogg (DTI), Henry Steel (Law Officers' Department) and John Bartlett (Office of the Governor of the Bank of England).

Yours ever
Rachel

RACHEL LOMAX

JOHNSON MATTHEY BANKERS

Paper by the Chancellor and the Attorney General

The continuing political and press interest in the Johnson Matthey Bankers case has remained at a high level, even during the Parliamentary recess. It is clear that the Opposition Parties will make a meal of it as soon as Parliament returns. Unless some form of independent published report can be promised, suspicions of a cover-up will become increasingly hard to dispel. There is also a legitimate public interest because of the probable loss of public money through the rescue.

Involvement of the police

2. The police will report shortly to the DPP on their preliminary enquiry. They strongly suspect fraud, but have no firm evidence. They are likely to recommend a full police investigation, which would be conducted by the Fraud Investigation Group (FIG). It is, however, clear that it would take FIG a long time - perhaps as long as 18 months to 2 years - to establish any firm basis for possible prosecutions, and it must remain doubtful whether they will ever succeed in doing so. And unless the police investigations result in prosecutions, none of the evidence they might unearth will become public. In any case, the evidence made public through prosecutions would in the nature of things relate only to limited aspects of JMB affairs.

Options for a published report

The Bank make a rather surprising offer on this (see their para 4).

3. There are overwhelming reasons for continuing to resist publication of the Price Waterhouse Report. An Inquiry under the 1921 Act would be wholly inappropriate.

4. An enquiry under Section 432 of the Companies Act could however meet the need for an independent public account of the affairs of the company leading to the collapse. The Secretary of State has a discretionary power to publish a report after considering its contents. If there were prosecutions, the report would not normally be published until after the end of court action (in the event of an unsuccessful prosecution there could well be arguments against publication). If no prosecutions are contemplated, the report would normally be published upon completion. There is therefore a possibility that no full public report would be available for at least three years. The Secretary of State can commission an interim report which would be likely to cover the main aspects of the debacle, but the timing of publication of any report would have to take account of progress in the civil action by the Bank against the auditors - which could be very protracted.

This is new, to me, & surely knocks a major hole in the Treasury argument. - They hadn't thought of this point before we raised it.

5. Section 432 Inspectors have powers to require witnesses to give evidence, which can, in appropriate circumstances, be passed to the police. Co-ordination of the police enquiries and those aspects of the inspectors' enquiries which relate to criminal matters could be achieved through FIG.

6. The Chancellor and the Attorney General believe that an inquiry under Section 432 offers the only practical route, even if early publica tion of a report were not to prove possible.

The Governor's case against Section 432 inquiry

7. The Governor has advanced a number of arguments against setting up a Section 432 inquiry. These are set out at (i) to (vii) in Nigel Wicks' letter of 6 September to Rachel Lomax (~~Annex~~ A).

Flag D

not attached

Would a Section 432 inquiry jeopardise prospects for sale? (Points (i), (iii) and (iv))

8. The Governor argues that an inquiry would delay sale of JMB; cause the bank's board and management to fall apart; and lead to indemnitors suing the Governor for compensation.

The Governor dealt with this. Fraud is against a person – 432 against a company.

9. It is, however, difficult to see why a Companies Act inquiry should deter a potential buyer more than the Fraud Squad investigation that is already under way. Although a Section 432 enquiry could be aimed at the company's affairs leading up to the collapse, the inspectors ought not to be prevented from following up any indications of subsequent wrong doing by anybody, including staff still employed by the company. But neither can the police be restricted to covering the pre-rescue period.

10. The board and management of JMB undoubtedly face a difficult task. But again it is not clear that these difficulties, which are already present, would be significantly

worsened by a Companies Act inquiry. Nor can this consideration be allowed to determine whether there is to be a Companies Act inquiry or not.

11. As for the indemnitors, whatever the arguments about the likelihood of their taking action against the Government, if the Secretary of State had acted bona fide in exercise of his statutory powers, the Attorney-General is in no doubt that no Court would uphold their case.

Would a Section 432 inquiry jeopardise prospects of successful prosecution?

12. The Governor argues that an inquiry would not deter irresponsible bankers, while successful prosecution would; and that it would delay any prosecutions (points (ii) and (vi)).

13. There is no reason why an inquiry should cause delay in mounting prosecutions, though prosecutions would delay its report. Given the inspectors' powers to require evidence and documents, the police might even be assisted in mounting a case. A Section 432 inquiry would also unearth any Companies Act offences and would draw out any general lessons to be learnt from the case.

The Governor's other points (v) and (vii)

14. The Governor doubted whether there was a precedent for a Companies Act inquiry into a bank which was a going concern. It is correct that London and County had already totally collapsed. But JMB would also have collapsed, had the Bank not rescued it.

But the Bank did

Had London and County been similarly rescued, that would not have been a good reason for not having an enquiry.

15. Finally, the Governor argued that JMB's civil action against Arthur Young would be jeopardised. If Price Waterhouse are right in their advice that JMB have a good case, the worst consequence of an inquiry would be delay. Moreover the current police investigation offers Arthur Young a rather better pretext for delay, since the question of whether they were fraudently misled by JMB management is germane to the issue of their accountability.

The involvement of public funds

16. There is of course legitimate concern about the potential cost to public funds, whether or not the eventual disposal is likely to be more affected by a Section 432 inquiry than by the police investigation. But this needs to be weighed against the wider political and public interest issues mentioned earlier.

What happens if no Section 432 inquiry?

17. Parliamentary pressure is most unlikely to die down. Apart from Dr Owen's demands for an inquiry into the bullion business, and Mr Sedgemore's allegations, the Opposition front bench is likely to continue pressure for publication of the Price Waterhouse report and a public inquiry. The Leader of the House appears to believe that demands for a debate in the next session will be irresistible.

18. In answer to Opposition pressure, the Chancellor will be able to say nothing beyond what is already on the record, and will have to refer back repeatedly to the police enquiries. Demands for a public inquiry will continue. A 1921 Inquiry will have to be resisted, and questions about a Section 432 inquiry referred to the Secretary of State. He would have to counter them by saying the police investigation must take its course - an argument which is most unlikely to satisfy demands for a public inquiry. The Government would be wholly on the defensive, in the absence of a convincing case, in a matter where they have every interest in a full investigation of the facts, and nothing to hide.

19. It is also highly probable, that unless there is a Companies Act inquiry, the TCSC (of which Mr Sedgemore is a member) would decide to hold its own inquiry. The Government could not resist this. The Governor would no doubt be required to give evidence and to provide an account of events at JMB, both before and after the rescue, as well as to defend the rescue itself. It is also highly probable that the TCSC would demand to see the Price Waterhouse report, and the Government would only be able to refuse by opposing the request on the floor of the House.

Conclusion

20. The Governor has raised a legitimate point about the public money that might be put at risk. But there are wider issues to be taken into account. In the Chancellor's and the Attorney General's judgement, the balance of the arguments points to recommending that the Secretary of State be invited to initiate

an inquiry under Section 432 of the Companies Act into events at JMB prior to its rescue by the Bank. This would guarantee an independent inquiry, though the results could not become public in less than a year, and then only if we had by that time given up all hope of prosecutions and saw no complications for the civil action. It should not be any more prejudicial to successful disposal than the police inquiry. It is the only possible way of providing a convincing answer to public and Parliamentary demands for a full explanation of events at JMB.

21. The Secretary of State for Trade and Industry has been consulted in the preparation of this paper.

20. IX.

FN 85

COVERING SECRET

18A

cc HMT

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

20 September 1985

David Norgrove Esq
10 Downing Street
London SW1

Dear David

JOHNSON MATTHEY BANKERS

I enclose the Bank's paper for next Tuesday's meeting with the Prime Minister.

Copies also go to Rachel Lomax (Treasury), Michael Gilbertson (DTI) and Henry Steel (Law Officers' Department).

Yours ever

John

John Bartlett
Private Secretary
to the Governor

20. 9.85

PAPER BY THE BANK OF ENGLAND

JMB: SHOULD THERE BE A DTI INQUIRY?

1 This paper sets out the main factors that in the Bank's view justify answering the question in the negative.

A POLICY OBJECTIVE

2 The Bank's policy objective is to return JMB to the private sector as soon as possible on the best possible financial terms. A decision to institute a DTI Inquiry is inconsistent with and prejudicial to this objective because:

(a) No potential buyer would be ready to conclude a deal in the face of such an Inquiry, which to judge by precedents would last at least a year and probably two or three. The uncertainty of the outcome and the fact that such an Inquiry would inevitably cause disruption throughout the business would make it difficult, if not impossible, for a Board of Directors to justify agreeing to purchase.

(b) Since the main policy objective would at best be postponed and in all probability frustrated, the Bank of England would have to continue to run a commercial business with potential loss prospects for far longer than is desirable. This probability is made the more likely as confidence in the bank from its customers would be weakened by the Inquiry, as would the loyalty and application of the bank's Board and management. The Bank of England could well be forced to dispose of JMB on well nigh "fire-sale" terms or even to put it into liquidation as the best means of saving the balance of its investment.

(c) A DTI Inquiry would delay the case against Arthur Young. This would entail cost because the benefit of the claim could well be included in any sale, and delaying the claim would thus depress its value. A DTI Inquiry could also lead to the publication of statements and findings that could be turned by Arthur Young to defeat the case against them. Additionally, would it be proper to conduct a DTI Inquiry into facts which are simultaneously the subject matter of a High Court action?

(d) The fact that the terms of reference of the Inquiry into JMB might be confined to the period up to 30 September 1984, or to the banking business only, would cut little ice with potential buyers or the market. Uncertainty would be bound to be increased and confidence in JMB reduced.

3 Taken together, these purely commercial factors point to a potentially serious loss of money to the public sector as a result of launching a DTI Inquiry. Loss would also be sustained by the indemnitors.

B ALLEGATIONS OF A COVER-UP

4 The Bank acknowledges the need to deal with allegations of a "cover-up", but believes that this is already being and can be further met in the following ways:

(a) The critics have seized particularly on the fact that Price Waterhouse's report has not been published. There are three reasons why no report has been published so far -

(i) to avoid prejudicing the claim against Arthur Young;

(ii) to maintain banking confidentiality;

(iii) Price Waterhouse's concern that they might be liable to claims for damages against named individuals.

As soon as the claim against Arthur Young has been filed (probably towards the end of this year) the Bank would be prepared for Price Waterhouse to publish as comprehensive a report as is compatible with meeting the points raised above. It is suggested that an independent Privy Councillor might be invited to certify that anything omitted from the published report (eg the names of individuals) was omitted for legal grounds and did not involve the suppression of any material facts.

(b) In addition, it is now public knowledge that a police investigation is in train and if it were decided to make this a FIG case, that could be announced and would be wholly consistent with the purposes for which Parliament was informed that the FIG arrangement was being put on a permanent footing in July 1984.

(c) As far as statements by the Bank itself are concerned, there has already been an account of the circumstances leading up to the rescue in the Annual Report. Moreover, if the Treasury Select Committee sought to conduct its own investigation, the Governor would certainly be ready to appear before it.

C OTHER POINTS

5 Several other factors need to be borne in mind:

(a) One purpose of a DTI Inquiry is to draw out general lessons from the evidence for the future. In the JMB case, however, the main elements of what went wrong in terms of incompetence and misjudgment are already abundantly clear. The subsidiary nature of other lessons that might emerge from a DTI Inquiry and the long delay before publication suggest that any further lessons which might emerge would be largely, if not wholly, valueless for the purposes of improving banking supervision.

(b) In terms of deterrence, much the most effective action that could be taken would be a prompt and successful prosecution for fraud if evidence can be found to justify it. But no prosecution could be properly launched while another official Inquiry into the same set of facts was being conducted.

(c) Other DTI Inquiries into significant cases over the past 15 years have, to the best of the Bank's knowledge, been initiated in respect of going concerns only where Directors, shareholders or creditors (or some combination) have sought such an Inquiry in the absence of any other means readily to hand for getting to the bottom of the matter. This is emphatically not the position in JMB: the shareholders do not want an Inquiry and there are no creditors who are at risk.

(d) According to precedent, DTI Inquiries have been used to elicit facts which, in turn, have been instrumental in the institution of criminal proceedings or actions for civil remedies. In this case, the reverse is the position. Criminal investigation is in process and a civil action has begun. A DTI Inquiry would be prejudicial to both these.

D CONCLUSION

6 The case for a DTI Inquiry therefore rests solely on the need to dispel the impression that there is a cover up. The Bank does not believe that a DTI Inquiry could possibly achieve so much more in this respect than the courses described in paragraph 4 above (including, in particular, early publication of a full report by Price Waterhouse) as to warrant the unpredictable but undoubtedly very large loss to public funds that such an Inquiry would cause.

Bank of England

Domestic Monetary Pol:

Econ Pol. PC 14

18

20. 9.85

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£500 - 400m
68 - 40-45
2 - 1.3
£120 - 90
Customers via other Central Banks

Potentially - valuable asset:

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?
Volunteers stay there through this

(c) A DTI Inquiry would delay the case against Arthur Young. This would entail cost because the benefit of the claim could well be included in any sale, and delaying the claim would thus depress its value. A DTI Inquiry could also lead to the

Risk of prior ? £140-150m
Forced sale £80
Long run £60-70m

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Bank of England

PRIME MINISTER

BANKING SUPERVISION: APPOINTMENTS

The Chancellor's minute below reports that the Governor has "informed" him of prospective changes in personnel and organisation in the Banking Supervision Department, i e these are matters for the Governor's decision, not the Chancellor's.

At first sight, the Governor's changes look illogical - there is no sense in splitting responsibility for Banking Supervision between **Galpin** (responsible for all individual banking institutions) and **Cooke** (responsible for general policy on Banking Supervision and international supervisory co-ordination). But the Treasury assure me that, in practice, Galpin will run Banking Supervision, both policy and individual cases. The Governor wants to use the formula in the draft below to save embarrassment for Peter Cooke who has just had a heart attack. More important: to save the Bank's reputation for Supervision. And how can he have these responsibilities after a heart attack.

The Treasury have emphasised to me that these changes deal mainly with internal organisation within the Supervision Department. The~~y~~ Bank have announced separately the strengthening of the Department's banking expertise through the recruitment of outsiders referred to in the side-lined passage in the draft. The Treasury also tell me that the Governor has decided that **George Blunden** should be the next Deputy Governor. Blunden is (very) willing. This will not be announced until 1 December because that is what McMahon's new employers want (although I bet it will be leaked long before then). Blunden's appointment as Deputy will, rightly, be taken in the City as further strengthening of the Bank's supervisory function, especially in view of his past supervisory experience in the Bank.

I recommend that you simply note the Governor's changes, but urge that he proceeds urgently with the further steps referred to in the last paragraph of the Chancellor's minute, which are needed to strengthen the Banking Supervisory Department.

Do you agree?

N.L.W.

N L WICKS

19 September 1985

DN (o/r)

2

PRIME MINISTER 18 September 1985

CITY REGULATION

I met Mark Weinberg yesterday to discuss with him progress being made in regulating the City, in view of your fears.

He reported that the legislation is well advanced in draft at the DTI, and that the Marketing of Investments Board is making rapid progress in tackling the difficult issues before it. The various interests in the insurance industry have now reached an agreement on disclosure of commissions: all those living within a maximum tariff system will have to report that they are operating under that agreement, and those outside it will have to declare their actual commissions.

They are dealing with the problem of conflicts of interest, where individual intermediaries sell insurance policies to the public but are at the same time in the pay of leading insurance companies. Either an insurance broker has to be an independent broker and act in the best interests of his client - he will be subject to tests to make sure that he is doing so - or he will have to be the agent of one insurance company and state clearly that he is on commission.

The Securities and Investment Board is finding its task more difficult because it has such a wide range of different businesses to regulate. However, it is making progress in defining the separate areas for the self-regulatory bodies and in thinking about the kind of tight disclosure requirements and monitoring that will be necessary to ensure reasonable practice. I urged Mark to be very firm on the clarity of disclosure of interests, dealing prices and commissions.

The main problem which they have not tackled is the question of solvency. As we saw with JMB, a regulator finds it extremely difficult to know what is reasonable business practice to ensure that the business being monitored remains solvent. If the regulator moves in too quickly, it can bankrupt a perfectly reasonable business because people's confidence will be lost as soon as a business is subjected to special scrutiny. If, however, the regulators dither, the problem builds up with disastrous results. There is no easy answer to this.

The challenge for the regulators will be to create a climate in which people find it worthwhile to be respectable and solvent, and attract clients by so doing. Only through there being a market interest in solvency and good behaviour will we succeed in having a financial industry reasonably free of bankruptcy and scandal.

I have written a longer piece on the pitfalls and problems for the regulators for publication next April (attached).

John and I agreed that there was no need to bother you with this now. DRN 19/9.

John Redwood

JOHN REDWOOD

MT

 Dom Monetary Policy

STERLING AND THE EUROPEAN RATE MECHANISM

(Joint Note by Treasury and Bank of England)

Introduction

The public stance of the Government has consistently been that sterling would join the Exchange Rate Mechanism (ERM) when the time was right. Answering Dr.Owen on 31 January this year in the House of Commons, the Prime Minister said:

> "We have always said that we shall join the Exchange Rate Mechanism of the EMS when we believe that the time is appropriate. It is kept under review from time to time, but I must make one thing clear. Joining the EMS would not obviate increases in interest rates, it would not obviate the need for financial discipline and, indeed, it might increase it."

2. The subject was last reviewed with the Prime Minister in February of this year. Much of the background material and analysis presented for the seminar at that time remains valid. But key charts and figures have been updated and are attached.

3. Some elements in the balance of argument have changed since February, and there have been important developments in both the substance and the public perception of the UK's financial position.

4. When we discussed the question on 13 February, the dollar had risen sharply, sterling had fallen not only against the dollar but also against European currencies, reflecting market doubts about the Government's commitment to its counter-inflation strategy, and UK interest rates had been forced up sharply. Any move to join the ERM at that time would have been seen as stemming from weakness and might have been interpreted as an attempt to escape from the necessary financial discipline rather than reinforce it.

5. Since then our position has steadily recovered. Inflation is clearly on the way down and is recognised to be so by all shades of opinion. The monetary situation, though difficult to interpret, looks a good deal healthier. We have pursued a cautious policy over interest rates. And our determination to stick to the counter-inflation policy is not being questioned. The dollar has come down substantially from the levels it reached in the winter, though it is still subject to a good deal of variation. Since 13 February, the pound has risen by 8 per cent against the DM and 23 per cent against the dollar.

6. In spite of this stronger position, and the good results we are seeing now in the rate of inflation, we have run into difficulties over the operation and management of monetary targets. Joining the ERM could provide an opportunity not merely to restate our economic and financial strategy, but to reinforce it. It would be no soft option. It would mean linking sterling to the DM, the currency of the strongest economy in Europe, which has an inflation rate of little more than 2 per cent.

Reinforcing the Strategy

7. The MTFS is, and must continue to be, the centrepiece of our financial strategy. Over the past few years we have been operating the policy against a background of currency upheavals overseas and an unprecedented period of decontrol and structural change in the financial markets which is likely to continue. In consequence, the target measures of money have been difficult to interpret, with the various indicators pointing in different directions. For reasons we discussed at the Prime Minister's monetary seminar in July, we have recently had particular difficulty with £M3. Despite these problems

there can be no question of doing without the discipline of monetary targets, though we have to recognise that they have for the present, particularly £M3, become a less reliable guide to the conduct of policy. This has created some difficulties in public presentation and in sustaining the credibility of the policy. Though we receive credit for the results of our policy, this is offset by criticism of the way in which we operate it.

8. We have always acknowledged that, in assessing monetary conditions, the exchange rate has an important role alongside the monetary indicators. The uncertainty recently attaching to our pursuit of monetary targetry has in practice obliged us to place greater emphasis on the exchange rate. And domestic financial markets too have been increasingly influenced by it. It is clear to them what the direction of the interest rate response of a Government committed to low inflation must be, and market interest rates almost always react to sharp exchange rate changes.

9. We have, however, had considerable difficulty in explaining, at any particular time, what weight the exchange rate has in policy decisions. This has itself become a major source of confusion in presenting policy. Markets and commentators continually speculate about the exchange rate level which the Government would like to see; many different exchange rate bands are hinted at. There are of course some advantages in keeping the markets guessing, and in being able to take some part of any pressure on the exchange rate. We certainly would not wish to announce a special target of our own for the sterling index. But greater clarity would simplify some of the problems of day to day conduct of policy, greatly improve its presentation and remove fears that we were exercising too much discretion. The discipline

of an exchange rate regime is more readily comprehensible than money supply targets on their own. Better public understanding would itself be valuable both politically and in influencing economic behaviour. And the only practicable possibility of clarifying this part of our policy would be to join the ERM.

10. It is neither necessary nor desirable that joining the ERM should mean abandoning monetary targets. They would remain a central part of the MTFS. We would need to make it clear that the strategy continued, and that our aim remained to secure a steady and sustained reduction in inflation. Like the Germans, we would continue to set and pursue monetary targets. We would need to consider further whether it would be right at the time of joining to make any changes in the chosen target aggregates in the new context of membership of the ERM. We have in any case to decide how to deal with the present difficulty with £M3. But joining the ERM would support the strategy at a period of some difficulty in both conducting and presenting monetary policy - a difficulty which was recognised at the Prime Minister's seminar on 16 July on monetary control, and which is otherwise likely to persist.

But are we like Germans 2 of us in Snake together

11. Our primary monetary objective would remain to keep monetary conditions firmly in a counter-inflationary direction. We have always recognised that conflicts could arise between sticking to monetary targets and keeping the exchange rate within ERM limits. This might occur, for example, if there were a weakening of German policy; or, if the market came to fear there could be such a weakening, and marked the DM down. Although realignments are permitted within the rules of the system, we would aim to avoid changes, especially in the first year or so, and build credibility in the market. If, however, sticking to the existing parity

required a loosening of policy which was judged to be inconsistent with the aim of keeping downward pressure on inflation our intention- and it would be a mark of strength - would be to raise the value of sterling within the ERM.

<u>Impact on Industry</u>

12. Linking sterling to the DM would be of value in reinforcing industry's determination to control its costs. There have been signs that firms are beginning to ease up on this front, following the strong improvement in their profitability. Manufacturing costs have risen much faster than in other major countries over the past year. Recent statements by the CBI and other industry spokesmen about the need for a lower exchange rate have not been helpful. Such statements both unsettle the markets and encourage firms to believe that they will be bailed out by depreciation.

13. Provided we are satisfied with the realism of the exchange rate at which we join and make it clear that the Government's monetary and fiscal stance remains determinedly counter-inflationary, membership of the ERM would be a valuable discipline. Holding to something like the present £/DM exchange rate would reinforce downward pressure on industrial costs and prices. And we should undoubtedly wish to discourage any idea of periodic devaluations. We should join from strength with the intention of staying strong. The CBI, Institute of Directors and others who in recent months have come to support our joining the ERM, could hardly do anything other than support this stance. They know that this is the philosophy of the ERM, and would have no easy excuse if they found that keeping up with the deutschemark was tough going.

<u>Could we make it work?</u>

14. There is no way in which we can confidently rule out the possibility of bouts of heavy pressure against sterling in the ERM. They could arise from differential movements into or out of the dollar if that currency were under pressure either way; or from a

severe movement of oil prices; or from a weakening of confidence if our inflation performance seemed to be faltering. Given the scale of financial flows through London, the pressure on us might be very large. And particularly in the early months, the markets might well seek to test our resolve.

15. The view that our reserves were inadequate for membership of the ERM was one of the main concerns expressed at the Prime Minister's seminar in February. We have recently strengthened our reserves substantially by borrowing \$2.5 billion on satisfactory terms. But we still have smaller reserves in relation to our volume of trade, and even more so in relation to our potential exposure to international capital movements, than other countries of the Community. We would not want to spend massive reserves, as the French did in late 1982, in defence of the indefensible. We would hope instead to recognise the need for policy change in good time and act on that. But all experience of recent years shows that, even where policies are basically sound, fashions and accidents can induce temporary capital flows on a substantial scale. In such circumstances we would have to be prepared to adjust domestic interest rates vigorously and promptly purely for exchange rate reasons.

They claim the full amount here of course

16. After a period of achieving a track record and consequent credibility in the ERM we could hope to benefit from the reinforcing effects of membership of a mechanism that has been remarkably successful in limiting exchange rate variations. The fact of being a member could then help to stabilise expectations and to reduce some of the speculative flows. Our best protection would be our own financial strategy and performance. Some commentators have drawn attention to the UK's failure to live within the "Snake"

in 1972. But the UK's relative fiscal and monetary position is now quite different from what it was in 1972; then monetary conditions were easy and getting easier, and there was a widespread view that the UK authorities wished to see a lower exchange rate.

Who decides parities?

17. At the discussion in February there was some concern about the influence of other Community countries over our exchange rate. The constitutional position is that initial parities and any subsequent changes are decided by unanimous judgment of all Community Finance Ministers, who meet for the purpose at "realignment conferences". At these there is often a good deal of argument as to whether X should devalue or Y revalue (the same thing in market terms but different in terms of political presentation), and at the margins about the amounts of any changes (with a tendency for resistance against demands for large changes). At the end of the day it is usual for a compromise to be reached, but in practice an individual country only really loses its freedom of action when that country is seeking special financial assistance, in which case attempts may well be made by others to impose policy conditions - an IMF-type situation. There is certainly an in-built pressure in the system against devaluation. But that is what we would want.

Conclusions

18. We are able now to contemplate joining the ERM from a position of some strength, based on our success in reducing inflation and the widespread acceptance of our determination to continue in that direction and the expectation that we shall succeed. But we face difficulties over the conduct and presentation of monetary policy based simply on target monetary aggregates: the exchange rate has increasingly had to be taken into account, and this has also been difficult to handle and present.

19. Joining the ERM at this juncture would reinforce our basic monetary strategy, simplify its operation in some respects and greatly clarify its public presentation. It would impose a useful discipline to make industry face the need to keep costs down, but would also be well received by a broad range of industrial opinion.

20. There would remain risks of occasional severe difficulties in resisting exchange rate pressures - difficulties which we have not entirely escaped by staying outside the ERM hitherto. Despite these and other problems associated with full membership of the EMS, it is the considered view of the Chancellor and the Governor that the balance of advantage is now clearly in favour of joining at the earliest practicable opportunity.

ANNEX A

QUESTIONS OF PROCEDURE

In the Community

The formal process of joining would be as follows:

- we would notify our intention to the Commission and to our partners;
- a "realignment" conference would be convened, almost certainly over a weekend (notice could be given as late as Friday evening);
- the form of the conference is a preliminary meeting of the Monetary Committee (Treasury and Bank officials), followed by a meeting of Finance Ministers and Central Bank Governors;
- subject to the possible qualifications mentioned below, the sole purpose of the conference would be to settle the rate at which sterling would join, and the consequent complete new grid of cross-parities and ecu rates.

2 There are just two qualifications about the substance of the discussion:

- it would have to cover in addition any special points or conditions we wanted to raise: but this does not arise, because a mark of moving into the system strongly would be that we were not seeking special conditions and, in particular, we would be accepting the standard margins of variation of +/-2.25%;

- there would be additional but by no means insuperable complications if, at the time of our entry, some other Community country wanted to take the opportunity of realigning its own currency.

3. The rate at which sterling would join would, in theory, be an open matter for negotiation with and among all the partners. In practice, there would be a strong sense among all concerned, and this would include the UK, that the chosen rates could not be very far from the prevailing market rates: to choose otherwise would risk confusion when markets reopened. This still leaves some room for manoeuvre over the precise rates (which could be such as to give an immediate market effect of sterling being in the middle or upper or lower part of the permitted range). We would want to decide for ourselves within this limited room for manoeuvre. We would have to explain and argue for our choice, but there must be a very strong probability that the general satisfaction of others with our joining at all would give us a strong hand to play.

4. With sterling in the ERM, the relationship between sterling and the DM would be particularly important for the authorities of both countries. Indeed, the ERM would become a different animal: a binary system instead of one with satellites around a single currency. The behaviour of the new system is not predictable - a point which we suspect the Germans and others have not fully recognised. We would want after entry to have some intensive discussions with our German opposite numbers on two main points. First, we would want to explore the possibility of a bilateral "swap" arrangement to be used by agreement in order to meet special DM/£ financial flows. Secondly, we would want to establish very close consultation procedures between our Finance Ministries and Central Banks on any measures or developments in the monetary field.

Parliament

5. The previous Labour administration gave an undertaking to consult Parliament in advance if and when there was a decision by them to join the ERM when it was set up. (Mr. Healey on 29 November, 1978 - the passage is well worth reading and is attached). We cannot trace any such undertaking having been given by the present administration.

6. This means that we could choose between the two options of informing Parliament before or after joining. In either case we would need to move fast in order to minimise the risk of any uncertainty and speculation affecting sterling's position in the market or actually or potentially within the ERM. The two options have different implications and problems:

(1) Undoubtedly best from the point of view of minimising market disruption would be to avoid any hint of our intentions up to Friday night; then arrange a weekend "realignment" conference; and begin to operate within the ERM when markets opened on Monday. A Statement to the House would be necessary on the Monday and a very early full debate would be inevitable. We would want and need to present the whole decision to join including the terms and agreed rates as a package and would have to resist any suggestion that we could adjust the rate at which we joined. We would of course have to

explain at the weekend conference that there would need to be a debate and vote in Parliament which, if lost, would effectively overturn our decision to join; but we would operate in the market as members at once. We see no reason why this should cause problems with other Community countries - or with markets, provided we made it clear that there was no question of the debate affecting our agreement on the rate.

(2) The alternative would be a Statement in the House on a Thursday announcing our intention to join "at the current market rate". The last point would be essential to minimise the risk of heavy speculation. But some speculation would be bound to develop - and it could affect existing ERM currencies in ways which would be unwelcome (rumours that a conference on sterling joining could provoke general realignment). There would certainly be pressure from some MPs for us to seek some different rate and for any rate agreed with other Community countries to be subject to reference back to Parliament. This would have to be resisted but could be embarrassing both in Parliament and in the markets. In any case, Parliament would be unlikely to give authority to the Government to negotiate entry without demanding opportunity for debate when the terms were known; so we would still expect to face that problem after the weekend and in the face of well prepared opposition.

7. The mood of some in Parliament would not be helped by such an important decision being effectively taken before they are told

of our intention. On the other hand, the double dose of the second option is unlikely to be helpful. And the market arguments point pretty strongly to the advantages of the first option. On balance we judge the first option preferable.

Risk of Leakages

8. The decision on handling Parliament - and on timing generally - may be affected by risks of leakages. We should obviously take all possible steps to avoid these risks. But we cannot do anything to prevent an invented story; and the amount of enthusiasm for a decision to join in some quarters of the press makes such a possibility a real one. For the present our response is that the question is of course under regular/continuous review - leaving the implication that nothing has changed. This position should be held for as long as possible: the moment we depart from it we are at risk of market speculation and a build-up of noisy argument: if we wished to enter we would need to move fast into one of the two options indicated above.

9. The worst risk of leakage would arise if we had to talk in advance with other Community countries or the Commission. We have concluded however that this would not be necessary given that our entry must be welcomed and that we would not be seeking special conditions.

Mr. Healey:

On the other hand, if the changes which I have described, and for which the Government are pressing, are made in the exchange rate regime in the next few days—and many other countries besides ourselves are pressing for these changes—if the Heads of Government were to agree next week on the necessary commitment to concerted action and resource transfers, and if, therefore, the Government decided that it would be in Britain's interest to join the exchange rate regime, then—I was asked this question at Question Time the other day—the Government would submit their view to Parliament for debate, and, if necessary, a vote, before the regime came into operation at the beginning of January.

I hope that that allays the anxieties which some of my hon. Friends, and indeed some of my right hon. Friends, have expressed.

Mr. J. Enoch Powell (Down, South): When the right hon. Gentleman says " before the regime came into operation ", does he mean before this country is committed to participate in it or after we are committed but before it begins to operate?

Mr. Healey : If the House were to take a view that was different from that of the Government, on a matter of this importance, it would indeed be a very serious matter. There is not the slightest question but that the Government would be guided by the views of the House. But I hope that the right hon. Gentleman, who is a stickler for constitutional precedent here, is not suggesting that the Head of the British Government should go to an international conference and enter into negotiations and reach conclusions *ad referendum* to votes in this House. I think that that would be a total breach of all historical precedent. If the right hon. Gentleman was suggesting it, he would have difficulty in reconciling it with his views on many other issues of a constitutional nature.

I have made it absolutely clear that the essence of democracy in this country is that the Government repeatedly have to take decisions on many matters and submit them to the view of the House. If the House rejects their views, they either resign or change their policies.

LR3.72

APPOINTMENTS IN CONFIDENCE

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

PRIME MINISTER

BANKING SUPERVISION: APPOINTMENTS

The Governor has informed me of a number of changes to the staffing of the Banking Supervision Department which he plans to put to Court on Thursday, to take effect as from 1 October.

The key change affects Peter Cooke, who will leave the Court and cease? to be head of Banking Supervision. He will remain at the Bank, with responsibilities for international supervisory co-ordination, notably as chairman of the Basle Committee of Supervisors. Rodney Galpin, a member of the Court, will take charge of Banking Supervision. David Walker is to replace Rodney Galpin as Chairman of JMB.

a role in [illegible] of policy re new Banking Act

Full details are given in the attached draft of the press notice which the Governor intends to issue next Tuesday.

These changes, particularly the replacement of Mr Cooke by Mr Galpin, are a step in the right direction. But the Governor is well aware that further steps are needed to strengthen the Banking Supervision Department.

N.L.

18 September 1985

SECRET

17

DRAFT (16. 9.85)

The Bank of England today announces a number of measures to strengthen and improve the supervision of banks and other financial institutions. These involve substantial increases at all levels in the resources devoted to the supervision of individual institutions, to supervisory policy, and to co-ordination between different supervisors internationally and domestically.

A new high-level supervisory committee is being set up under the Chairmanship of the Deputy Governor, with Messrs Cooke, George, Galpin and Walker as members. This will be ultimately responsible under the Governor for all decisions on individual supervisory questions; for the evolution of supervisory policy; for co-ordinating supervisory principles and practice where differing institutions are involved; and for monitoring and minimising underlap and overlap between different supervisory regimes.

In Banking Supervision the full range of questions hitherto handled at Director level by Mr Cooke will be split between him and Mr Galpin. Mr Galpin, hitherto in charge of Corporate Services in the Bank and Chairman of JMB, will relinquish these responsibilities and take charge of the supervision of all individual banking institutions. Mr Cooke will retain the responsibility for general policy on banking supervision (including the preparation of the new Banking Act) and all his international responsibilities for supervisory co-ordination, most notably his Chairmanship of the Basle Committee of Supervisors. (?Expand on the growth of these demands.)

Mr Quinn will continue as Head of Banking Supervision Division, reporting to Mr Galpin on all questions involving individual institutions and to Mr Cooke on questions of general policy. Banking Supervision is being further expanded. (Mr Quinn to provide a passage outlining the increases in staff over the past and what is now projected. This should recall the recruitment of Procter (flagged some time ago) as well as the inward and outward secondments with commercial banks.)

Under Mr George, the Gilt-Edged Division is being significantly expanded in numbers. Most of these are coming from elsewhere in the Bank but in addition Mr Robin McConnachie (?age), previously with the Inland Revenue, has been recruited as a Senior Manager. Within the Gilt-Edged Division a new supervisory function is being set up under Mr Andrew Jennings with a team of four supervisors working to him. (Mr George to advise on this wording and whether we can have a few sentences on their role in the new gilts market.)

Under Mr Walker the two functions of industrial finance and securities supervision are being brought together under Mr C J Farrow. Mr Jonathan Charkham currently in charge of PRO NED is to join the Bank as a Chief Adviser with responsibilities in this area. Mr Walker and Mr Farrow will continue the Bank's liaison work with the DTI, the SIB and the various City markets. (Secondments of Bank of England staff to the SIB, Take-over Panel will be continued/stepped up?)

Mr Galpin's responsibilities for the corporate services of the Bank - including Banking Department, Registrar's Department and the Printing Works will be assumed by Mr Dawkins who becomes an Associate Director.

Mr Galpin has naturally to resign as Chairman of JMB on assuming his responsibility for the supervision of banks. He is to be succeeded by Mr Walker. Mr Alan Lord, a non-Executive Director of the Bank will also be joining the Board of JMB as a non-Executive member.

All these moves will take place on 1 October, except that of Mr Charkham who joins the Bank on 1 November.

16 September 1985

LR3.57

SECRET

Prime Minister

16

(2).

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

13 September 1985

David Norgrove Esq
10 Downing Street
LONDON SW1

Dear David

FOREIGN CURRENCY BORROWING

... I attach a revised version of the briefing on the $2 billion floating rate note issue. Subject to anything untoward happening between now and then we now plan to announce it early on Monday morning, 16 September.

The new version of the briefing includes a suggested line to take (defensive point number 4) on the Prime Minister's point about running down the reserves to pay off the Labour debt.

Yours ever
Rachel

RACHEL LOMAX
Principal Private Secretary

156/2

~~SECRET~~ Unclassified

HMG DOLLAR FLOATING RATE NOTE ISSUE

Factual

An announcement will be made early on Monday morning (16 September) that HMG is issuing US $2 billion of floating rate notes (FRNs).

2. The notes have a 7 year maturity and carry a coupon of 3 months' LIBID with no margin, reset and payable quarterly.

3. The issue is being organised by the Bank of England on the Treasury's behalf and is jointly lead-managed by Warburgs and Credit Suisse First Boston.

4. The notes are being sold in the international market in the normal manner for a eurobond operation.

Line to take

1. Part of prudent reserves management.

2. Reflects judgement of appropriate level of foreign currency reserves for UK to hold at time of exchange market uncertainty. At end of 1982, by when most of the more expensive of the foreign currency debt inherited from the last Labour government had been repaid, convertible currency reserves stood at the equivalent of $9.6 billion (and total reserves at $17.0 billion). They now stand at $7.5 billion (and $14.3 billion). HMG issue will restore them broadly to the level which seemed appropriate at the end of 1982 and does so now.

3. In last few years official foreign currency borrowing has been undertaken indirectly through the nationalised industries under the exchange cover scheme (with details published monthly in reserves press announcements). The

size of the operation on this occasion makes it sensible to borrow in the Government's own name.

4. Market response very favourable. Largest FRN ever at finest terms available to any borrower for an issue of this type. Indication of market view of quality of UK name.

Defensive

1. **ERM**

Position unchanged. Situation under continuous review.

2. **Intervention**

No change in policy. Not borrowing to support sterling. Chancellor has made clear on many occasions his attitude towards the use of intervention to influence exchange rate, though, as experience in early part of the year showed, in certain circumstances coordinated intervention can have a useful role to play (and can be undertaken profitably).

3. **Reversal of policy on debt repayment**

[Economic Secretary said in Written Answer on 24 November 1984 (col 448) that official debt had been reduced by $10 billion from figure reached by Labour government and that "a proper balance between the figures that we have now reached may well be where we should rest for the time being".]

Policy was to repay substantial part of expensive foreign debt inherited from Labour Government. This we have done. Official debt at end of August was $10 billion lower than in May 1979 and $14 billion below peak at end 1977. After this issue it will be still be $8 billion below inherited level and $12 billion below peak. Moreover in contrast to most of Labour debt the new issue is on very fine terms indeed. Reflects fact that this is a step taken from a position of strength, not weakness.

4. **Running down of reserves to repay Labour debt**

Of course a substantial part of the debt repayments were financed from the reserves. How else would it have been done? What the Government was doing, and taking credit for, was getting rid of large amount of expensive liabilities we did not need.

And NB: (i) Even so, net reserves are nearly $3 billion higher than they were in April 1979 (as a result of valuation factors, SDR allocations and small amount of intervention).

(ii) The UK's total net external assets, private and public sector combined, have increased by over £60 billion since the end of 1979 (from £12.4 billion at end-1979 to £73.5 billion at end-1984).

5. **Reasons for changes in reserves**

Changes in reserves over time reflect number of factors - intervention, valuation changes and net borrowing. Over whole period since April 1979 there has been a substantial reduction in net borrowing, a number of valuation changes in different directions and a small plus from intervention. The reduction since end-1982 partly reflects valuation changes and partly intervention undertaken at the beginning of 1983.

6. **Comparisons with other borrowers**

This is the largest FRN ever issued and HMG has obtained the finest terms available to any borrower for an issue of this type.

7. **If questioned about EC issue**

(EC launched a $1.8 billion 5 year floating rate note on 22 May 1985 at a margin of 1/16 over LIBID but with lower front-end fees than our own issue and a slightly lower all-in cost).

The two issues are not comparable. HMG's issue is larger, and its maturity is longer. The only sensible comparison is with where the EC issue is currently trading, and on that basis the two issues are virtually level.

If pressed.

The real difference is that the EC issue was too tightly priced, very badly received in the market, and has still not yet fully sold into firm hands. By contrast, the initial reception for HMG's issue is excellent.

8. **Mismatch or capping features**

Specialist features of this type can be useful to some issues, but we are confident that HMG's issue will sell on its merits without any need for gimmicks.

9. **Exchange rate/monetary effects**

The issue will not have any significant effects on either the exchange rate or the monetary aggregates.

10. **Effect on the dollar**

Proceeds will be added to the reserves. So we will be adding the same amount to the demand for dollar assets (to hold in our reserves portfolio) as to the supply (in terms of the new HMG liabilities). There will therefore be no significant effect on the dollar exchange rate.

11. <u>**Silly time to acquire dollars**</u>

We will be adding the same amount to both our dollar assets and our dollar liabilities. Our <u>net</u> dollar liability as a result of this operation will remain unchanged. So any change in the value of the dollar will have no significant effect on the value of our <u>net</u> assets.

12. <u>**Cost of the issue**</u>

The issuing expenses are expected to total around £200,000.

13. <u>**Tax evasion**</u>

The issue follows standard Eurobond practice in paying interest gross. Any UK resident investors will, of course, have to fulfil their legal obligations in reporting details of interest received to the Inland Revenue.

157/14

OFFICIAL DEBT AND RESERVES FACTSHEET

Level of official reserves

$ billion

End-period	Total	o/w convertible currencies
1979	22.5	18.0
1980	27.5	18.6
1981	23.3	13.5
1982	17.0	9.6
1983	17.8	9.0
1984	15.7	7.6
1985 (August)	14.3	7.5

Level of official debt

	Total	o/w HMG borrowing
1979	20.7	9.7
1980	17.4	7.7
1981	13.3	4.6
1982	12.1	3.9
1983	12.0	3.7
1984	11.3	3.4
1985 (August)	11.9	3.4

INTERNATIONAL COMPARISON OF RESERVES

End-July 1985, $ billion

	Total	of which convertible currencies
UK	11.5	8.1
Germany	44.5	35.9
US	35.5	8.0
Japan	29.0	23.8
France+	26.5	21.7
Italy	23.8	19.5

* gold valued at SDR 35 per oz

\+ June data.

Peaks and troughs

$ billion

		Reserves		Official debt	
		Total	Convertible currencies	Total	HMG
Under Labour	high	21.9 (Mar '79)	19.3 (Jan '78)	22.5 (Dec '77)	12.9 (Sept '77)
(Mar '74-Apr 79)	low	4.1 (Dec '76)	2.5 (Dec '76)	8.7 (Mar '74)	4.5 (Sept '74)
Under Conservative	high	28.4 (Feb '81)	19.7 (May '80)	22 (May '79)	10.1 (May '79)
(May '79 to date)	low	14.0 (May '85)	6.8 (Mar '85)	11.0 (Sept '84)	3.2 (Apr (84)

Major HMG borrowings since 1974

Date	Amount	Description	Terms	Repayment/amount outstanding
March 1974	$2.5 bn	Eurodollar bank credit 10 years on a rollover basis with a 3, 6 or 12 month option	Floating rate yrs 1 & 2: LIBOR + 3/8% 3, 4 & 5: LIBOR +½% 6 & 7: LIBOR +5/8% 8, 9, 10: LIBOR +¾%	Repaid in monthly instalments from May-July 1981
Jan 1976	SDR 1 bn	1975 oil/facility	Floating rate	Equal quarterly repayments from Apr '79 to Jan '83

Date	Amount	Description	Terms	Repayment/amount outstanding
May 1976	SDR 700 mn	1975 stand by arrangement	Floating rate	Repaid by Apr '79.
Jan-Aug 1977	SDR 3.36 bn (Note only SDR 1.64 bn drawn down)	1977 stand-by arrangement. To be drawn down over 2 years	Floating rate	Repaid by Apr '79
April 1977	$677 mn (equivalent)	Foreign currency bonds denominated in $ issued with 5, 7 and 10 yr maturities for $202 mn, $82 mn and $18 million respectively. Others: DM 365 mn, Swfr 360 mn and Yen 21,500 mn issued with single maturity of 7 yrs	5 yr $ bonds at 8 3/8% 7 yr $ bonds at 8 5/8% 10 yr $ bonds at 8 7/8% 7 yr DM bonds at 7½% 7 yr Swfr bonds at 5 7/8% 7yr Yen bonds at 8%	Bulk of repayments made in Apr 1984. Remaining $18 million due for repayment in '87
February 1977	$1.5 bn	Eurodollar bank credit. 7 yrs on a rollover basis with a 3, 6 or 12 month option. Loan drawn down in 2 tranches: $1 bn and $0.5 bn	Floating rate yrs 1 & 2: LIBOR +7/8% yrs 3 to 7: LIBOR +1%	Repaid in monthly instalments from July to Dec 1980
May 1978	$350 mn	$ bond issue in New York: $200 mn with a 7 yr maturity and $150 mn with a 15 yr maturity.	Fixed rate 7 yr : 8½% 15 yr : 8 7/8%	7 yr bonds repaid in May 1985. 15 yr bond due 1993

15

PRIME MINISTER

2

FOREIGN CURRENCY BORROWING

The issue of a floating rate dollar note is to be announced on Monday. I have asked for revised briefing to be available for you before the weekend.

DAVID NORGROVE
12 September 1985

SECRET

ELBANC ECL

14

10 DOWNING STREET

12 September 1985

From the Private Secretary

FOREIGN CURRENCY BORROWING

PM BOX

The Prime Minister has seen the Chancellor's minute to her of 11 September. She agrees to the Chancellor's plan for a $2 billion floating rate note early next week and she notes that if the market reaction was particularly favourable and terms would not be sacrificed, the Chancellor would propose to raise the size of the issue.

The Prime Minister is however doubtful about the line suggested in the Chancellor's final paragraph. She has commented that to present the operation as a natural evolution of the previous nationalised industry borrowing programme would give the Opposition good opportunities for adverse comment on the side effects of de-nationalisation. They would say among other things that the Government have sold off the nation's assets and now are having to borrow.

Points 3 and 4 of the defensive briefing might be expanded to cover the accusation that the Government ran down the reserves in order to be able to make claims about the repayment of debt inherited from the Labour Government. This new borrowing shows that the Government's claims were spurious.

BF

The Prime Minister is leaving for the Middle East on Monday. Could I please have revised briefing for use as necessary by her, by close of play tomorrow?

in Go PM

SWH

(David Norgrove)

Mrs. Rachel Lomax.
H.M. Treasury.

SECRET

Line to take

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2. Reflects judgement of appropriate level of foreign currency reserves for UK to hold at time of exchange market uncertainty. At end of 1982, by when most of the more expensive of the foreign currency debt inherited from the last Labour government had been repaid, convertible currency reserves stood at the equivalent of $9.6 billion (and total reserves at $17.0 billion). They now stand at $7.5 billion (and $14.3 billion). HMG issue will restore them broadly to the level which seemed appropriate at the end of 1982 and does so now.

3. In last few years official foreign currency borrowing has been undertaken indirectly through the nationalised industries under the exchange cover scheme (with details published monthly in reserves press announcements). Decision now to borrow in Government's own name reflects judgement about market opportunity which now exists to borrow at very advantageous terms as well as smaller number of potential nationalised industry borrowers as a result of privatisation programme.

4. The rightness of that judgement reflected by market response. [Largest FRN ever at finest terms available to any borrower for maturity even of this type.] Indication of market view of quality of UK name.

Defensive

1. ERM

Position unchanged. Situation under continuous review.

2. Intervention

No change in policy. Not borrowing to support sterling. Chancellor has made clear on many occasions his attitude towards the use of intervention to influence exchange rate. But, as experience in early part of the year showed, in certain circumstances co-ordinated intervention can have a useful role to play (and can be undertaken profitably).

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Policy was to repay substantial part of expensive foreign debt inherited from Labour Government. This we have done. Official debt at end of August was $10 billion lower than in May 1979 and $14 billion below peak at end 1977. After this issue it will still be $8 billion below inherited level and $12 billion below peak. Moreover in contrast to most of Labour debt the new issue is on very fine terms indeed. Reflects facts that this is a step taken from a position of strength, not weakness.

4. Reasons for changes in reserves

Changes in reserves over time reflect number of factors - intervention, valuation changes and net borrowing. Over whole period since April 1979 there has been a substantial reduction in net borrowing, a number of valuation changes in different directions and a small plus from intervention. The reduction since end-1982 partly reflects valuation changes and partly intervention undertaken at the beginning of 1983.

5. **Comparisons with other borrower**

[Largest FRN ever at finest terms available to any borrower for an FRN of comparable maturity.]

6. **[If questioned about EC issue**

EC launched a $1.8 billion 5 year floating rate note on 22 May 1985 at a margin of 1/16 over LIBID, ie sub-LIBOR. This was for a shorter maturity and had a poor market reception.]

7. **Exchange rate/monetary effects**

The issue will not have any significant effects on either the exchange rate or the monetary aggregates.

8. **Effect on the dollar**

Proceeds will be added to the reserves. So we will be adding the same amount to the demand for dollar assets (to hold in our reserves portfolio) as to the supply (in terms of the new HMG liabilities). There will therefore be no significant effect on the dollar exchange rate.

9. **Silly time to acquire dollars**

We will be adding the same amount both to our dollar assets and to our dollar liabilities. Our net dollar liability as a result of this operation will remain unchanged. So any change in the value of the dollar will have no significant effect on the value of our <u>net</u> assets.

OFFICIAL DEBT AND RESERVES FACTSHEET

Level of official reserves

$ billion

End-period	Total	o/w convertible currencies
1979	22.5	18.0
1980	27.5	18.6
1981	23.3	13.5
1982	17.0	9.6
1983	17.8	9.0
1984	15.7	7.6
1985 (August)	14.3	7.5

Level of official debt

	Total	o/w HMG borrowing
1979	20.7	9.7
1980	17.4	7.7
1981	13.3	4.6
1982	12.1	3.9
1983	12.0	3.7
1984	11.3	3.4
1985 (August)	11.9	3.4

Peaks and troughs **$ billion**

		Reserves		Official debt	
		Total	Convertible currencies	Total	HMG
Under Labour (Mar '74-Apr 79)	high	21.9 (Mar '79)	19.3 (Jan '78)	22.5 (Dec '77)	12.9 (Sept '77)
	low	4.1 (Dec '76)	2.5 (Dec '76)	8.7 (Mar '74)	4.5 (Sept '74)
Under Conservative (May '79 to date)	high	28.4 (Feb '81)	19.7 (May '80)	22 (May '79)	10.1 (May '79)
	low	14.0 (May '85)	6.8 (Mar '85)	11.0 (Sept '84)	3.2 (Apr (84)

Major HMG borrowings since 1974

Date	Amount	Description	Terms	Repayment/amount outstanding
March 1974	$2.5 bn	Eurodollar bank credit 10 years on a rollover basis with a 3, 6 or 12 month option	Floating rate yrs 1 & 2: LIBOR + 3/8% 3, 4 & 5: LIBOR +½% 6 & 7: LIBOR +5/8% 8, 9, 10: LIBOR +¼%	Repaid in monthly instalments from May-July 1981
Jan 1976	SDR 1 bn	1975 oil/facility	Floating rate (based on IMF charges)	Equal quarterly repayments from Apr '79 to Jan '83

Date	Amount	Description	Terms	Repayment/amount outstanding
May 1976	SDR 700 mn	1975 stand by arrangement	Floating rate (based on IMF charges)	Repaid by Apr '79.
Jan-Aug 1977	SDR 3.36 bn (Note only SDR 1.64 bn drawn down)	1977 stand-by arrangement. To be drawn down over 2 years	Floating rate (based on IMF charges)	Repaid by Apr '79
April 1977	$677 mn (equivalent)(1)	Foreign currency bonds denominated in: $ issued with 5, 7 and 10 yr maturities for $202 mn, $82 mn and $18 million respectively. Others: DM 365 mn, Swfr 360 mn and Yen 21,500 mn issued with single maturity of 7 yrs	5 yr S bonds at 8 3/8% 7 yr $ bonds at 8 5/8% 10 yr $ bonds at 8 7/8% 7 yr DM bonds at 7½% 7 yr Swfr bonds at 5 7/8% 7yr Yen bonds at 8%	Bulk of repayments made in Apr 1984. Remaining $18 million due for repayment in '87
February 1977	$1.5 bn	Eurodollar bank credit. 7 yrs on a rollover basis with a 3, 6 or 12 month option. Loan drawn down in 2 tranches: $1 bn and $0.5 bn	Floating rate yrs 1 & 2: LIBOR +7/8% yrs 3 to 7: LIBOR+1%	Repaid in monthly instalments from July to Dec 1980
May 1978	$350 mn	$ bond issue in New York: $200 mn with a 7 yr maturity and $150 mn with a 15 yr maturity.	Fixed rate 7 yr : 8½% 15 yr : 8 7/8%	7 yr bonds repaid in May 1985. 15 yr bond due 1993

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

Prime Minister
Content for the issue to go ahead next week?
DRN
11/9.

PRIME MINISTER

FOREIGN CURRENCY BORROWING

We discussed, in May and more recently, the question of a substantial foreign currency borrowing in the Government's own name in order to replenish the reserves. You agreed that such a borrowing should be undertaken, with the details to be decided in the light of market circumstances at the time.

A very attractive opportunity has now arrived and, if prompt advantage is taken of it, I believe that the market reception of an HMG eurodollar bond issue would be very favourable and command fine terms.

The issuing houses advise we move as quickly as possible, and this is fully endorsed by the Bank of England. I propose, therefore, to plan on the basis of a $2 billion floating rate note early next week. This would be the largest ever issue of its kind. If the market reaction was particularly favourable, and terms would not be sacrificed, I would propose to raise the size of the issue.

Presentation will obviously be important. My intention would be to present the operation as a natural evolution of the previous nationalised industry borrowing programme, and a prudent exercise in the management of the reserves. I attach a fuller note of the line I believe we should take.

N.L.

N.L.
11 September 1985

I think this will give the Labour party great opportunities for adverse comment on the side effects of denationalisation: no

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

Prime Minister 2
To note.

6 September 1985

D Norgrove Esq
10 Downing Street
London SW1

DB 6/9.

Dear David,

NATIONAL SAVINGS INTEREST RATES

We spoke earlier to day about the proposal to reduce National Savings rates, following the cut in building society rates announced last month. The Chancellor was anxious that the changes in National Savings rates should be announced on Monday next week, before Tuesday's money supply figures. The Prime Minister agreed to this so long as the Chancellor was satisfied that the reduction would not put the £3 billion target for National Savings over the year at risk, and that the announcement would not be taken badly by the markets in the light of today's exchange rate movements.

The Chancellor has considered these points and concluded that the balance of advantage lies in an announcement on Monday. Arrangements for this have now been put in hand. The cut in rates will be seen as a reaction to the building societies' earlier move, and should not be taken to have any wider market significance. And because the reductions are slightly less than those made by the building societies, they will help to restore some of the competitiveness that National Savings lost earlier in the year, and keep them well on track towards achieving the £3 billion target for 1985-86.

The Council for the Building Societies Association recommended a 1¼ per cent cut from 1 September in building society net deposit rates. The changes in National Savings rates will be a 1 per cent reduction on net instruments and a 1¼ per cent reduction on gross instruments. Details of the current and proposed new rates are as follows:-

	Current	Proposed
Income and Deposit Bonds	13.25	12.00
Invac	12.75	11.50
Fixed Interest Certificates	8.85	7.85
Yearly Plan	9.28	8.19
General Extension Rate	9.51	8.52

These new rates will be announced on Monday at 5.30pm.

Yours sincerely,

Phil Wynn Owen.

P WYNN OWEN
Assistant Private Secretary

file DA. 13

cc MASTER SET

10 DOWNING STREET

From the Principal Private Secretary

6 September 1985

Dear Rachael,

JMB

The Prime Minister had a long talk today with the Governor, at Dunphail, about the suggestion that there should be a Companies Act inquiry into JMB. As a result the Prime Minister is not yet convinced that an inquiry is the right course. The Prime Minister's doubts reflect the following seven concerns put to her by the Governor:

(i) While the Fraud Squad inquiry should not delay the sale of the bank, a Companies Act inquiry would cause a delay. This is because the Fraud Squad inquiry is directed against specific individuals, who are not now associated with the bank. Thus that inquiry need not impinge upon the bank's current business and prospects, and so need not deter prospective purchasers. But a Companies Act inquiry concerns the bank itself and thus would involve, to some extent at least, the new owner. Such involvement would be bound to deter any new purchaser, so that the bank's sale could be delayed or its sale price reduced.

(ii) A Companies Act inquiry would not, in the Governor's view, serve to deter bankers from the sort of conduct which had caused the downfall of JMB. That could only be achieved through the establishment of an effective prosecuting authority which would bring irresponsible bankers to book.

(iii) It was doubtful whether the present Board and Management of JMB would hold together during a Companies Act inquiry, with the consequence that the bank would collapse. The Bank would also lose the opportunity for recovering as much of its investment in JMB. This would be bad for the Bank of England, as well as for the reputation of the City.

(iv) If it could be argued that a Companies Act inquiry delayed the sale of JMB, or reduced its sale price, or indeed precipitated the bank's collapse, the Indemnity

CST

Group would, no doubt, seek compensation from the Government to the extent that there was a greater call on their indemnity.

(v) The Governor doubted whether there had been a Companies Act inquiry into a bank which was a going concern. The London and Counties inquiry was no precedent since that company had already totally collapsed.

(vi) A prosecution for fraud would, in the Governor's view, be ruled out while the Companies Act inquiry was proceeding. Thus there could be delay in bringing to justice those responsible for the JMB affair.

(vii) The Bank of England's civil action for damages against Arthur Young for their negligent audit of JMB's accounts could be held up by a Companies Act inquiry.

The Prime Minister believes that these issues were not disposed of in her earlier discussion with the Chancellor and she would like them to be considered at a meeting, under her chairmanship, between the Chancellor of the Exchequer, the Secretary of State for Trade and Industry, the Attorney General, and the Governor (who should feel free to bring along one adviser to the discussion).

Our office will be in touch with yours about the timing of a meeting. Meanwhile, I suggest that the Treasury should set in hand the preparation of a paper which, among other things, deals with the several issues referred to above.

I am sending a copy of this letter to John Mogg (Department of Trade and Industry), Henry Steel (Law Officers' Department) and John Bartlett (Office of the Governor of the Bank of England).

Yours sincerely

Nigel Wicks

Mrs. Rachel Lomax,
HM Treasury.

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5 September 1985

JMB AND ANSBACHER

There is for the record one point worth mentioning in relation to my letter to you of yesterday: the board of Ansbacher took the view that it would be in the company's best interests to let the matter rest rather than to reopen past history. They made no specific reference to a Companies Act inquiry.

I am sending a copy of this letter to Henry Steel in the Attorney General's office.

(DAVID NORGROVE)

Mrs Rachel Lomax,
HM Treasury.

SECRET

JB

subject cc master

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10 DOWNING STREET

From the Private Secretary

4 September 1985

JMB AND ANSBACHER

The Prime Minister today discussed with the Chancellor and Attorney General the Chancellor's paper which you sent to me with your letter of 3 September.

The Prime Minister expressed concern and surprise at the apparent assumption that the police were unlikely to secure enough evidence for a prosecution of employees or ex-employees of JMB. The Chancellor said that the difficulties being experienced by the police in investigating the affair and the time they were taking showed the problems. The Office of the Director of Public Prosecutions and the Governor of the Bank of England also were doubtful about the possibility of prosecutions. The Governor's view carried weight both because of the knowledge the Bank had gained about JMB's affairs and also because if there were to be a prospect of a prosecution, the need for a Companies Act inquiry - which the Bank strongly opposed - would be undermined. These judgments might be wrong and if so that would be good news. However, the judgment about the need for an inquiry had to be made on the basis of the most realistic possible assessment of the prospects. The Chancellor further noted that a Companies Act inquiry into a bank was not unprecedented. Though the circumstances were not entirely similar, an inquiry had been carried out into London and County Securities in the mid-1970s.

In response to the Prime Minister, the Chancellor and Attorney General explained that the police investigation now in train was preliminary and the Fraud Investigation Group had not yet been called in. The preliminary investigation was needed in order to show evidence of crime. If this could be shown the Fraud Investigation Group would then be called in.

The Prime Minister expressed doubt about the proposal for a Companies Act inquiry on several counts. The process itself had weaknesses. The Government would in effect be saying that if those responsible could not be convicted in court, they should be convicted in the court of public opinion by a process in which they could incriminate themselves and in which they could not protect themselves under the libel laws. More generally, the report of the

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inspectors would implicitly or explicitly criticise the way the Bank had exercised its supervisory responsibilities and this would in turn reflect on the Treasury and on the Government. The Prime Minister urged strongly the need for a move to a completely reformed system of supervision which would be above reproach and seen to work. The scandals in the City were doing immense damage to its reputation.

The Prime Minister accepted that the Price Waterhouse report on JMB could not be published. Furthermore the realisation that the police seemed unlikely to find grounds for prosecution and that their investigations would take a long time to come to final conclusions were new circumstances. The Prime Minister accepted on these grounds the Chancellor's proposal, with which the Attorney General had agreed, for an inquiry into JMB under Section 432 of the Companies Act. The Chancellor should consult the Secretary of State for Trade and Industry. A meeting with the Governor would also be needed. In the meanwhile the Attorney General could continue with preparations for the inquiry. The inspectors should be urged to work with great urgency towards an interim report and they should be allowed all the resources - including people - necessary to achieve this. (In this context it was noted that the choice of accountancy firms which could provide an inspector was limited by the way in which many of them shared insurers. This warranted study, in conjunction with DTI).

In a brief discussion of Ansbacher, the Chancellor said that the Board of the Company were opposed to a Companies Act inquiry on the grounds that those responsible had now left the Company and that the need now was for Ansbacher to rebuild its reputation. The police themselves did not wish to investigate what had taken place unless there were a complaint. The Governor of the Bank of England was not prepared to initiate a complaint, though he would be prepared to co-operate with an inquiry (if that were the Government's decision) within any limits set by the Banking Act. In these circumstances a Companies Act inquiry should be carried out under the terms of Section 447. When a report had been received, the Secretary of State for Trade and Industry would be able to decide whether it warranted police involvement.

The Prime Minister agreed that the intention to mount an inquiry into the Ansbacher affair under Section 447 should now be discussed with the Secretary of State for Trade and Industry by the Chancellor. It would also need to be discussed with the Governor.

I am sending a copy of this letter to Henry Steel (Attorney General's Office).

DAVID NORGROVE

Mrs Rachel Lomax,
H. M. Treasury

10

PRIME MINISTER

JMB AND ANSBACHER

You are meeting tomorrow morning at 9 am to discuss this with the Chancellor and Attorney General. You have in your folder:

- briefing by the Policy Unit (Flag A);

- Nigel Wicks' minute to you for your meeting last Friday with the Chancellor (Flag B);

- paper by the Chancellor (Flag C).

The Chancellor has asked strongly that no one except you, the Attorney and me should see the paper or attend the meeting. The Policy Unit contested this request but accepted after discussion that they should not see the paper tonight. I undertook to ask you whether you wanted the Policy Unit to attend the meeting in spite of the Chancellor's wishes. Could you please let the Duty Clerk know tomorrow morning or tell Caroline when she comes up to see you first thing?

I too have not yet seen the paper, in my case because I am following your instructions on going home.

Three points on the issue itself:

(i) The Chancellor sees it as an advantage that further questions would be easier to fend off once a Companies Act enquiry was announced. But, if true, the Opposition would say that is precisely why the enquiry was decided upon. If the enquiry then produced inconclusive results they would crow still more loudly.

(ii) What are the questions which the Chancellor believes he will find it so difficult to answer?

(iii) A Companies Act enquiry into a bank may be unprecedented. (The Treasury are checking this in view of your doubts.) People might well also find out that the Governor did not want it. This new development might be seen by many people as the Government moving on to the Bank's turf. The Government would then be more closely associated with any future problems in the City, and some of the blame would rub off on to it. If the Companies Act enquiries go ahead, the Chancellor's proposals on banking supervision would need to be all the better to be able to provide a defensible position for the Government.

The Treasury are preparing for a meeting on banking supervision itself. No date has yet been fixed. I have urged them to get on quickly with the paper which will be needed. If you continue to have strong doubts at the end of tomorrow's meeting, you could conclude that a delay will make a decision in favour of an enquiry more difficult, but that you will make up your mind on the Chancellor's proposal when you are able to put it in the wider context of banking supervision.

DRN

(DAVID NORGROVE)
3 September 1985

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COVERING SECRET AND COMMERCIAL IN CONFIDENCE

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

3 September 1985

David Norgrove Esq
10 Downing Street
LONDON SW1

Dear David,

JMB AND ANSBACHER

... I attach a memorandum by the Chancellor, as a basis for tomorrow morning's discussion with the Prime Minister and the Attorney General.

A copy has also gone to the Attorney General.

Yours ever
Rachel

RACHEL LOMAX
Principal Private Secretary

Spare for D. Norgrove

Ansbacher and Johnson Matthey Bankers

Note by the Chancellor of the Exchequer

This note is intended as a basis for discussion of whether there should be Companies Act inquiries into the affairs of Ansbacher and JMB respectively.

Ansbacher

The following is a brief chronology of events:-

January 1985: Press stories of difficulties at Ansbacher. Ansbacher extricates itself from recent loss-making acquisition of Wall Street securities firm (Laidlaw Adams and Peck). Charles Williams succeeded unexpectedly as Group Managing Director by Richard Fenhalls.

April 1985: Williams becomes Labour life peer. Press story that (Belgian - based) Groupe Pargesa/Bruxelles Lambert, who have 29.9% stake in Ansbacher will have to underwrite a rescue rights issue 3 times as large (£35m?) - as previously anticipated (S/Times 7 April).

17 May: Bank supervisors telephone Treasury officials to warn that Ansbacher will announce a rights issue on 21 May which would reveal near-insolvency (to be fully underwritten by GP/BL). Losses attributed by Bank to Laidlaw acquisiton (see above) and to a commodity dealing subsidiary. I was informed.

21 May: Announcement of £35.6m rights issue, and £31.4m loss in year ended 31 March. Ansbacher circular to shareholders notes questions about interim profit of £1.35m declared in September

1984: committee of Fenhalls and Vercambre (both arrivals to the board since the interim dividend) appointed to review circumstances in which interim dividend came to be paid. (In the event rights issue leaves GP/BL with 75% of Ansbacher.)

24 July: Ansbacher circular (Annex 1) to shareholders reports Fenhalls' and Vercambre's conclusions - that the board had not been in a position to form a true and fair view of Ansbacher's consolidated position (a substantial loss) at the time of the interim dividend. The Board had been provided by Williams with a summary assessment which was deficient and over-optimistic. But found no motive of personal gain on the part of any past or present director connected with the interim dividend and concluded it would be in Ansbacher's best interests to let matters rest.

25/28 July: Press interest with political overtones.

30 July: Ansbacher AGM.

2 August: At Attorney General's request (via DPP), Fraud Squad asked to see Governor about Ansbacher.

6 August: Solicitor-General meets Governor. Governor emphasises Bank willing to co-operate in any law enforcement investigation but has no further information about possible Companies Act offences than is in Ansbacher's statement to shareholders.

7 August: My office informed by Solicitor-General's office that Section 447 Companies Act investigation appears appropriate and suggests Treasury Ministers should advise the Secretary of State for Trade and Industry accordingly. Solicitor-General repeats this in writing to Economic Secretary (on 8 August).

It is quite clear from the letter to shareholders of 24 July (Annex 1) that at the least inadequate information was provided to shareholders at the time the interim dividend was declared. It is very possible that they were deliberately misled. The Law Officers have made it clear that they do not want to instigate a police inquiry if the Bank are not prepared to lodge a complaint.

A Companies Act inquiry could take one of two forms. The alternatives are set out in Annex 2. The more usual form of inquiry for a case such as Ansbacher would be under Section 447. While this would not result in a published report, any evidence suggesting criminal activity could be passed to the police. The alternative of a Section 432 inquiry would be more high profile, and the report would probably be published.

Against an inquiry, it could be argued that the shareholders are not complaining about the conduct of the business, and the Fenhalls/Vercambre letter recommends that bygones be bygones. Nor does the Governor consider an inquiry necessary. He reports that the Bank have no evidence of offences against the Companies Act beyond the Fenhalls/Vercambre letter and press reports. At a time of great public concern, however, about malpractices in the City, and in the light of a clear likelihood of a breach of the Companies Act, the Government would appear to be turning a blind eye if there were not at least a Section 447 inquiry.

JOHNSON MATTHEY BANKERS

The course of events has been as follows:-

June 1983 - June 1984: As we now know, during this period there was mis-reporting of 2 large exposures by JMB - although it was not discovered until May 1985. JMB's report for March 1984 (due in April) did not reach the Bank until June. Arthur Young signed off JMB's 1983/84 accounts with a clean audit certificate.

July 1984: The Bank sought a meeting with JMB (which JMB delayed).

Early August 1984:

- (Without the Bank's knowledge) Arthur Young sent JMB a letter warning of shortcomings in their control systems.
- The Bank receive JMB's report for June and the Bank/JMB meeting was held. The Bank expressed serious concern, sent in 2 officials. Arthur Young was requested to re-examine the loans.

25 September: The Bank were informed by JMB that provisions against bad loans required in the light of Arthur Young's examination threatened JMB's solvency.

25-27 September: At Bank's urging, Arthur Young carried out a wider examination. The Bank began discussing liquidity support for JMB with clearers, and the Deputy Governor gave Peter Middleton an initial warning of problems. By the night of 27 September, a team from the clearers was examining JMB's books; the Bank had called in Price Waterhouse; and JMB's insolvency was clearly exposed.

28-30 September: Abortive negotiations arranged by Bank with possible purchasers of JMB over the weekend culminated in news agency stories about a London bullion house in difficulty.

1 October:

- 6am: Peter Middleton was telephoned and told that the Bank's resources were unlikely to be adequate to rescue JMB.

- 7.30am: I held a meeting at which the Governor informed me that in fact the Bank proposed to rescue JMB from its own resources (together with £50m from JM plc and £50m warranties from the gold market and the clearers).

- Later that day the Bank purchased JMB for nominal sum from JM plc. The capital deficiency was estimated at £108m.

3 October: The Bank informed Treasury officials that the deficiency was now £150m, but that the warranties had also increased from £50m to £90m. (In the event, the detailed commitments of the other banks and the gold market were not settled until 29 March 1985. They take the form of a Bank indemnity to JMB of up to £150m against losses on commercial loans, supported by counter-indemnities for half of any such losses from the clearers (up to £35m), gold market members (£30m) and other accepting houses (£10m).)

October: The Bank took over direction of JMB. Staff from other banks were drafted in to assist in "reordering the loan portfolio and records". Price Waterhouse commissioned by Bank to make confidential reports about the state of JMB.

9 November: The Governor sent me the Bank's initial confidential report on the rescue. Inter alia it says:

> "On the basis of the information available to the Bank we have no grounds to believe there was fraud on the part of the bank's officers ..."

22 November: Bank deposits £100m with JMB. Treasury not informed. (See 18 December).

27 November: I saw the Governor with officials, and we agreed to set up the review committee under the Governor's chairmanship.

17 December: I announced the review in the House of Commons.

18 December: In response to Press stories, the Bank confirmed (and informed the Treasury for the first time of) £100m deposit.

13 February: Price Waterhouse (second) interim report, sent by the Bank to certain Treasury officials on a personal basis.

8 May: Ian Stewart confirmed (in a written answer) that the Bank's Annual Report to me under the Banking Act 1979 will attach an account by the Bank of events concerning JMB and its rescue.

13 May: The Bank announced a capital re-organisation of JMB (£50m ordinary, £25m redeemable and £25m subordinated loan stock). £100m deposit to be repaid. The latest estimate of likely call on indemnities was announced to be £65m.

28 May: The Deputy Governor informed Peter Middleton that only in the previous week the Bank had discovered that JMB had substantially under-reported their large exposures.

19 June: Chancellor saw Price Waterhouse Report for the first time.

20 June: I made my statement on the Review Committee's report and laid the Bank's Annual Report under the Banking Act, with their note on JMB, before Parliament. JMB announced it will sue Arthur Young. The potential claim on the indemnity was estimated at £68m.

I also said in the House:

> "No prima facie evidence of fraud has so far been uncovered. The Price Waterhouse report turned up no prima facie evidence of fraud. However, if any prima facie evidence of fraud were to be turned up in further investigations, of course the appropriate action would be taken".

9 July: The Bank informed Ian Stewart in a letter:

> "No prima facie evidence of fraud has been discovered. It is clear, however, that the serious inadequacies of JMB's internal systems left it unduly exposed to fraud. The City Fraud Squad will be assisting ... [Price Waterhouse in a more detailed loan examination than hitherto]"

The Bank had approached the police on 5 July. Significant further documents had been confirmed missing since my statement on 20 June. The Bank had previously thought it a reasonable assumption that the missing documents would eventually come to light, given the disorder in JMB's systems.

11 July: Oonagh McDonald in a PQ and letter to you, asked for a tribunal of enquiry under the 1921 Act into JMB and the Gomba group of companies. You answered on Treasury advice:

> "I see no purpose in the establishment of such an enquiry".

16 July: I had separate meetings with the Attorney General and the Governor to discuss Fraud Squad involvement.

17 July: I made a further statement. I explained to the House that in the light of serious and unexplained gaps in JMB's records

(revealed by continuing investigations since my statement on 20 June), JMB had requested the City of London police to conduct a preliminary inquiry with a view to establishing whether any criminal offences have been committed. The report will go to the DPP. I side-stepped ("wait, and see") Hattersley's and Oonagh McDonald's suggestions of a 1921 Act Tribunal inquiry (or Select Committee investigation) after the police investigation.

Sedgemore made his allegations re Hepker, Fraser, Sipra.

<u>23 July</u>: JMB issued its writ against its former auditors, Arthur Young.

<u>24 July</u>: Arthur Young issued writs against me and BBC/ITN/C4.

<u>26 July</u>: Adjournment debate.

<u>1 August</u>: David Owen wrote to you requesting a public tribunal of inquiry. You reiterated in reply that you saw no grounds for setting one up.

<u>14 August</u>: (Section 447) Companies Act investigation is (exceptionally) announced, into Sumrie Clothes (chaired by Hepker).

<u>14 August</u>: Sedgemore dossier delivered to Treasury.

Throughout this whole period there has been constant pressure for the publication of the Price Waterhouse report.

The present position

The Governor reports that the affairs of JMB are looking slightly better than the Bank originally thought. It looks as though the estimate of £68m to be met collectively by the banks' indemnity and the Bank of England could be unduly pessimistic. The Governor's latest estimate is that it may be £20-30m on the high side. The Governor also reports that around 50 organisations have expressed an interest in buying JMB, two or three of whom are clearly buyers subject to price. Negotiations about a complete sale are continuing with serious prospective purchasers, all of whom are reputable big banks. But no firm deal is likely within two to three months at the earliest.

On the legal front, Freshfields are preparing JMB's statement of claim against the auditors, Arthur Young. I am myself preparing my response to the statement of claim by Arthur Young in their libel action. I must emphasise that the case for a Companies Act inquiry into JMB is considered in this paper entirely on its merits. It has no bearing one way or the other on the libel action.

The police are conducting a preliminary enquiry, and the Fraud Squad should present their preliminary report to the DPP within a few weeks. The absence of vital documents related to some of the more doubtful loans, and indications the police have received that substantial numbers of documents were shredded, strongly suggests fraud. It is probable that the police will tell the DPP that they regard a full police investigation as desirable. It is, however, clear that the papers of JMB are in such a confused state that it could take the police a long time to establish any firm basis for possible prosecutions, and it is doubtful whether they will ever succeed in doing so.

Following our meeting on 1 August, I have reconsidered the case for publishing the Price Waterhouse Report. My view, with which the Attorney General agrees, is that this is not possible, for the following reasons:-

(i) - This is a confidential document of the Bank of England. In the Attorney's view, the future value of such confidential investigations would be seriously prejudiced if witnesses were to find evidence published which they had given in the belief that it was in confidence.

(ii) Much of the information in the Price Waterhouse report relates to details of individual's accounts. This is protected both by customary commercial confidentiality and under the Banking Act.

(iii) The Price Waterhouse reports provide the basis for the Bank's action against Arthur Young.

Political interest in JMB has remained at a high level, despite the Bank's attempt in its annual report to dispel anxieties by being more than usually forthcoming. Even during the recess, interest has been kept up by David Owen's demands for a 1921 Tribunal, derived from his (I am advised, misguided) serious worries about JMB's gold bullion business, and Brian Sedgemore's voluminous and headline-catching allegations. The Opposition front bench, although slow off the mark, have kept up pressure for publication of the Price Waterhouse report and a tribunal of enquiry under the 1921 Act. The case will not go away. Parliamentary interest will revive once Parliament reassembles and in John Biffen's view, there will be no way of resisting a debate before the end of the session.

<u>The need for an independent, published Report</u>

The fundamental difficulty arises from the absence of a published independent account of what went wrong. The Price Waterhouse report cannot be published, for the reasons given above. Unless the police investigations result in prosecutions, none of the evidence they might unearth will become public. There is a real possibility that the police will be unable to mount a prosecution.

There are overwhelming arguments against a 1921 tribunal:-

(i) The JMB case does not constitute a crisis of confidence of the gravity normally associated with such an inquiry.

(ii) The proceedings would be conducted in public, and therefore reported daily, and no doubt prominently.

(iii) The cost of such a tribunal would be substantially greater than for a Companies Act inquiry, without any corresponding benefits (the expenses of the tribunal would have to be met, as well as the cost of representation of witnesses at risk of being criticised in the tribunal's report).

(iv) As the Crown Agents case has shown, such an inquiry can take as long as four years.

(v) Witnesses could refuse to give incriminating evidence in the absence of express immunity from prosecution.

I have become convinced that some form of independent published report will be necessary to dispel accusations of a "cover up". These allegations are aimed at three separate targets. It is argued that this is another example of the City closing ranks - incompetence at the level displayed by the management of JMB would never have been tolerated in a manufacturing company; it is alleged that Ministers are in some way implicated, through connections with customers of JMB, particularly Mr Shamji of Gomba; and it is also said that the Bank of England wishes to cover up its own incompetence.

A Companies Act inquiry

An inquiry under Section 432 of the Companies Act would meet this need. Its proceedings would not be public, but it would publish a report. The Secretary of State can commission an interim report - if published, say after a year, it would cover all the main aspects of the debacle. Although Companies Act inquiries are not treated as sub judice for the purposes of proceedings in Parliament, the Speaker would be likely to seek to avoid prejudice against individuals by unrestrained comment and speeches. The Government would nevertheless be in a strong position to refute allegations of any kind of "cover up" and to refer critics to the prospect of the inspectors' report.

It is also highly improbable that if the Government were to volunteer a Companies Act inquiry under Section 432, the case for a 1921 tribunal of inquiry would continue to be pressed.

Against this, the Governor believes that the announcement of an inquiry would seriously jeopardise his chances of disposing successfully of JMB, and could cause a flight of customers, leading to collapse. The Bank would then be exposed to further criticism of their stewardship of JMB, through no fault of their own. Furthermore, if JMB did collapse again, there would be a substantial cost to public funds.

The Governor's objections must be given due weight. But his fears may be exaggerated. Prospective purchasers already know the Fraud Squad are investigating JMB, and that prosecutions may result. Furthermore, it should be possible to confine the terms of reference of the inquiry to the period prior to the Bank's intervention. But the Governor feels very strongly and will want to put his case to you personally, if we decide in favour of a Companies Act inspection.

There is an obvious awkwardness in announcing a Companies Act inquiry now. I shall be asked why this was not done right at the start, and what has happened since.

I believe these presentational difficulties can and should be overcome. Although we have consistently refused a 1921 tribunal of inquiry, we have never explicitly ruled out a Companies Act inquiry. It would be perfectly reasonable to say that in view of continuing pressure for publication of the Price Waterhouse report, I have reconsidered the decision not to publish. Regretably, there are still powerful reasons for its remaining confidential. But public concern for an independent published report was understandable, and for this reason I had invited the Secretary of State to consider setting up a Section 432 Companies Act inquiry.

Clearly any such inquiries must be conducted in such a way as not to hold up the progress of concurrent police inquiries.

Conclusion

I therefore recommend that the Secretary of State for Trade and Industry be invited to institute inquiries under the Companies Act into both JMB and Ansbacher. In the case of JMB this should certainly be under Section 432. For Ansbacher, Section 447 seems the better route, though there may be a case for proceeding under Section 432.

The Attorney General has seen this note, and agrees with the substance.

N.L.

3 September 1985

Annex 1

Henry Ansbacher Holdings PLC

(Registered in England No. 1180361)

Registered Office:
1 Mitre Square,
London EC3A 5AN

24th July, 1985

Dear Shareholder,

Payment of the Interim Dividend of 1.5p per share paid on 20th December 1984.

In my letter to you of 21st May 1985 I reported that a Committee of the Board consisting of Messrs Fenhalls and Vercambre, who were not Directors at the time of payment of the interim dividend on 20th December 1984, had been appointed to review the circumstances in which it came to be paid. In the appendix to this letter is set out a copy of the report of 22nd July 1985 which that Committee has delivered to the Board.

The Board has unanimously accepted the findings and recommendations of the Committee as set out in the Report.

As you will have seen from our recent rights issue circular, the Board had taken immediate remedial action prior to the findings of the Committee to prevent the recurrence of the sort of matters which were the subject of the investigation by the Committee. It has taken action to ensure that appropriate checks and balances apply throughout your Company.

I therefore believe that the Board has established a firm base for the protection of the Company and your interests in the future.

Yours sincerely,

David LeRoy-Lewis,
Chairman.

APPENDIX

REPORT on the payment of an interim dividend by Henry Ansbacher Holdings PLC on 20th December 1984 in respect of the six-month period ended on 30th September 1984

To: *The Directors of Henry Ansbacher Holdings plc* 22nd July 1985
From: *Richard Fenhalls and Claude Vercambre*

1 On 14th May 1985 we were appointed to form a sub-committee of the Board to enquire into and report on the circumstances surrounding the payment of an interim dividend of 1.5p per share by Henry Ansbacher Holdings PLC ("HAH") on 20th December 1984 in respect of the six months ended on 30th September 1984.

2 We have been assisted in our enquiries and findings of fact by Mr Henri Perpete, the external auditor of Groupe Bruxelles Lambert SA who has devoted the equivalent of some 5 working weeks to going through the papers and records of the Company and its subsidiaries and interviewing various people. We did not commission an audit.

3 In setting the parameters of our enquiries we acted on legal advice from Messrs Barlow Lyde & Gilbert, solicitors of 1 Finsbury Avenue, London EC2.

4 We have considered the Interim Statement of 8th November 1984 which accompanied the announcement of the Directors' intention to pay a special interim dividend of 1.5p per share on 20th December 1984. We are of the opinion that the Interim Unaudited Results for the half year ended 30th September 1984 given in that Statement did not give a true and fair view of the profits and losses of the Company and its subsidiaries on a consolidated basis for that period.

We are of the opinion that the Interim Statement should have shown a substantial loss and not a profit for the half year ended on 30th September 1984 and that there were no profits out of which an interim dividend could have been paid on 20th December 1984. For the same reasons we also believe that the language of the Interim Report was unrealistic in that it did not objectively reflect the true underlying trend of the businesses.

5 The Company did not obtain any professional advice from outside the group in relation to the declaration or payment of the Interim Dividend.

6 Summarised information was supplied to the Board in relation to the results of the company to 30th September 1984 by the then Group Managing Director which omitted facts which in our view should have been made available to the Board and without which the Board was not in a position to form a true and fair view of the affairs of the Company on a consolidated basis. We are of the opinion that the Board of the Company as a whole did not have a true and fair view of the consolidated affairs of the Company prior to the payment of the dividend.

7 On legal advice from Barlow Lyde & Gilbert we have considered whether any Director had acted without an honest belief that there were profits when there were not.

8 We have found no evidence that any Director who was not a member of the Permanent Committee of the Board or any non-executive Director who was a member of the Permanent Committee did so act. Insofar as The Lord Spens, Charles B Longbottom and Peter F Phillips are concerned, who were in senior executive positions at the relevant time, we have found no evidence that their knowledge of the respective portions of the company under their direct responsibility, extended to specific knowledge of other parts of the business of the company.

9 The interests of the Directors of the Company in the shares of the Company are set out in Appendix IV Paragraph 5 on pp 30 and 31 of the proposals for the Financial Reconstruction of the Company sent to shareholders on 21st May 1985.

10 We find that the creditors at the time of the payment of the interim dividend on 20th December 1984 were not prejudiced since new capital has been raised by the Company.

11 We find that no motive of personal gain was involved on the part of any past or present Director connected with the dividend payment. Indeed, the shareholding body as a whole benefited from the payment, for they received the money.

12 In view of our findings in the previous paragraph and our belief that it is in the Company's best interests to let the matter rest rather than to reopen matters which are now past history, we would recommend that no action be taken against any Director arising out of the payment of the interim dividend on 20th December 1984. We have discussed this recommendation with Groupe Pargeson/Bruxelles Lambert who concur with it

Annex 2

Forms of Companies Act investigation

There are two possible routes under the Companies Act:-

(a) **Section 447**

The more usual type of inquiry in simple and low profile cases. The Act empowers officials of the DTI to look at, and seize if necessary, books, records and papers of a company. The grounds for the inquiry are that the Secretary of State considers there is "good reason" (it is under this Section that an investigation is being conducted into Sumrie Clothes, a customer of JMB). Inquiries are relatively quick, discreet, and do not result in a published report. There are powers to require "explanations" of papers etc demanded by officials. Refusal to co-operate can result in fines. Information obtained can be disclosed with a view to prosecution if criminal charges are made. It is not usual to announce a Section 447 inquiry, though this is sometimes done (as with Sumrie).

(b) **Section 432**

A more formal inquiry. Independent inspectors are appointed (a QC and a senior accountant), and witnesses have legal representation. The Secretary of State can order such an investigation in circumstances suggesting fraud; if acts or omissions by the company are likely to be unfairly prejudicial to some part of its members; if a company's management has been guilty of "fraud, misfeasance or other misconduct towards the company or its members"; or if the company's members have not been given all the information in respect of its affairs which they might reasonably expect. Evidence may be required under oath. Failure to give evidence when summonsed is liable to the same penalties as contempt of court. The report of the inspectors is normally published, although the proceedings take place in private. The process is fairly lengthy, but the Secretary of State can require an interim report. (This normally occurs when circumstances strongly suggest criminal activity, and the inspectors wish to expedite criminal proceedings.)

Section 432 inquiries are normally set up at the instance of the Secretary of State. But it is also possible for an interested party - e.g. a disgruntled shareholder - to obtain a court order setting up an inquiry (e.g. in the recent case of Milbury Investments).

The report of a Section 432 inquiry is admissible in legal proceedings "as evidence of the opinion of the inspectors in relation to any matter contained in the report". In practice this procedure is never followed. The police do however frequently use inspectors' reports as the basis for their own enquiries. The same evidence can be elicited from the same witnesses either by the police in obtaining a statement if the witnesses are prepared to answer, or through cross-examination in court.

Neither the Secretary of State nor the inspectors have powers to grant immunity to witnesses in respect of subsequent prosecution. Although the Attorney does have such a power, it is never used in the context of a Companies Act inquiry. This marks an important difference from tribunals under the 1921 Tribunals of Enquiry Act. Immunity is not infrequently given to witnesses before these tribunals, because they have the right to refuse to incriminate themselves, which is specifically not available to witnesses in Companies Act inquiries.

E. R.

SECRET

8

3 September 1985

PRIME MINISTER

JOHNSON MATTHEY BANKERS AND ANSBACHER

MEETING WITH ATTORNEY GENERAL AND CHANCELLOR, 4 SEPTEMBER

Should these companies be investigated under Part XIV of the Companies Act 1985? The Attorney General and the Chancellor will argue for such an investigation.

The issues are:

a. Can Companies Act proceedings speed up the enquiry so that such skeletons as there are, are out of the cupboard as quickly as possible? (At the moment, the DPP and Scotland Yard report a huge and lengthy investigation which, on best estimates, if charges are brought, might mean a trial in 1987/88.)

b. Will more of the truth be brought out?

c. In view of all that has happened (see Annex) and the time that has elapsed, can we show that there is good reason for acting so late? Have we fresh evidence?

We are doubtful about all these points and even if the Chancellor hypothesises the DPP does not prosecute JMB that should not worry us. We can rightly say we trust the police.

LBTAAZ

SECRET

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The Dangers in using a DTI Investigation

1. We will be criticised for not leaving investigation to the police.

2. The police are proud of their speeded up procedure, and might feel their noses are out of joint.

3. We may be criticised for not doing this investigation sooner (in respect of JMB).

4. The Governor of the Bank of England has threatened to publicly oppose DTI investigation of JMB.

5. Why it will be said by David Owen and others if we are serious in our intention to have a full inquiry into JMB do we duplicate the "independent" police inquiry with an investigation which will be seen as a Whitehall (and therefore a Government) inquiry even if an independent accountant is appointed. Why did we refuse a tribunal as late as 2 August this year?

6. We may be criticised for attacking Kinnock's adviser, Lord Williams (Chairman of Ansbacher).

7. We might have egg on our faces if it is shown that we

SECRET

E.R.

SECRET

do not have "good reason" for the investigation within the meaning of Section 431(3). This is possible in the case of Ansbacher because the shareholders did not object to the error made by Williams and the company has already been cleared by one audit by a Belgian form of accountants.

Conclusion

We advise great caution in both cases. You should wait at least until mid-September, when the police say they will be in a better position to judge the evidence on JMB.

Hartley Booth.

HARTLEY BOOTH

The Chancellor has expressed ~~a~~ wish that his paper goes to you & Private Office only.

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ANNEX

Resumé of Events

1984	25-30 September	Failure of JMB made apparent to Bank of England
	2 October	Heads of agreement between Bank of England and JMB for the sale of JMB signed
	10 November	Bank of England placed deposit of £100 million with JMB
	17 December	Chancellor stated to the House of Commons that banking supervision would be fully reviewed by a Committee
1985	20 June	Review Committee Report announced in Commons (34 recommendations) Bank announced initiation of legal proceedings against the auditors of JMB: Arthur Young McClelland Moores & Co Chancellor stated in Commons that Bank acted within their discretion to nationalise JMB

SECRET

ANNEX (cont.)

	Losses of £348 million announced, of which £130 million and £150 million were met, leaving £68 million to be paid 50:50 by Bank and private sector banks (ie £34 million by the Bank)
17 July	Announcement by the Chancellor that JMB had invited the police to investigate and report to the DPP

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1.

PRIME MINISTER

JMB AND ANSBACHER

A meeting on the possibility of a Companies' Act inquiry into JMB and Ansbacher has now been arranged for Wednesday morning, 4 September, at 9 am. Treasury are preparing a note.

They would prefer at this stage to confine the meeting to yourself, the Chancellor and the Attorney-General. The Chancellor would want to talk to the Secretary of State for Trade and Industry if the meeting decides in principle that a Companies' Act inquiry would be worthwhile. The Chancellor would also prefer not to have the Governor at the meeting.

Content?

Yes m

DRN

DAVID NORGROVE

2 September 1985

EL3AMQ

(LO3RC) DEG

File

6.

10 DOWNING STREET

From the Private Secretary

30 August 1985

JMB AND ANSBACHER

The Prime Minister and Chancellor today discussed whether there should be a Companies Act inquiry into the affairs of JMB and Ansbacher.

It was agreed that the Chancellor would prepare a note as the basis for a further meeting. This should cover, among other things, the powers of inspectors, the legal position on the use of material gained in such an inquiry, for example in a prosecution, and the chronological history of these affairs, covering what we were told and what the truth was in the event. I accept that the last of these may not be very full in the time available to prepare it.

BF

I shall discuss with you separately who should be invited. The meeting will probably need to be on Wednesday morning, 4 September, to be confirmed later.

David Norgrove

SMH

Mrs. Rachel Lomax,
H.M. Treasury. — 1869.

CONFIDENTIAL

file

(LO3ALD) DSG

10 DOWNING STREET

From the Private Secretary

30 August 1985

BANKING SUPERVISION

The Prime Minister and the Chancellor agreed today that it would be useful to hold a meeting on proposals for changes in banking supervision. The full note to serve as a basis for this meeting should cover, among other things, the duties of auditors, international comparisons including particularly the United States and Germany, and a discussion of the rule that 25 per cent of a bank's assets may be loans to a single customer.

The Prime Minister also urged the Chancellor to include a firm discussion of banking supervision in his Mansion House speech.

David Norgrove

Mrs. Rachel Lomax,
H.M. Treasury.

CONFIDENTIAL

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cc Press Office VC

10 DOWNING STREET

THE PRIME MINISTER

2 August 1985

Confidential

Dear Dr. Owen.

Thank you for your letter of 1 August. I have seen the Governor's reply of 2 August and in view of that I see no grounds for setting up a public Tribunal of Inquiry.

Yours sincerely

Margaret Thatcher

The Rt. Hon. Dr. David Owen, MP.

Sent c/o 33 St Peter's Grove, Hammersmith, W6.

cc 2 Warren Cottages, Wembury, Plymouth, S Devon.

ECL

The Governor

Bank of England
London EC2R 8AH

2 August 1985

The Rt Hon Dr David Owen MP
House of Commons
London
SW1A 0AA

Dear Dr. Owen,

You sent to me a copy of your letter of 1 August to the Prime Minister in which you suggest that I should establish a public Tribunal of Inquiry into the affairs of Johnson Matthey Bankers and Johnson Matthey plc. It is not a matter for me to establish an inquiry of this sort but I have been asked by the Prime Minister to reply on the substance of the points you make.

You suggest from information in your possession that the statements which I made in my letter to you of 21 December last year are unfounded. I reject this entirely. Overall the bullion business of the JMB group traded at a profit before the date of JMB's acquisition by the Bank of England and has continued to do so.

You refer first to your knowledge that two senior employees of Johnson Matthey Commodities Inc, JMB's bullion dealing subsidiary in New York, have been removed from their posts. I confirm that both individuals were recently required to resign in order that new management could take over. The New York company traded profitably until early this year but subsequently has not achieved satisfactory results. In these circumstances, the Board of JMB thought it appropriate to change the management. No misconduct lies behind the reason for their departure.

You say you were informed that JMB was in the habit of depositing large quantities of metals with JM plc and that these metal deposits have not been properly secured. While metal facilities from JMB to JM plc have existed in the past and still continue, by far the larger part of the metal connection between the two companies reflects an arrangement under which JMB make use of JM plc's refineries to produce small gold bars which are successfully marketed worldwide. This is an important trading relationship between the two companies, from which it is obviously not possible to eliminate commercial risk, but which confers on JMB the unique advantage of being able to market small gold bars bearing the JM assay mark. The arrangements between the two companies are designed to ensure, as far as possible, that the property in this gold remains with JMB; and both companies' accounts show no debtor/creditor position in respect of this industrial process.

You refer to the possible consequences of a liquidation of JM plc. In such a contingency, there must be some risk, but recent figures released by JM plc have publicly revealed that that company is considerably stronger than when the banking facility was arranged last Autumn. This is illustrated by the fact that this stand-by facility of £250 mn has been used to a very limited extent and for short periods in the past and has not been drawn on at all in recent months.

I am taking this opportunity to be as helpful with my response as I can but I feel bound to advise that the publication of your allegations could only harm confidence in JMB. You share with me the main objective of returning JMB to the private sector as soon as possible and on the best possible terms; I hope you will not take steps which might prejudice this final objective.

Yours sincerely

R. Leigh-Pemberton

VR4

NBPM

AT 2/8

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

2 August 1985

Andrew Turnbull Esq
10 Downing Street
London SW1

Dear Andrew,

LETTER FROM DR DAVID OWEN: JMB

You will by now have received a copy of the Governor's reply to Dr Owen's letter to the Prime Minister of 1 August. The Chancellor and the Governor discussed a draft early this afternoon and the Governor was able to assure the Chancellor that he had satisfied himself that the information in the letter was correct and went no further than was required to answer the points raised by Dr Owen.

The Chancellor suggests that the Prime Minister might like to reply to Dr Owen on the following lines:-

> "I have seen the Governor's response to your letter of 1 August and in view of that I see no grounds for setting up a public tribunal of enquiry."

The Chancellor discussed this form of words briefly with the Attorney General yesterday afternoon and he was content.

I am copying this letter to Henry Steel (Law Officers' Department) and John Bartlett (Bank of England).

Yours ever
Rachel.

RACHEL LOMAX

Dom Monetary Pol. Econ Pol.
Pt 14.

02. VIII

PM 85

cc A/J (2)

THE RT HON DR DAVID OWEN MP

HOUSE OF COMMONS
LONDON SWIA OAA

1 August 1985

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

Dear Prime Minister,

I am writing to you formally to urgently request that you ask the Governor of the Bank of England to establish a public Tribunal of Inquiry into the affairs of Johnson Matthey Bankers and Johnson Matthey plc. As you will know, I have been concerned from the start, in letters to the Chancellor of the Exchequer and to the Governor of the Bank of England, about the continuing risk to public funds following the Bank of England's decision to rescue Johnson Matthey Bankers from collapse. I have consistently argued that the core of JMB's business - in the bullion and commodities markets - has been and remains commercially unsound and in my letter to the Chancellor of the Exchequer of 18th December, a copy of which I enclose, I issued a detailed analysis of JMB's accounts to justify this argument.

The Chancellor of the Exchequer has consistently passed the responsibility for replying to the Governor of the Bank of England. On 21st December I received a letter from Johnson Matthey Bankers Limited, a copy of which I also enclose, and a letter from the Governor of the Bank of England couched in such unequivocal language that I had only two alternatives; either to call for the resignation of the Chancellor of the Exchequer and the Governor, since I assumed that the Chancellor would not have let the Governor's letter to me stand if he did not accept it, or to accept their word that the bullion operations of JMB were perfectly sound. I decided to accept their word.

I am now, however, in possession of information which causes me grave concern and leads me to believe that the confident assertions in the letter from the Governor of 21st December are unfounded. I am told that -

> Mr Dennis Selby, 36 years a JMB employee and manager of JMB's bullion business in London and, most recently, in New York, has been removed from his post;

Mr Martin Stokes, the chief JMB bullion dealer in New York, has also been removed from his post;

I am further reliably informed that Johnson Matthey Bankers was in the habit of depositing large quantities of metals with JM plc in order to assist the industrial company and that these metal deposits have not been properly secured;

It has been put to me that the quantities of metal could be as large as 15 tons of gold, worth around $150 million, and 200 tons of silver, worth around $35 million. Were JM plc to go bankrupt, it is obviously vital, since public money is involved, to know whether Johnson Matthey Bankers can be repaid for these deposits and the exact nature of the arrangements that have been made between Johnson Matthey Bankers and JM plc;

There are several other matters causing concern as a result of Ernst & Whinney's report relating to the indemnity, but these are peripheral to the central question which relates to the soundness of Johnson Matthey Bankers' bullion operations.

I am sending a copy of my letter by hand to the Governor since, in my judgement, action needs to be taken by the Bank of England today and decisions announced no later than tomorrow. In the hope that you will act urgently, I do not intend to release this correspondence to the press at this moment and I hope you will be able to write back to me announcing the establishment of a Tribunal after the close of trading on the bullion market on Friday.

Yours sincerely

David Owen

DAVID OWEN


PM 3

THE RT HON DR DAVID OWEN MP

HOUSE OF COMMONS
LONDON SWIA OAA

18 December 1984

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London SW1

Your decision to set up an internal review of the present Bank of England supervisory arrangements in light of the collapse of Johnson Matthey Bankers (JMB) unfortunately does not deal with my main anxiety namely the extent to which public funds are still at risk over and above the present 75 million pounds. I am still very concerned that the Governor, - judging by what he said to me on 13 December and yourself judging by yesterday's exchanges in the House - are proceeding on the assumption that the problems in JMB are confined to a few bad loans in its commercial loanbook and that its core bullion business is basically sound. I fear that there are good prima facie grounds for believing otherwise. The best calculations available appear to demonstrate that JMB has had and will continue to have problems in the bullion sector of its operations. I would be grateful to receive your comments on these calculations and I do not think that this can await your review. As a basis for this figuring, I am assuming a 2-3% interest spread on the existing loans and fees charged for new loans of between 1 and 3% which my economic advisers tell me are normal for this typ: cf business.

On the basis of these assumptions and taking an average loanbook of 287 million pounds - based on the average of the figures quoted in JMB's audited accounts for 1983 and 1984 (see enclosure) - the commercial loanbook activity should have achieved profits over interest costs of between 7.2 million pounds and 13.1 million pounds. Overall bank earnings would be further increased by income from interest on the bank's capital. Taking last year's average UK rate of 9.25%, these additional earnings would amount to between 5.2 million pounds and 7.4 million pounds. Therefore, JMB's total earnings should have ranged from 12.5 million pounds to 20.5 million pounds even if it had done no bullion business at all.

Of course, one must allow for provision for bad debts and estimated overheads. As the financial statements, somewhat unusually, do not disclose a provision figure, I am taking a figure of 3 million pounds to be reasonable. My estimate of 2.9 million pounds for total overheads is based on the figure quoted in the annual accounts, scaled down for the number of employees involved in the banking side of the business. Thus, one would expect to see a gross profit from the commercial loanbook activity of between 6.6 million pounds and 16.6 million pounds. In fact the audited accounts show an adjusted pre-tax profit of only 4 million pounds for all JMB's operations. The obvious conclusion is that the bullion business made sizeable losses.

The foregoing analysis serves to support the argument which I first put to you in my letter of 2 November, namely that the main business of JMB - its bullion operation - is in serious trouble. The underlying losses cannot come from any other source. I note that the Governor, in his letter to me of 9 November, conceded that the major component of JMB's business is bullion and that the smaller associate components are virtually insignificant in overall terms both of turnover and profit. You must admit that it seems most unlikely that these losses could emanate from the minor sections of JMB's business. But is it not also the case that JMB's involvement in the riskier type of commercial lending was necessitated by a need to boost current earnings at the very time when the bullion business was beginning to show signs of ill-health, and did this not contribute directly to the eventual collapse?

The Bank of England's share is now 50%, i.e. 75 million pounds, in the current indemnity agreement, which has still to be signed by the other participants - the clearers, accepting houses, and bullion dealers. Perhaps they too are becoming worried about the health of JMB's bullion operation. If my above calculations are broadly correct, the Bank will find itself having to cover further losses which will necessitate a larger injection of its resources beyond the 75 million pounds already allocated. This explains why I asked you in the House yesterday to confirm that the Bank will not expose an even larger sum of public money to this very real risk at JMB. You gave me no such assurance. Can I repeat my request that you confirm that no further public money will be put at risk over JMB?

Following your Statement in the House yesterday, which is belatedly the first attempt at public accountability for the Bank's actions in the JMB affair, I am releasing this letter and its calculations to the press.

David Owen

JMB BULLION PROFITABILITY FOOTNOTES

1 Assumes an average balance based on opening and ending balance sheet amounts.

2 Capital calculated as follows:

Case 1: £80MM less £23MM due to subsidiaries.
Case 2: £80MM less £23MM owed to subsidiaries plus £17MM due from subsidiaries.
Case 3: £80MM - as in balance sheet.

3 Assumes immaterial provisions since they are not disclosed in the financial statements.

4 Pretax profit derived as follows:

Retained Profit		£3,100
Less:	Tax adjustment	(3,400)
	Group relief	(100)
Add:	Good will	400
	Dividend	4,000
Adjusted JMB Pretax Profit		£4,000

5 Estimated overhead determined as follows:

Annual report says 540 employees cost £7.8MM. ASSUME total overhad is 200% or £15.6MM. If JMB employs 100 people their estimated overhead is £2.9MM.

JMB BULLION PROFITABILITY ANALYSIS

(All Data from March 1984 JMB Audited Financial Statements)

	FOOTNOTES	CASE 1	CASE 2	CASE 3
A. JMB Commercial Loan Book:				
1. Loan Book INTEREST:				
3/84 £362MM 3/83 £212				
£574 ÷ 2 = £287MM at spreads ranging from 2-3% (increasing in 1/2% increments from Case 1 to Case 3)	1	5,740	7,175	8,610
B. New Loan Fees - Rates Assumed: 1-3%		1,500	3,000	4,500
		7,240	10,175	13,110
C. INTEREST on Capital at the Years Average Rate of 9.25%	2			
Case 1 - £57MM		5,273		
2 - £74MM			6,845	
3 - £80MM				7,400
		12,513	17,020	20,510
D. Provision for Bad Debts	3	3,000	2,000	1,000
H. Less Estimated Overhead (w/o allocation between businesses)	5	2,900	2,900	2,900
F. Estimated Gross Banking Profits		6,613	12,120	16,610
G. Less Retained Profit for the Year	4	4,000	4,000	4,000
H. Net Bullion Loss (Profit)		2,613	8,120	12,610
I. Adjustment to Ignore Assumption of Interest on Capital (Col. C)		5,273	5,845	7,400
J. Net Bullion Loss (Profit) with Assumption that JMB Earned no Interest on Capital		(2,660)	1,275	5,210

The Governor

Bank of England
London EC2R 8AH

21 December 1984

The Rt Hon Dr David Owen MP
House of Commons
London
SW1A 0AA

Dear Dr. Owen,

The Chancellor of the Exchequer has sent me a copy of your letter of 18 December on Johnson Matthey Bankers (JMB).

You have been informed on several occasions both by myself and the Deputy Governor that on the basis of the facts as known to the Bank and to JMB the problems which gave rise to the rescue operation for JMB arose in the commercial loan book and do not arise in relation to its bullion and other dealing operations which have been and remain profitable. The advice which you have received is ill-informed and the conclusions you draw ill-founded.

Your assertions, and attempts to demonstrate that the bullion operations of JMB are basically unsound, would, I believe, diminish the confidence of its customers and counterparties and their willingness to do business with it, making it more difficult for JMB to trade profitably in the future. I feel sure you must see that such a reaction could only have the effect of diminishing the value of JMB when, as we intend, it is sold back to the private sector and can only increase the risk of loss from the rescue operation, the prevention of which, as I understand it, is your principal concern. In so far as your assertions relate to the unprofitability of bullion operations generally, other bullion dealers could of course also be affected.

As you have released your letter to the Chancellor to the Press, I am also releasing my reply.

Yours sincerely,

R. Leigh-Pemberton

Member of the London Gold Market

JOHNSON MATTHEY BANKERS LIMITED

5 LLOYDS AVENUE
LONDON EC3N 3DB
Telephone: 01-481 3181
Telegrams: Mattheyban London Telex
Telex: 884491

Your ref.

Our ref.

The Rt Hon Dr David Owen, MP
Norman Shaw North Building,
Victoria Embankment,
LONDON SW1

21st December 1984

Dear Doctor Owen

I thought you would wish to see the enclosed copy letter before it appears in either "The Times" or the "Financial Times", to both of whose editors it has been sent.

Yours sincerely,

P. Brenan

PATRICK BRENAN
Finance Director

Member of the London Gold Market

JOHNSON MATTHEY BANKERS LIMITED

5 LLOYDS AVENUE
LONDON EC3N 3DB
Telephone: 01-481 3181
Telegrams: Mattheyban London Telex
Telex: 884491

Your ref.

Our ref.

The Editor,
The Times,
New Printing House Square,
Gray's Inn Road,
LONDON WC1

21st December 1984

Dear Sir,

In his open letter to the Chanceller of the Exchequer, Dr David Owen sets out some estimates which, he believes, show that the bullion business of Johnson Matthey Bankers Limited has lost money and may continue to do so.

Dr Owen's figures, and therefore his conclusions, are wrong. The newly-appointed directors now have sufficient information to confirm that JMB's bullion business not only has been profitable but remains so. The losses are overwhelmingly attributable to bank lending of poor quality. Lending money is easy. Lending in the confident expectation of punctual repayment is another matter.

The new Board, with able help from the staff and from other banks, is making progress. It would be a great pity if the job were made more difficult by wrong conclusions based on incorrect data.

Yours faithfully,

P. Brenan. Martin Harper

PATRICK BRENAN MARTIN HARPER

Directors

Copy to The Rt Hon Dr David Owen, MP

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10 DOWNING STREET

From the Private Secretary

1 August 1985

JMB: LETTER FROM DR OWEN

I attach a copy of the letter which the Prime Minister has just received from Dr Owen demanding the immediate establishment of a Tribunal of Inquiry into the affairs of JMB and JM plc.

The Prime Minister would be grateful for urgent advice.

I am copying this letter to Henry Steel (Law Officers' Department).

bf

(Andrew Turnbull)

Mrs. Rachel Lomax,
H.M. Treasury.

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10 DOWNING STREET

From the Private Secretary

31 July 1985

cc MASTER SET

Dear Rachel,

JOHNSON MATTHEY BANKERS

The Prime Minister discussed developments over Johnson Matthey Bankers today with the Chancellor of the Exchequer and the Attorney General. The Chancellor said that when he had made his statement on 20 June he had been advised that there was, at that point, no evidence of fraud. Shortly afterwards new information had come to light and he had been required to make a fuller statement that, while there was no evidence of fraud, there were grounds for calling in the police to conduct an investigation. The Government had, as a result, been made to look defensive and evasive, although at all times he had revealed to Parliament as much as he properly could given the information available to him. The pressure for further investigation into the affairs of JMB had continued. Rather than be put in the position of responding to such pressure, the Government could instigate a further report on JMB.

The Chancellor said he had identified two ways in which this might be done: to seek the agreement of Price Waterhouse to the publication of the report they had prepared for the Bank; or for the Secretary of State for Trade and Industry to appoint a QC and a senior accountant to conduct a Companies Act inspection. The objection to the former was that Price Waterhouse had conducted their investigation on the understanding that it would remain confidential. If their agreement to publication were secured, the report could be published in full or with certain details of customers omitted, though this would encourage the press to seek to identify the people concerned. A Companies Act inspection would be unusual, especially at this stage. Difficulties in the banking sector had previously always been dealt with by the Bank, and appointment of outside investigators would be seen as an implied criticism of the Governor and of the Bank. It would also take a few months to complete.

The Attorney General said the case for a further investigation and report was linked to the progress of the police investigation. If evidence of fraud were found

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quickly and a trial soon followed, the case for a separate investigation would be weaker.

In discussion, it was noted that the Bank had shown shortcomings both in its supervision before the collapse of JMB and in its efforts subsequently to clear the matter up. The impression had been given of not being in charge of events. The Price Waterhouse report had been received in February and should have alerted the Bank to the need to consult the police or to consider writing to the Chancellor to recommend a Companies Act inspection. The Chancellor should also have been informed earlier on the material in the report.

Summing up the discussion, the Prime Minister said it was not possible to decide whether a further investigation and report should be undertaken, or what form this should take, though there was in principle a preference for publication of the Price Waterhouse report rather than a Companies Act inspection which would take much longer. Before these issues were considered further, the Attorney General should examine the likelihood of a prosecution resulting from the police investigation.

I am copying this letter to Henry Steel (Law Officers' Department).

Yours sincerely
Andrew

Andrew Turnbull

Mrs. Rachel Lomax,
H. M. Treasury.

Prime Minister ②
To be aware AT 31/7

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SSBF

CABINET OFFICE
Central Statistical Office
Great George Street, London SW1P 3AQ Telephone 01-233

29 July 1985

Dear Prime Minister

REVISIONS TO GDP GROWTH RATES

I am writing to say that an article reporting the results of an analysis of revisions to quarterly estimates of growth rates of Gross Domestic Product (GDP) will appear in the July issue of Economic Trends, which is expected to appear on 12 August. The analysis was carried out by the Research and Special Studies Unit of the Central Statistical Office, in collaboration with the National Accounts Branch. The results have been discussed with Treasury officials.

The analysis finds that revisions to growth rates of constant price GDP have been more often upward than downward. After five years the balance is about two thirds upward to one third downward. The range of revisions is quite large; historically two thirds of the revised annual growth rates after five years have been in the range from 0.3 percentage points below the first estimate to 1.7 percentage points above.

Prime Minister
10 Downing Street
London SW1

To assist in interpreting movements in the economy, we shall show the range within which the revised values of current growth rates are likely to lie, on the assumption that future revisions are similar to those in the past. The article quotes ranges calculated to include two thirds of the revised values, and announces that in future articles and press notices on GDP each growth rate estimate will have a similar range quoted. As an example, the growth rate between the fourth quarters of 1983 and 1984 was first estimated as 2.4 per cent (this being affected by the miners' strike); the article quotes the range within which the finally revised value is likely to lie as 2.1 to 4.1 per cent.

Yours sincerely

John Boreham

JOHN BOREHAM

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Monetary Bulletin

No. 174 July 1985

Tax Anomalies & Financial Markets

During the last eighteen months, there has been a series of tax changes. Their overall effects may not be generally appreciated because the individual elements were anounced piecemeal, one between budgets and two at the report stage of the 1985 Finance Bill. The more surprising effects, which are explained below, are:-

i) investment in ordinary shares will in some circumstances be subsidised, while the main subsidy to direct investment in plant and machinery has been withdrawn;

ii) the gilt-edged market should have fallen relative to the equity market;

iii) long term investment in gilt-edged stocks will be penalised while short term speculation will be encouraged;

iv) monetary growth will be encouraged;

v) investors who are not short term speculators and who are subject to capital gains tax should consider purchasing long gilt futures on LIFFE rather than hold long dated gilt-edged stock; and

vi) they should also consider purchasing "synthetic bonds" rather than hold short dated gilt-edged stock.

The relevant tax measures are:-

i) The withdrawal of first year capital allowances, in the 1984 Budget.

ii) The change for most investors in the taxation of income on gilt-edged stock, from a receipts to an accrual basis, announced in February 1985 and fully effective from 28th February 1986.

iii) The extension of indexation relief to include both the first year after purchase and allowable losses in real terms, in the 1985 Budget.

iv) The full exemption of gilt-edged stock from capital gains tax (CGT) for disposals after 1st July 1986, at the Report stage of the 1985 Finance Bill.

v) The change in the CGT identification rules for ordinary shares from first in, first out (FIFO) to last in, first out (LIFO), also at the Report stage of the 1985 Finance Bill.

Ordinary share subsidy

This will be available in only a minority of circumstances and will depend on two conditions. First, the finance for an investment in ordinary shares will have to be raised by borrowing from a bank or issuing a qualifying (i.e. high coupon) bond, and the interest on it will have to be allowable for tax purposes. Tax relief will, accordingly, be available not only on the real rate of interest but also on the rate of inflation. The second condition is that both the investor and the investment must be subject to CGT; indexation relief will then be available.

The subsidy arises because the tax treatment of inflation in not symmetrical. It is tax free on the investment but allowable on the loan. The effect at 6% inflation and 35% corporation tax is that the Inland Revenue will pay just over 2% of the rate of interest. It should be noted, however, that payment of the subsidy will be delayed until the investment is sold. Further, the investor must be able to use the tax loss, i.e. he must have gains elsewhere which would otherwise be subject to CGT.

It might seen ironical that the Government has given this incentive to paper transactions while at the same time withdrawing first year allowances on direct investment in plant and machinery.

Gilt-edged versus Equities

Partly as a result of the above changes, and partly as a result of the changing tax treatment of gilt-edged stock, the gilt-edged market should have fallen relative to the ordinary share market. Indexation relief is available on the latter but not the former. Gilt-edged investors will be subject to income tax, where appropriate, on that part of the return on their investment which compensates them for inflation. Being more precise, the equity market should have risen because of the extension of indexation relief combined with the retention of LIFO, while the prices of high coupon gilt-edged stock should have fallen because losses taken within a year of purchase will no longer be allowable after 1st July 1986 and because accrued interest will be subject to tax as income.

Speculation

Long term investment in gilt-edged stock will be less attractive, for the reasons given above. In contrast, the full exemption of gilt-edged stock from CGT after 1st July 1986 means that the gilt-edged market will be by far the most important market in which short term speculation will be completely free of tax for investors normally subject to CGT.

Monetary Growth

A gilt-edged stock used to be a more tax efficient investment than a bank deposit because short term losses were allowable and accrued interest was tax free on disposals of stock held for more than a year. Interest on bank deposits is now paid net of composite rate tax, unless the bank is offshore, but the overall result of the changes in the tax treatment of gilt-edged stock is that bank deposits have gained in relative attraction. This will encourage a somewhat faster growth of the money supply. Speculative balances moving in and out of the gilt-edged market could also increase the volatility of monetary growth.

Futures

If the price of a gilt future falls, the loss will be allowable for CGT if the future is sold. If the price rises, the gain can be obtained tax free by waiting for delivery of the underlying stock when the contract matures and then selling it. The option of tax free profits and allowable losses, which has been withdrawn for the gilt-edged market, still exists for the gilt future on LIFFE.

Synthetic Bonds

A synthetic gilt-edged stock can be created by (i) selling sterling and buying dollars in the spot market, (ii) using the dollars to purchase a US Treasury bond and (iii) carrying out a series of transactions in the forward exchange market to convert the receipts from the US Treasury bond, both interest and capital repayment, back into sterling. It is, however, normally possible to create only short dated synthetic bonds because the forward exchange market for longer term payments is thin. Such synthetic bonds are subject to CGT and therefore indexation relief is obtainable.

Conclusion

Anomalies of the sort described are inevitable if the system is partially indexed. Attempts to plug them will lead to a nightmare of complication. The conclusion is that once indexation has been started in a major way the whole system should be indexed as soon as possible. The alternative is to scrap CGT completely.

Foreign buying of gilt-edged stock

The latest banking statistics disclose that between mid-December and mid-May purchases of gilt-edged stock by foreigners amounted to no less than £1½bn. We estimate that such purchases could have amounted to a further £1bn during the last two months. The total of £2½bn during seven months is unprecedented.

Monetary Growth in the Month to Mid-June

Monetary growth for all but the two narrowest aggregates, Mo and currency, was heavily distorted in banking June by the large issue of Abbey Life shares. It is not possible to calculate the exact extent of the distortion and, therefore, our normal table on the underlying growth rates has been excluded. For the record, the seasonally adjusted data for the five weeks to 19th June are shown in Table I.

Table I
Changes in the Month to mid-June

	£m	pa
Mo	105	9%
Currency	21	2%
Retail M1	2,080	74%
M1	2,149	48%
Sterling M3	2,240	23%
PSL1	2,346	24%
PSL2	3,442	21%
Bank lending in sterling to private sector	1,390	13%

The published position over the longer term now becomes:-

Table II
Published Growth Rates

		3 months	6 months	1 year*
Narrow money:	Mo	6	3	5
	Currency	3	5	4
	Retail M1	33	11	10
	M1	45	19	18
	M2	n.a.	n.a.	9
Broad money:	Sterling M3	23	16	12
	PSL1	23	16	12
	PSL2	16	16	14

* 1985/6 Target

The two narrowest aggregates showed only modest growth in banking June. This reassuring pattern appears to have continued in July when we estimate that Mo grew by only ½%. Its growth rate, therefore, remains firmly in the middle of its 3-7% target range.

All the other aggregates are distorted by the Abbey Life issue. Since some £4bn of returnable application monies were held in a suspense account, the Bank of England followed its normal practice and added 60% of these funds to the non-interest bearing sight deposits and deducted 40% from the bank borrowing of UK residents. Apart from the likelihood that 60:40 is not the correct proportion, some of the monies will probably have come from non-residents. The Bank's adjustment will, therefore, have increased the published data for U.K. residents' bank deposits by too much. This same factor also partially explains an unusually unfavourable banking sector external counterpart to sterling M3. Since an estimate of the impact of these distortions will be subject to a very large margin of error, a full analysis of the underlying trends must wait until next month, when the distortions from the Abbey Life issue will unwind.

Seasonal Adjustment Revisions

The Bank of England has issued its annual revisions to the seasonal factors for the monetary data. The changes in the growth rates of the aggregates for the year to mid-May as a whole are insignificant but the profiles within the year have changed, as shown in the following table.

Table III - Monetary Growth to mid-May

	3 month		6 month		1 Year	
	Old	Revised	Old	Revised	Old	Revised
Mo	4.4	4.2	3.7	4.1	5.5	5.4
Currency	4.8	3.7	3.9	3.8	5.2	5.1
Retail M1	5.3	3.4	0.6	0.1	4.2	4.2
M1	34.9	33.2	12.7	12.3	15.7	15.7
Sterling M3	19.0	18.4	10.6	11.6	11.6	11.6
PSL1	18.1	18.4	9.5	10.7	11.8	11.9
PSL2	13.3	13.9	11.6	12.7	14.4	14.7

GTP/RLT/RR

MONETARY GROWTH

In Nominal Terms

Percentage Annual rates		Mo	Currency	Retail M1	M1	M2	Sterling M3	PSL1	PSL2
Changes in year to:									
1984	July	6	5	7	13	11	7	8	12
	Aug.	5	6	9	14	12	8	8	12
	Sep.	5	6	8	15	12	9	9	13
	Oct.	5	6	7	15	12	8	9	13
	Nov.	6	6	9	18	13	10	11	15
	Dec.	7	5	9	18	11	9	9	14
1985	Jan.	5	5	7	15	10	9	10	15
	Feb.	5	6	7	14	10	10	10	15
	Mar.	5	6	5	13	10	9	10	15
	Apr.	6	4	4	15	9	12	13	16
	May.	5	5	4	16	8	12	12	15
	June.	5	4	10	18	9	12	12	14
Changes in 6 months to:									
1985	Jan.	5	5	6	13		11	12	16
	Feb.	6	5	2	9		10	11	16
	Mar.	5	4	3	11		10	10	16
	Apr.	5	3	2	14		15	15	17
	May.	4	4	0	12		11	11	13
	June.	3	5	11	19		16	16	16
Changes in 3 months to:									
1985	Apr.	5	3	0	20		18	18	16
	May.	4	4	3	33		18	18	14
	June.	6	3	33	45		23	23	16

In Real Terms

Percentage Annual rates		Mo	Currency	Retail M1	M1	M2	Sterling M3	PSL1	PSL2
Changes in year to:									
1984	July	1	1	3	9	7	3	3	7
	Aug.	0	1	4	9	7	3	3	7
	Sep.	1	1	3	11	7	4	4	8
	Oct.	0	1	2	10	7	3	4	8
	Nov.	1	1	4	13	8	5	6	10
	Dec.	2	0	4	14	7	5	5	10
1985	Jan.	0	0	2	10	5	4	5	10
	Feb.	0	0	1	9	5	4	5	10
	Mar.	-1	0	-1	7	4	3	4	9
	Apr.	-1	-2	-3	8	2	5	6	9
	May.	-2	-2	-3	9	1	5	5	8
	June.	-2	-3	3	11	2	5	5	7
Changes in 6 months to:									
1985	Jan.	0	0	1	8		6	6	11
	Feb.	0	-1	-3	4		5	6	10
	Mar.	-1	-2	-4	5		3	4	9
	Apr.	-2	-4	-5	7		8	8	10
	May.	-3	-3	-7	5		4	3	5
	June.	-5	-2	4	12		9	8	9
Changes in 3 months to:									
1985	Apr.	-2	-5	-7	13		11	11	9
	May.	-3	-4	-4	26		11	11	7
	June.	-2	-5	26	37		16	15	9

Chart 1 - Monetary Growth in NOMINAL Terms (% p.a.)

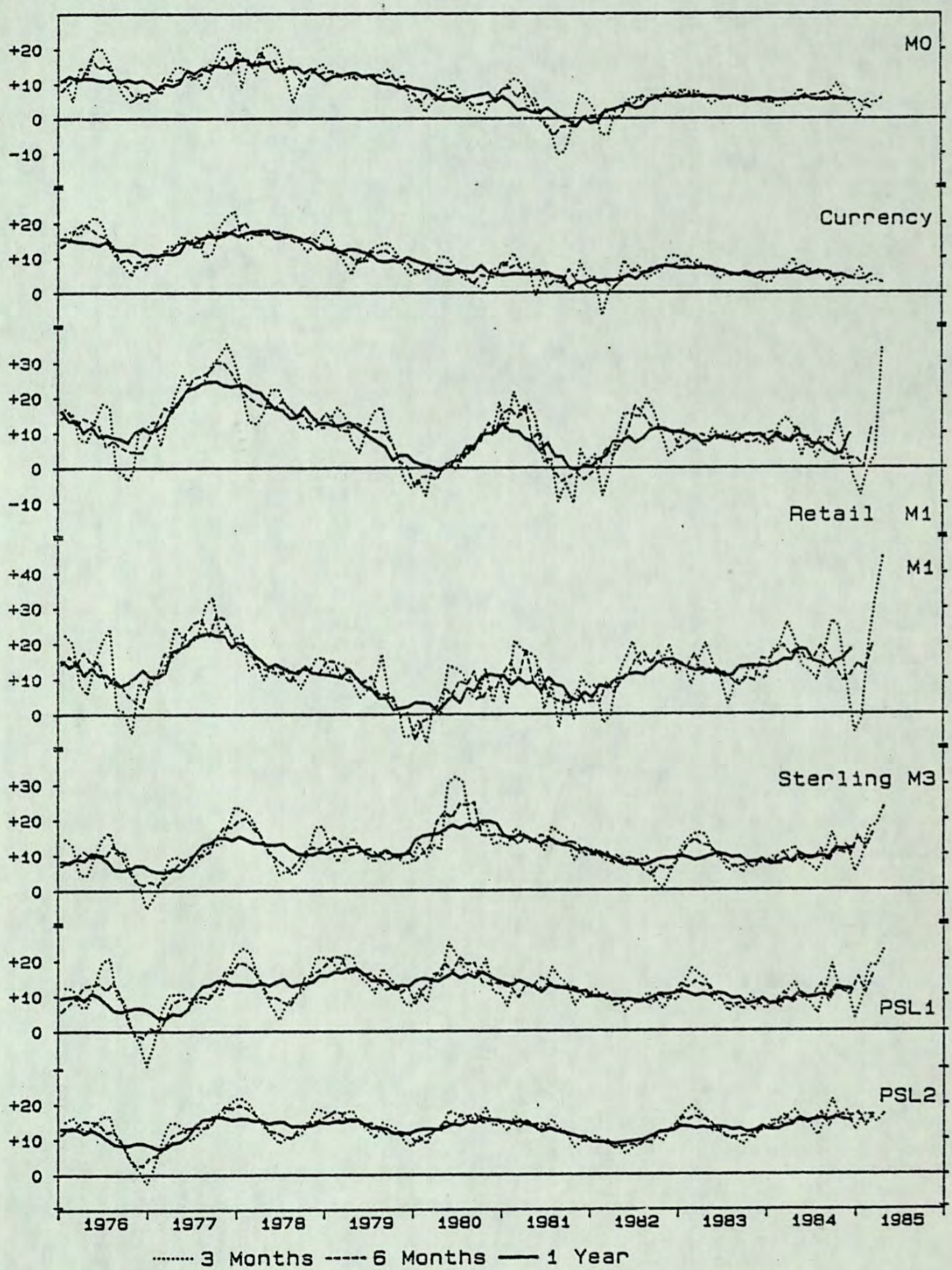


Chart 2 - Monetary Growth in REAL Terms (% p.a.)

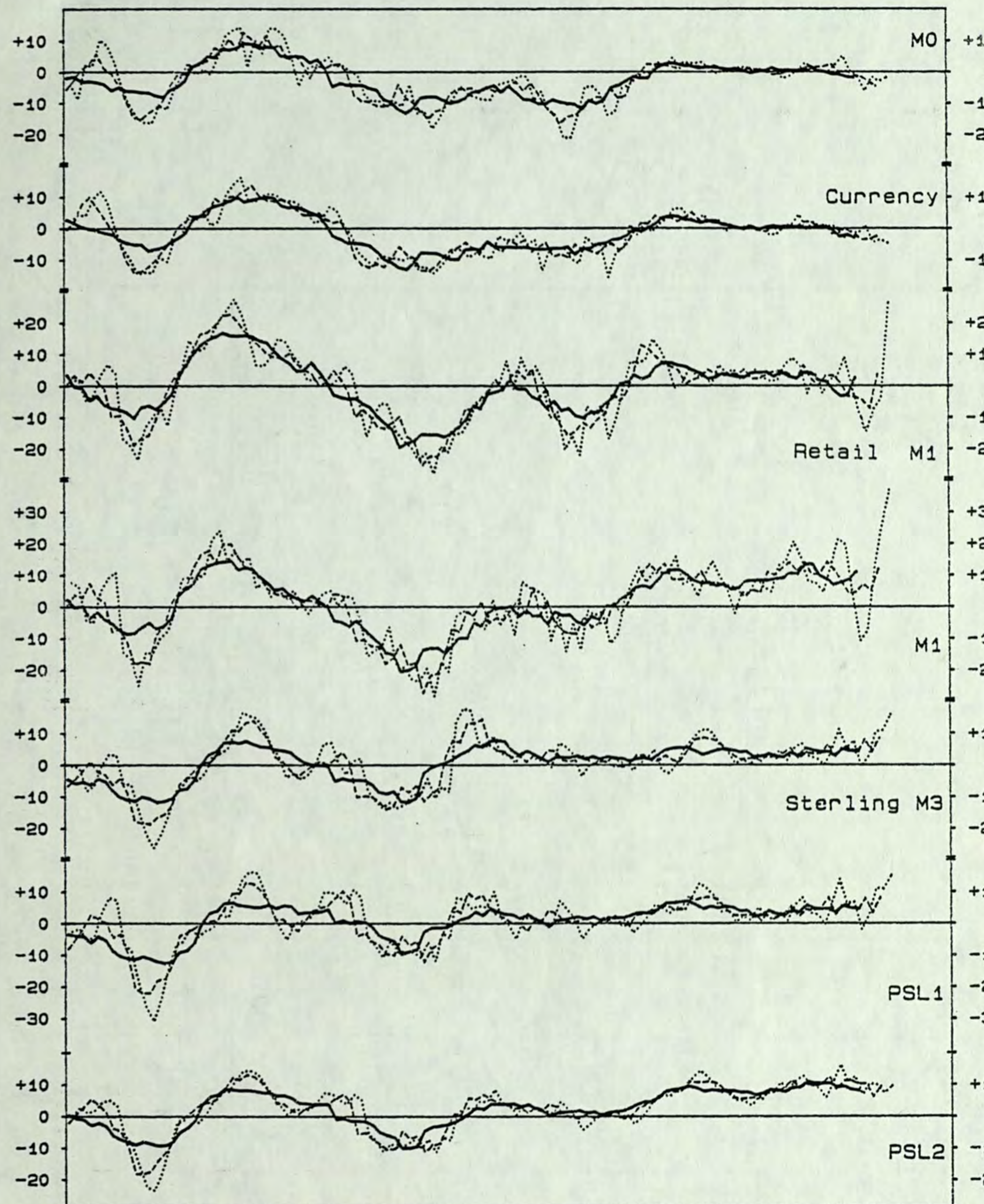
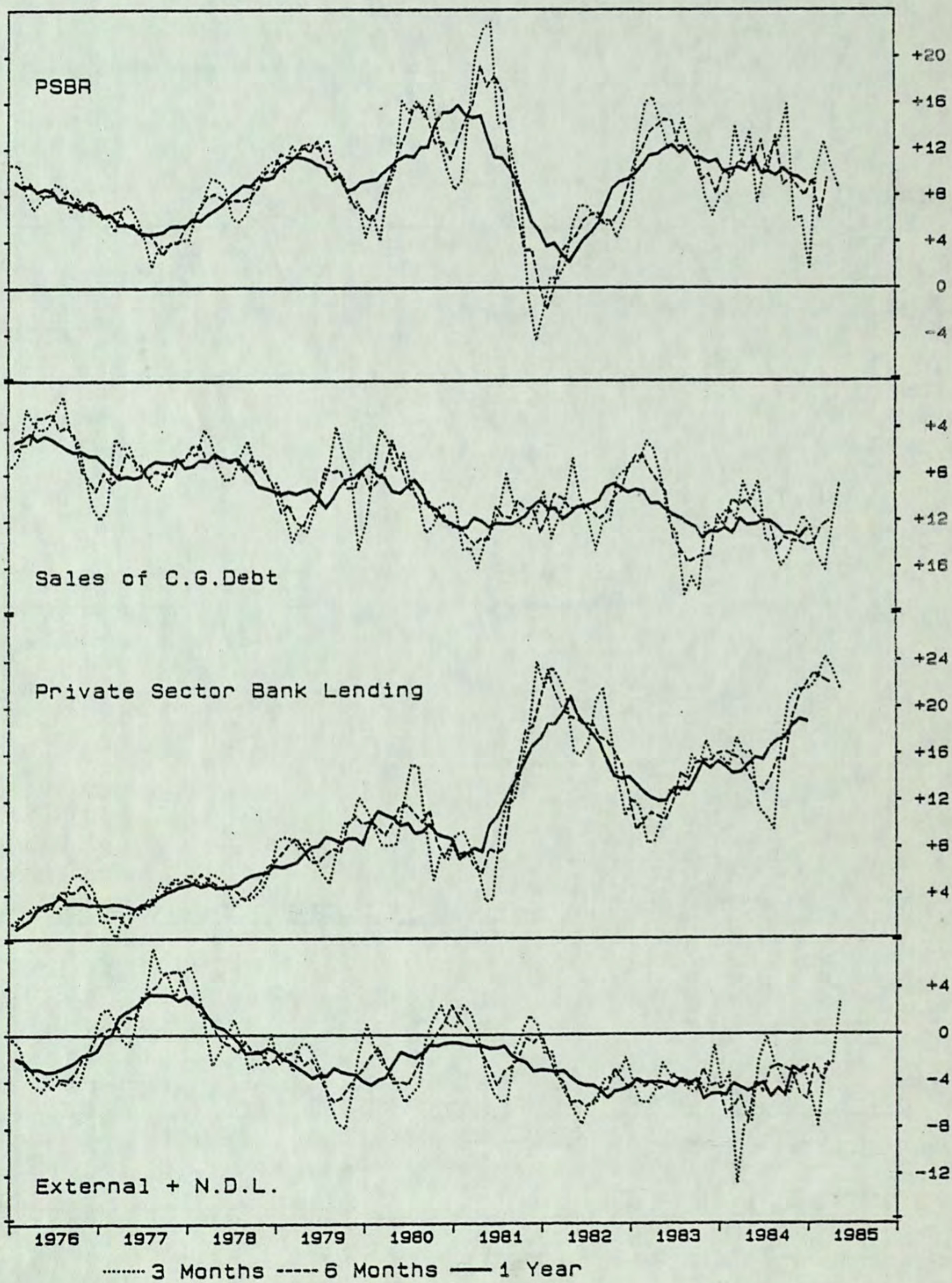


Chart 3 - Components of Monetary Growth (bns)



STATISTICS

reprinted from Bank of England *Banking Statistics*

Money stock: amounts outstanding

[Table 11.1 in the *Quarterly Bulletin*]

£ millions

	Notes and coin in circulation with public	UK private sector sterling sight deposits: Non-interest-bearing[a]	UK private sector sterling sight deposits: Interest-bearing	Money stock M1[b]: Unadjusted	Money stock M1[b]: Seasonally adjusted	UK private sector sterling time deposits[c]	Money stock £M3[b] [d]: Unadjusted	Money stock £M3[b] [d]: Seasonally adjusted	UK private sector deposits in other currencies [c]	Money stock M3[b] [d]: Unadjusted	Money stock M3[b] [d]: Seasonally adjusted
	1	*2*	*3*	*4*		*5*	*6*		*7*	*8*	
Month ended											
1984 May 16	11,834	20,593	13,485	45,912	45,850	55,669	101,581	102,240	15,595	117,176	117,840
June 20 [e]	11,941	20,648	13,964	46,553	46,730	57,252	103,805	103,990	15,675	119,480	119,660
July 18	12,213	20,694	14,094	47,001	46,590	56,768	103,769	103,370	16,940	120,709	120,310
Aug. 15	12,156	20,981	14,035	47,172	47,230	57,141	104,313	104,050	16,468	120,781	120,520
Sept. 19 [e]	12,102	20,850	14,774	47,726	47,810	57,651	105,377	105,340	17,896	123,273	123,230
Oct. 17	12,115	21,022	15,483	48,620	48,510	57,359	105,979	105,800	17,995	123,974	123,790
Nov. 21	12,186	21,251	16,474	49,911	50,090	58,809	108,720	108,120	18,573	127,293	126,690
Dec. 12 [e]	12,641	22,272	16,617	51,530	50,650	58,001	109,531	108,480	19,468	128,999	127,950
1985 Jan. 16	12,113	20,860	16,268	49,241	49,670	60,129	109,370	109,590	20,838	130,208	130,430
Feb. 20	12,210	20,476	16,041	48,727	49,530	60,306	109,033	109,919	21,420	130,453	131,335
Mar. 20[e]	12,322	20,603	16,981	49,906	50,490	59,468	109,374	110,877	20,436	129,810	131,307
Apr. 17	12,435	21,468	18,604	52,507	51,980	61,240	113,747	114,129	18,481	132,228	132,607
May 15	12,441	21,440	19,422	53,303	53,210	60,732	114,035	114,661	19,025	133,060	133,681
June 19[e]	12,438	23,511	19,397	55,346	55,370	61,443	116,789	116,956	19,054	135,843	136,012

Money stock: changes[f]

[Table 11.2 in the *Quarterly Bulletin*]

£ millions: *percentages in italics*

	Notes and coin in circulation with public	UK private sector sterling sight deposits: Non-interest-bearing [a]	UK private sector sterling sight deposits: Interest-bearing	Money stock M1[b]		UK private sector sterling time deposits [c]	Money stock £M3[b] [d]		UK private sector deposits in other currencies [c]: Trans-actions	UK private sector deposits in other currencies [c]: Valuation changes [g]	Money stock M3[b] [d]	
	1	*2*	*3*	*4*		*5*	*6*		*7*		*8*	
Month ended (unadjusted)												
1984 June 20	+ 107	+ 55	+ 469	+ 631		+ 1,568	+ 2,199		− 202	+ 257	+ 2,254	
July 18	+ 272	+ 46	+ 130	+ 448		− 484	− 36		+ 673	+ 592	+ 1,229	
Aug. 15	− 57	+ 287	− 59	+ 171		+ 373	+ 544		− 395	− 77	+ 72	
Sept. 19	− 54	− 131	+ 739	+ 554		+ 505	+ 1,059		+ 397	+ 1,026	+ 2,482	
Oct. 17	+ 13	+ 172	+ 709	+ 894		− 292	+ 602		− 405	+ 504	+ 701	
Nov. 21	+ 71	+ 229	+ 991	+ 1,291		+ 1,450	+ 2,741		+ 846	− 268	+ 3,319	
Dec. 12	+ 455	+ 919	+ 133	+ 1,507		− 1,162	+ 345		+ 478	+ 357	+ 1,180	
1985 Jan. 16	− 528	− 1,412	− 349	− 2,289		+ 2,128	− 161		+ 94	+ 1,276	+ 1,209	
Feb. 20	+ 97	− 384	− 227	− 514		+ 177	− 337		− 36	+ 618	+ 245	
Mar. 20	+ 112	+ 127	+ 940	+ 1,179		− 808	+ 371		− 69	− 925	− 623	
Apr. 17	+ 113	+ 865	+ 1,623	+ 2,601		+ 1,772	+ 4,373		+ 228	− 2,183	+ 2,418	
May 15	+ 6	− 28	+ 818	+ 796		− 553	+ 243		+ 335	+ 209	+ 787	
June 19	− 3	+ 2,071	− 35	+ 2,033		+ 631	+ 2,664		+ 674	− 665	+ 2,673	
Month ended (seasonally adjusted)												
1984 June 20	+ 126	+ 171	+ 574	+ 871	*+ 1.9*	+ 849	+ 1,720	*+ 1.7*	− 202	+ 257	+ 1,775	*+ 1.5*
July 18	+ 20	− 249	+ 81	− 148	*− 0.3*	− 480	− 628	*− 0.6*	+ 673	+ 592	+ 637	*+ 0.5*
Aug. 15	+ 54	+ 567	+ 16	+ 637	*+ 1.4*	+ 22	+ 659	*+ 0.6*	− 395	− 77	+ 187	*+ 0.2*
Sept. 19	+ 70	− 259	+ 774	+ 585	*+ 1.2*	+ 682	+ 1,267	*+ 1.2*	+ 397	+ 1,026	+ 2,690	*+ 2.2*
Oct. 17	+ 41	+ 69	+ 590	+ 700	*+ 1.5*	− 239	+ 461	*+ 0.4*	− 405	+ 504	+ 560	*+ 0.5*
Nov. 21	+ 58	+ 630	+ 894	+ 1,582	*+ 3.3*	+ 731	+ 2,313	*+ 2.2*	+ 846	− 268	+ 2,891	*+ 2.3*
Dec. 12	− 47	+ 342	+ 150	+ 445	*+ 0.9*	− 547	− 102	*− 0.1*	+ 478	+ 357	+ 733	*+ 0.6*
1985 Jan. 16	+ 119	− 691	− 411	− 983	*− 1.9*	+ 2,077	+ 1,094	*+ 1.0*	+ 94	+ 1,276	+ 2,464	*+ 1.9*
Feb. 20	+ 46	− 24	− 164	− 142	*− 0.3*	+ 457	+ 315	*+ 0.3*	− 36	+ 618	+ 897	*+ 0.7*
Mar. 20	+ 48	− 167	+ 1,077	+ 958	*+ 1.9*	+ 21	+ 979	*+ 0.9*	− 69	− 925	− 15	–
Apr. 17	− 16	+ 97	+ 1,416	+ 1,497	*+ 3.0*	+ 1,760	+ 3,257	*+ 2.9*	+ 228	− 2,183	+ 1,302	*+ 1.0*
May 15	+ 80	+ 229	+ 915	+ 1,224	*+ 2.4*	− 718	+ 506	*+ 0.4*	+ 335	+ 209	+ 1,050	*+ 0.8*
June 19	+ 21	+ 2,059	+ 69	+ 2,149	*+ 4.0*	+ 91	+ 2,240	*+ 2.0*	+ 674	− 665	+ 2,249	*+ 1.7*

[a] After deducting 60% of net debit transit items (see additional notes to Table 6 of the *Quarterly Bulletin*).

[b] M1 equals columns 1 + 2 + 3. £M3 equals M1 + column 5. M3 equals £M3 + column 7.

[c] Including certificates of deposit.

[d] Excluding public sector deposits.

[e] Changes in the monthly-reporting population occurred in these months. See also the additional notes to Table 3 in the *Quarterly Bulletin*, and, for March and June 1985, footnotes [b] and [d] respectively to Table H on page 5.

[f] Changes in the money stock may differ from those which can be calculated by reference to amounts outstanding. (See additional notes to Table 11 of the *Quarterly Bulletin*.) In December 1984, the changes are stated after the exclusion of the bank deposits of British Telecom PLC.

[g] See additional notes to Tables 6 and 11 of the *Quarterly Bulletin*.

[See page 529 in the December 19[illegible] Quarterly Bulletin]

An alternative presentation of counterparts to changes in £M3

£ millions

	Public sector borrowing requirement (surplus−)[a]: Central government borrowing requirement	Public sector borrowing requirement: Other public sector contribution / Purchases (−) of public sector debt by UK private sector (other than banks): Other public sector debt	Purchases (−) of public sector debt: Central government debt: British government stocks	Central government debt: Other	External and foreign currency finance of public sector (increase−): Purchases of British government stocks by overseas sector	External and foreign currency finance of public sector: Other [b]	Banks' sterling lending to UK private sector [c]	External and foreign currency transactions of UK banks [d]: Sterling deposits from, net of market loans to, banks abroad (increase−)	Other overseas sterling deposits	Other sterling lending to overseas sector[e]	Banks' net foreign currency liabilities [+] (increase −)	Net non-deposit sterling liabilities (increase−)	Money stock £M3[a] (columns 1-13)
	1	*2* *3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*	*12*	*13*	*14*
Month ended (unadjusted)													
1984 June 20	+ 2,259	− 153	− 370	− 584	+ 322	− 85	+ 1,563	− 155	− 246	+ 183	+ 28	− 563	+ 2,199
July 18	− 42	− 279	− 644	− 160	− 65	− 246	+ 1,184	− 135	− 137	+ 122	− 139	+ 505	− 36
Aug. 15	+ 924	+ 288	− 1,508	− 46	+ 28	+ 166	+ 162	+ 144	− 115	− 174	+ 264	+ 411	+ 544
Sept. 19	+ 1,180	+ 141	− 86	− 756	− 360	− 228	+ 973	− 547	+ 111	+ 826	− 362	+ 167	+ 1,059
Oct. 17	+ 293	+ 50	− 877	− 580	+ 163	− 28	+ 3,136	− 253	− 637	+ 382	+ 75	− 1,122	+ 602
Nov. 21	+ 1,994	+ 478	− 1,035	− 503	− 111	+ 87	+ 1,503	− 269	− 354	+ 699	+ 174	+ 78	+ 2,741
Dec. 12	+ 773	− 79	− 501	− 30	+ 35	+ 90	+ 385	+ 177	− 95	+ 268	− 333	− 345	+ 345
1985 Jan. 16	− 2,005	+ 295	− 630	− 344	− 182	− 231	+ 3,012	+ 602	− 487	+ 356	− 383	− 164	− 161
Feb. 20	− 310	+ 93	− 1,552	− 8	− 407	− 252	+ 1,351	− 270	− 57	+ 202	+ 204	+ 669	− 337
Mar. 20	+ 361	+ 56	− 790	− 356	− 265	+ 49	+ 1,839	− 1,711	− 25	+ 163	+ 1,774	− 724	+ 371
Apr. 17	+ 2,783	+ 354	− 720	− 617	− 245	+ 115	+ 2,831	+ 375	− 286	+ 251	+ 741	− 1,209	+ 4,373
May 15	+ 497	+ 66	− 586	− 114	− 347	+ 217	+ 865	+ 301	− 68	+ 269	− 468	− 389	+ 243
June 19	+ 2,650	− 443	–	− 220	− 466		+ 769	+ 326	− 561	− 273	+ 1,215	− 333	+ 2,664
Month ended (seasonally adjusted)													
1984 June 20	+ 1,028	+ 175	− 370	− 594	+ 322	− 92	+ 1,620			− 104		− 265	+ 1,720
July 18	+ 316	− 196	− 644	− 170	− 65	− 253	+ 330			− 333		+ 387	− 628
Aug. 15	+ 979	+ 305	− 1,508	− 161	+ 28	+ 159	+ 680			+ 124		+ 53	+ 659
Sept. 19	+ 1,467	+ 118	− 86	− 864	− 360	− 235	+ 1,365			− 248		+ 110	+ 1,267
Oct. 17	+ 318	− 9	− 877	− 501	+ 163	− 35	+ 2,087			− 319		− 366	+ 461
Nov. 21	+ 1,665	+ 397	− 1,035	− 403	− 111	+ 80	+ 1,691			+ 389		− 360	+ 2,313
Dec. 12	− 1,121	+ 195	− 501	+ 15	+ 35	+ 83	+ 1,581			+ 52		− 441	− 102
1985 Jan. 16	+ 317	+ 84	− 630	− 362	− 182	− 181	+ 2,131			+ 73		− 156	+ 1,094
Feb. 20	+ 819	+ 76	− 1,552	− 109	− 407	− 259	+ 1,698			− 14		+ 63	+ 315
Mar. 20	+ 1,214	+ 2	− 790	− 352	− 265	+ 45	+ 1,811			− 124		− 562	+ 979
Apr. 17	+ 910	+ 138	− 720	− 545	− 245	+ 112	+ 2,574			+ 1,445		− 412	+ 3,257
May 15	+ 391	− 5	− 586	− 123	− 347	+ 213	+ 1,437			+ 184		− 658	+ 506
June 19	+ 774	− 27	–	− 262	− 470		+ 1,390			+ 871		− 36	+ 2,240

[a] Excluding public sector bank deposits.
[b] Including public sector foreign currency bank deposits.
[c] Including holdings of sterling certificates of deposit issued by building societies, and net purchases by the Issue Department of commercial bills and, from February 1985, of promissory notes relating shipbuilding paper guaranteed by the Department of Trade and Industry.
[d] A seasonally-adjusted breakdown of these transactions is not available.
[e] Including net purchases of ECGD-backed promissory notes by the Issue Department.
[f] Including net non-deposit liabilities in foreign currency. (See the *quarterly Bulletin* for June 1985—page 185.)

M0, the wide monetary base

[Table 2 in the Quarterly Bulletin

£ millions: *percentages in italics*

End-banking-month series

	Notes and coin in circulation outside the Bank of England: In circulation with public: Unadjusted	In circulation with public: Seasonally adjusted	Held by banks (till money): Unadjusted	Held by banks (till money): Seasonally adjusted	Bankers' deposits with the Banking Department: Operational deposits: Unadjusted	Cash ratio deposits: Unadjusted
	1		*2*		*3*	*4*
Amount outstanding at						
1984 May 16	11,834	11,859	1,201	1,215	159	533
June 20	11,941	11,986	1,215	1,240	204	533
July 18	12,213	12,007	1,314	1,237	169	533
Aug. 15	12,156	12,061	1,277	1,239	50	533
Sept. 19	12,102	12,131	1,284	1,280	158	533
Oct. 17	12,115	12,172	1,235	1,250	153	533
Nov. 21	12,186	12,231	1,243	1,263	189	582
Dec. 12	12,641	12,184	1,385	1,241	205	582
1985 Jan. 16	12,113	12,304	1,320	1,299	190	582
Feb. 20	12,210	12,351	1,225	1,275	90	582
Mar. 20	12,322	12,400	1,231	1,296	29	582
Apr. 17	12,435	12,384	1,312	1,320	162	582
May 15	12,441	12,464	1,275	1,290	187	628
June 19	12,438	12,486	1,350	1,379	93	628
Change in month ended						
1984 June 20	+ 107	+ 126	+ 14	+ 24	+ 45	–
July 18	+ 272	+ 20	+ 99	− 3	− 35	–
Aug. 15	− 57	+ 54	− 37	+ 2	− 119	–
Sept. 19	− 54	+ 70	+ 7	+ 41	+ 108	–
Oct. 17	+ 13	+ 41	− 49	− 31	− 5	–
Nov. 21	+ 71	+ 58	+ 8	+ 13	+ 36	+ 49
Dec. 12	+ 455	− 47	+ 142	− 22	+ 16	–
1985 Jan. 16	− 528	+ 119	− 65	+ 57	− 15	–
Feb. 20	+ 97	+ 46	− 95	− 24	− 100	–
Mar. 20	+ 112	+ 48	+ 6	+ 20	− 61	–
Apr. 17	+ 113	− 16	+ 81	+ 24	+ 133	–
May 15	+ 6	+ 80	− 37	− 30	+ 25	+ 46
June 19	− 3	+ 21	+ 75	+ 88	− 94	–

Monthly-average series

	Notes and coin in circulation outside the Bank of England: Unadjusted	Notes and coin: Seasonally adjusted	Bankers' operational deposits with the Banking Department: Unadjusted	M0 (wide monetary base) (columns 5 + 6): Unadjusted	M0: Seasonally adjusted	
	5		*6*	*7*		
Average amount outstanding in month ended						
1984 May 16	13,157	13,160	138	13,295	13,298	
June 20	13,195	13,246	179	13,374	13,425	
July 18	13,376	13,332	165	13,541	13,497	
Aug. 15	13,478	13,333	164	13,642	13,497	
Sept. 19	13,471	13,451	139	13,610	13,590	
Oct. 17	13,379	13,479	178	13,557	13,657	
Nov. 21	13,403	13,555	180	13,583	13,735	
Dec. 12	13,804	13,568	356	14,160	13,924	
1985 Jan. 16	14,222	13,701	139	14,361	13,840	
Feb. 20	13,411	13,698	177	13,588	13,875	
Mar. 20	13,542	13,784	144	13,686	13,928	
Apr. 17	13,907	13,864	162	14,069	14,026	
May 15	13,761	13,861	156	13,917	14,017	
June 19	13,888	13,944	178	14,066	14,122	
Change						
1984 June 20	+ 38	+ 86	+ 41	+ 79	+ 127	*+1.0*
July 18	+ 181	+ 86	− 14	+ 167	+ 72	*+0.5*
Aug. 15	+ 102	+ 1	− 1	+ 101	–	–
Sept. 19	− 7	+ 118	− 25	− 32	+ 93	*+0.7*
Oct. 17	− 92	+ 28	+ 39	− 53	+ 67	*+0.5*
Nov. 21	+ 24	+ 76	+ 2	+ 26	+ 78	*+0.6*
Dec. 12	+ 401	+ 13	+ 176	+ 577	+ 189	*+1.4*
1985 Jan. 16	+ 418	+ 133	− 217	+ 201	− 84	*−0.6*
Feb. 20	− 811	− 3	+ 38	− 773	+ 35	*+0.3*
Mar. 20	+ 131	+ 86	− 33	+ 98	+ 53	*+0.4*
Apr. 17	+ 365	+ 80	+ 18	+ 383	+ 98	*+0.7*
May 15	− 146	− 3	− 6	− 152	− 9	*−0.1*
June 19	+ 127	+ 83	+ 22	+ 149	+ 105	*+0.7*

Transactions balances and components of M2

[Table 11.1 and 11.2 in the *Quarterly Bulletin*]

£ millions: *not seasonally adjusted*

	Notes and coin in circulation with public	UK private sector sterling non-interest-bearing sight deposits with banks[a]	Non-interest-bearing M1[b]	Other UK private sector sterling retail deposits with banks	UK private sector retail shares and deposits with building societies	National Savings Bank ordinary account	M2[b]	Public sector retail deposits with banks	Overseas retail deposits with banks
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*
Amounts outstanding									
1984 June 20[c]	11,941	20,648	32,589	30,455	63,237	1,743	128,024	1,079	3,193
July 18	12,213	20,694	32,907	30,736	64,050	1,750	129,443	886	3,308
Aug. 15	12,156	20,981	33,137	30,613	64,340	1,736	129,826	945	3,185
Sept. 19[c]	12,102	20,850	32,952	30,677	64,447	1,741	129,817	972	3,357
Oct. 17	12,115	21,022	33,137	30,863	64,786	1,749	130,535	1,089	3,289
Nov. 21	12,186	21,251	33,437	31,283	65,200	1,761	131,681	1,177	3,391
Dec. 12[c]	12,641	22,272	34,913	31,043	66,055	1,730	133,741	890	3,399
1985 Jan. 16	12,113	20,860	32,973	31,561	67,593	1,785	133,912	1,087	3,643
Feb. 20	12,210	20,476	32,686	31,815	67,597	1,758	133,856	1,104	3,651
Mar. 20[c]	12,322	20,603	32,925	32,453	67,892	1,762	135,032	1,094	3,753
Apr. 17	12,435	21,468	33,903	32,910	67,710	1,738	136,261	1,033	4,111
May 15	12,441	21,440	33,881	33,291	67,111	1,754	136,037	1,060	4,152
June 19[c]	12,438	23,511	35,949	33,893	67,629	1,752	139,223	1,086	4,186
Changes in month ended [d]									
1984 July 18	+ 272	+ 46	+ 318	+ 281	+ 813	+ 7	+1,419	− 193	+ 115
Aug. 15	− 57	+ 287	+ 230	− 123	+ 290	− 14	+ 383	+ 59	− 123
Sept. 19	− 54	− 131	− 185	+ 64	+ 107	+ 5	− 9	+ 27	+ 172
Oct. 17	+ 13	+ 172	+ 185	+ 186	+ 339	+ 8	+ 718	+ 117	− 68
Nov. 21	+ 71	+ 229	+ 300	+ 420	+ 414	+ 12	+1,146	+ 88	+ 102
Dec. 12	+ 455	+ 919	+1,374	− 240	+ 855	− 31	+1,958	− 287	+ 8
1985 Jan. 16	− 528	−1,412	−1,940	+ 518	+1,538	+ 55	+ 171	+ 197	+ 244
Feb. 20	+ 97	− 384	− 287	+ 254	+ 4	− 27	− 56	+ 17	+ 8
Mar. 20	+ 112	+ 127	+ 239	+ 638	+ 295	+ 4	+1,176	− 10	+ 102
Apr. 17	+ 113	+ 865	+ 978	+ 457	− 182	− 24	+1,229	− 61	+ 358
May 15	+ 6	− 28	− 22	+ 381	− 599	+ 16	− 224	+ 27	+ 41
June 19	− 3	+2,071	+2,068	+ 602	+ 518	− 2	+3,186	+ 26	+ 34

[a] After deducting 60% of net debit transit items (see additional notes to Table 6 of the *Quarterly Bulletin*).
[b] Non-interest-bearing M1 equals columns 1+2. M2 equals non-interest-bearing M1+columns 4+5+6.
[c] See footnote [e] to Table D on page 3.
[d] See footnote [f] to Table E on page 3.

Private sector liquidity, and other deposits

[Summary of Table 12 in the *Quarterly Bulletin*]

£ millions

	'Money'	Other money-market instruments	Savings institution deposits and securities		Certificates of tax deposit		PSL1 (columns 1+2+5)	PSL2 (columns 1+2+3+6)	PSL1	PSL2	Other shares and deposits with building societies	
	Seasonally adjusted	Seasonally adjusted	Seasonally adjusted		Seasonally adjusted		Seasonally adjusted	Seasonally adjusted	Seasonally adjusted change in month [b] [c]	Seasonally adjusted change in month [b] [c]	Unadjusted	
			Total (net)	*of which shares and deposits with building societies* [a]	Issues net of surrenders	Column 5 less building society holdings					Amount outstanding	Change in month
Month ended	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*	*12*
1984 June 20	102,458	3,402	70,299	*66,631*	2,145	1,942	108,005	178,101	+2,247 *+2.1*	+3,514 *+2.0*	18,979	− 6
July 18	101,828	3,270	71,591	*67,781*	2,061	1,855	107,159	178,544	− 855 *−0.8*	+ 419 *+0.2*	18,892	− 87
Aug. 15	102,450	3,404	72,535	*68,655*	1,937	1,710	107,791	180,099	+ 610 *+0.6*	+1,531 *+0.9*	18,766	−126
Sept. 19	103,745	3,631	73,436	*69,817*	1,913	1,665	109,289	182,477	+1,480 *+1.4*	+2,358 *+1.3*	18,641	−125
Oct. 17	104,191	3,639	74,930	*71,398*	2,323	2,060	110,153	184,820	+ 864 *+0.8*	+2,340 *+1.3*	18,522	−119
Nov. 21	106,542	3,463	76,564	*72,883*	2,618	2,189	112,623	188,758	+2,467 *+2.2*	+3,932 *+2.1*	18,283	−239
Dec. 12	106,901	3,340	77,248	*73,641*	2,537	2,107	112,778	189,596	− 330 *−0.3*	+ 343 *+0.2*	18,145	−138
1985 Jan. 16	107,983	3,172	79,218	*75,614*	2,681	2,414	113,836	192,787	+1,057 *+0.9*	+3,173 *+1.7*	17,919	−226
Feb. 20	108,237	3,148	80,610	*76,955*	2,695	2,498	114,080	194,493	+ 241 *+0.2*	+1,686 *+0.9*	17,651	−268
Mar. 20	109,142	3,262	81,846	*77,977*	2,840	2,509	115,244	196,759	+1,191 *+1.0*	+2,280 *+1.2*	17,518	−133
Apr. 17	112,391	3,238	81,815	*77,900*	3,081	2,742	118,710	200,186	+3,471 *+3.0*	+3,412 *+1.7*	18,258	+740
May 15	112,924	3,085	82,301	*78,313*	2,975	2,634	118,984	200,944	+ 252 *+0.2*	+ 718 *+0.4*	19,031	+773
June 19	115,184	3,304	83,408	*79,359*	2,900	2,558	121,388	204,454	+2,346 *+2.0*	+3,442 *+1.7*	19,156	+125

[a] Including UK non-bank private sector's holdings of certificates of deposit and time deposits issued by building societies.
[b] Percentage changes are shown in italics.
[c] In December 1984, the changes are stated after exclusion of the bank deposits and certain other liquid assets of British Telecom PLC.

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SECRET (AND PERSONAL UNTIL THURSDAY 18 JULY)

MONTHLY MONETARY REPORT: JUNE-SEPTEMBER

- The exchange rate, real interest rates and MO growth all suggest that monetary conditions remain tight. But £M3's 12-month growth rate at 12% is 3 points above the top of its target range.

- All the aggregates apart from MO were distorted by the oversubscription for Abbey Life which resulted in £4 billion being held on suspense accounts on make-up day. The Bank as usual assumed that 60% of the money will go back into bank deposits and 40% will reduce bank lending but the true unwinding is unknown.

- As the exchange rate has appreciated over recent months, private sector flows in the externals suggest that UK residents have been switching back into sterling. In the last three banking months private sector transactions with banks have registered an inflow of £2½ billion compared with an outflow of £1.3 billion in the previous year, adding to £M3.

- Over the last 3 banking months there has been no overfunding (seasonally adjusted) on the conventional definition but £¾ billion on the wide definition. The level of money market assistance over the same period has nevertheless fallen by £2¼ billion due to large unadjusted CGBR's.

- Over the next 3 months we expect MO's annual growth rate to stay at around 5% - the middle of its target range - while £M3's 12 month rate is forecast to increase to about 13%, 4 points above the top of its range.

- In July £M3 is expected to grow by around ½% if we achieve the gilts target of gross sales of £1¼bn and if the Abbey Life distortions unwind in the predicted manner. If in the remaining week of the banking month no more gilts are sold, £M3 could grow by around 1%.

HF3 July 1985

SECRET (AND PERSONAL UNTIL THURSDAY 18 JULY)

MONTHLY MONETARY REPORT: JUNE-SEPTEMBER

Monetary Aggregates

In banking June £M3 grew by 2 per cent, 0.3 per cent above forecast. MO grew by 0.7 per cent, slightly less than forecast. 12 month growth in £M3 is now 11.9 per cent, with 3 and 6 month growth substantially higher. Annual growth in MO is now 5.2 per cent close to the mid-point of its target range, and about ¼ per cent below the steady 5½ per cent annual growth rate experienced for most of the past year. 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. Growth in the broad and narrow aggregates over the past 8 years is shown in chart 1, while chart 2 provides a breakdown of the counterparts and components of changes in £M3 in recent months.

Table 1: Target Aggregates: Recent Experience

per cent, s.a.

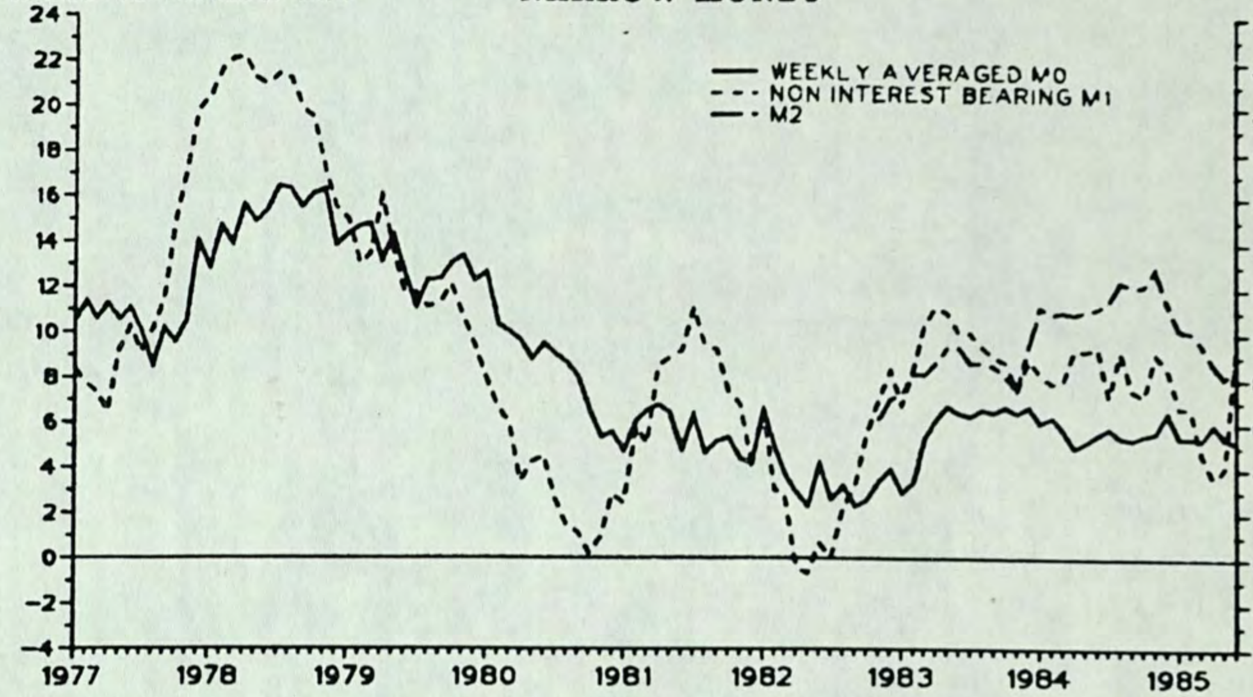
	MO	£M3
Monthly change		
April	0.7	2.9
May	-0.1	0.4
June	-0.7	2.0
Growth to mid-June at an annual rate over past:-		
3 months	5.7	23.5
6 months	2.9	16.1
12 months	5.2	11.9

2. The monthly path of MO continues to be erratic. But the 12 month growth rate has shaded down over the last few months, suggesting there is little reason to believe that underlying growth has risen. If anything, it may be moving down in response to the level of interest rates.

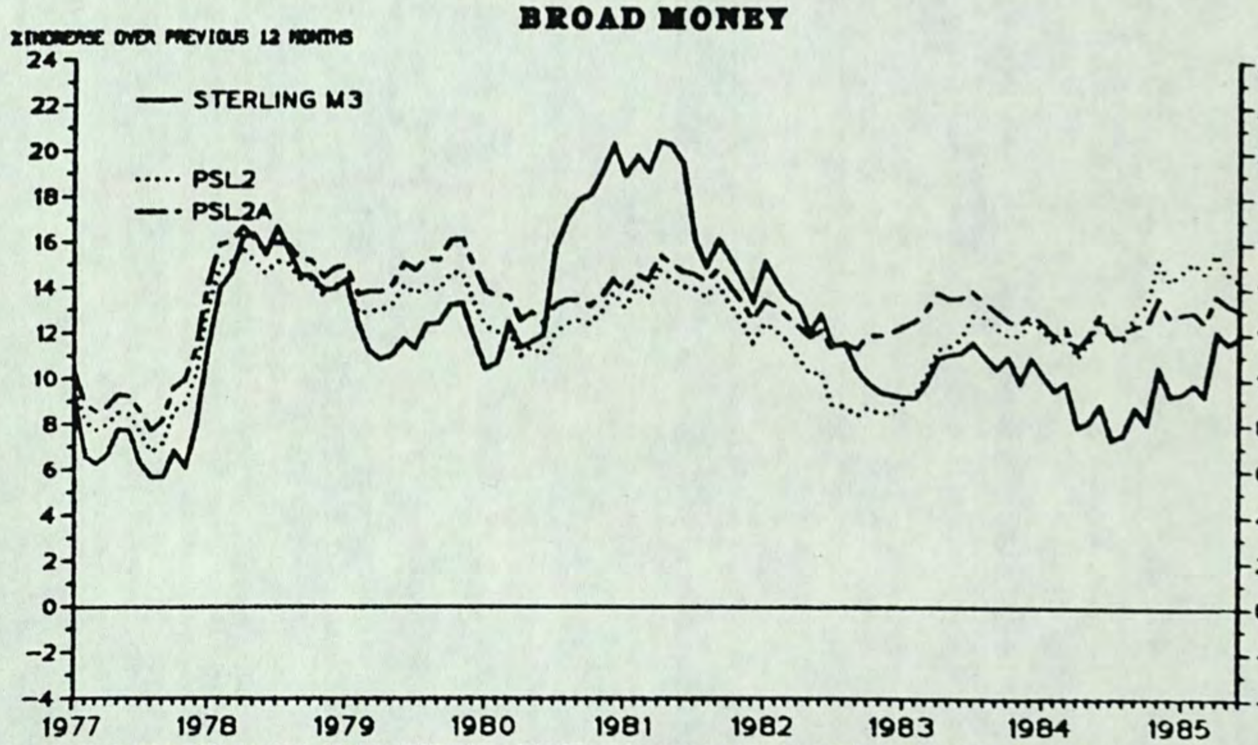
3. All the aggregates except MO are likely to have been affected by the Abbey Life oversubscription; £4.2 billion of application

CHART I : ANNUAL GROWTH RATES OF MONETARY AGGREGATES

NARROW MONEY



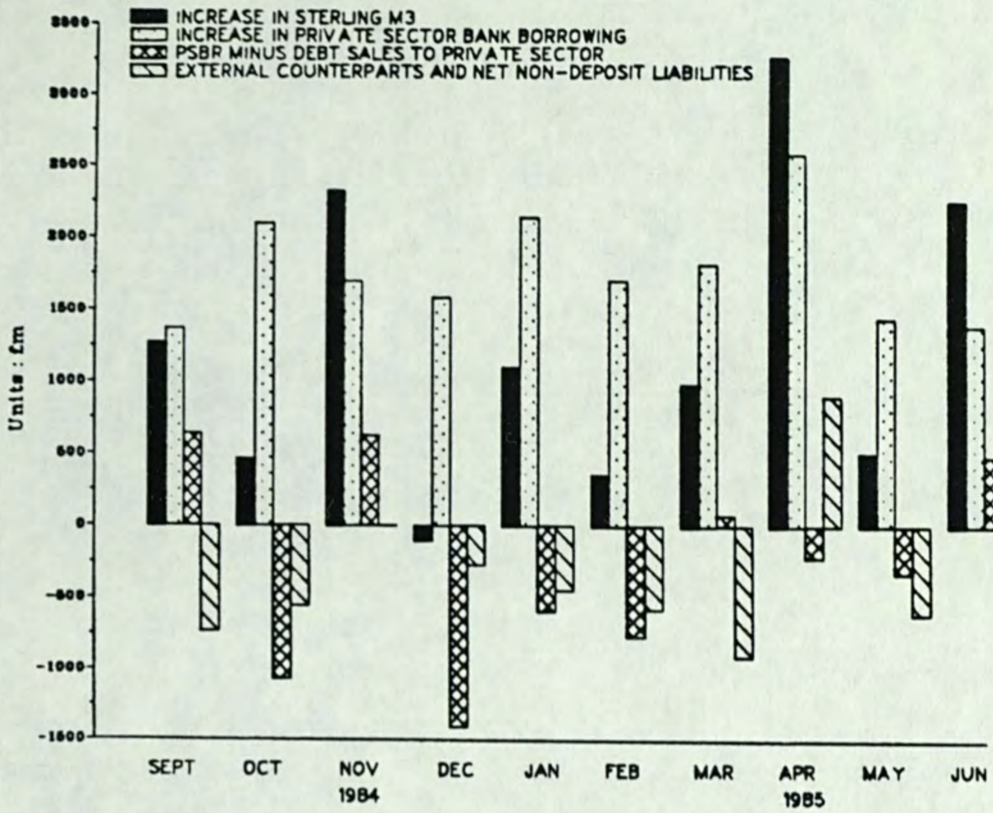
BROAD MONEY



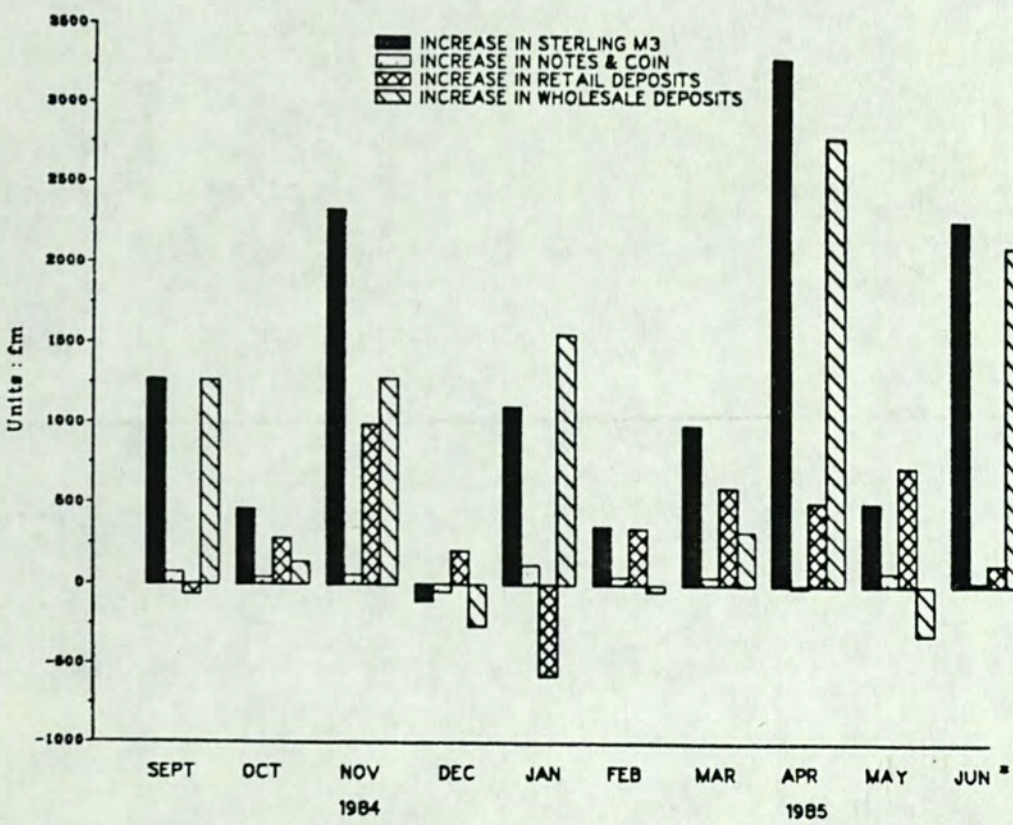
NOTE: THE GROWTH RATES OF M0 BETWEEN SEPTEMBER 1981 AND AUGUST 1982 ARE ADJUSTED TO REMOVE THE DISTORTION CAUSED BY THE CHANGED DEFINITION OF BANKERS BALANCES WITHIN M0

CHART II

INCREASE IN STERLING M3 AND COUNTERPARTS



INCREASE IN STERLING M3 AND COMPONENTS



* Adjusted for estimated effects of Abbey Life oversubscription

monies was in suspense account on make-up day. NIB M1 rose at a monthly rate of 6.2 per cent; an obvious distortion resulting from the conventional treatment of the money on suspense - 60 per cent allocated to increasing non-interest bearing deposits, 40 per cent to reducing sterling lending. The impact on £M3 is more difficult to assess. It depends on two factors:

(i) the proportion of the oversubscription representing deposits built up specifically to apply for Abbey Life shares.

(ii) The accuracy of the 60:40 split.

We think it likely that little "new" money will have been created, since the institutions, which formed the bulk of the applicants, are currently cash rich. The 60:40 split may, if anything, under-estimate the proportion financed by deposits for the same reason. On the other hand, anecdotal evidence from the banks is that some institutions with substantial cash balances borrowed in order to finance their applications. We have worked on the assumption, therefore, that the 60:40 split is correct and that no new deposits were attracted specifically for Abbey Life.

4. The public sector impact on £M3 was expansionary by £½ billion, compared to a forecast expansionary impact of £1 billion. The CGBR was more than £½ billion lower than forecast, and the "other public sector" contribution was about £¼ billion less expansionary than forecast. But this was partly offset by no net sales of gilts to the nbps (and correspondingly high sales overseas), compared to forecast sales of £350 million.

5. Sterling lending rose by £1.4 billion. What this implies for underlying lending depends on how the Abbey Life effect is allowed for. If the 60:40 split is accurate this would be broadly consistent with our current assessment of underlying lending.

6. The other counterparts are on the new basis, with foreign currency net non-deposit liabilities included in the externals rather than in nndls. The externals were more than £½ billion more expansionary than forecast, probably because the strong pound

and high UK interest rates have attracted money into sterling. The foreign currency perpetual floating issues by UK banks, to the value of £1 billion had no net effect on £M3, having equal and offsetting effects within the externals. Nndls were flat this month compared to an average contractionary effect of about £¼ billion over the last year.

7. Building society inflows appear to be running at an underlying level of around £1200 million a month of which just under half represents accruing interest. We expect inflows to be fairly healthy over the next 3 months and there may be a small rise in their liquidity ratio.

Other indicators of monetary conditions

8. **Inflation:** The twelve-month increase in retail prices to May was 7 per cent, and is unlikely to be lower in June or July. A fall in retail price inflation is still expected later in the year. The twelve-month increase in the producer output price index (excluding food, drink and tobacco) has been in the range 6¼-6½ per cent since the beginning of the year. The index for materials and fuels purchased by manufacturing industry fell between May and June - the second consecutive monthly fall - and in June input prices were only 2.2 per cent higher than twelve months earlier. Average earnings continue to grow at an underlying annual rate of 7½ per cent, but unit wage cost growth appears to be higher than for some time, although the likelihood of revisions to the unit wage cost series makes interpretation of these figures difficult.

9. **House prices:** The latest evidence gives conflicting signals about the trend in house price inflation. A survey of estate agents by the Royal Institution of Chartered Surveyors suggested that prices rose much more slowly between February and May than is usual at this time of year. This slowdown appeared to be confirmed by figures from the DOE showing that house prices at the mortgage approval stage were 5.6 per cent higher in May than a year earlier and figures from the Abbey National Building Society

suggesting that prices rose by just 4.6 per cent between the second quarter of 1984 and the second quarter of 1985. However, the Halifax Building Society announced that their house price index rose by 8.3 per cent over the twelve months to June and the Anglia Building Society announced that house prices rose by 6.3 per cent in the first half of 1985.

10. **Real interest rates:** Real interest rates were little changed in June, although real long rates, as measured by the yields on index-linked gilts did increase slightly.

11. **Exchange rate:** The exchange rate improved against most currencies during June. Its index value against the EMS currencies was the highest monthly average since September 1983; the $/£ rate touched 1.40 and the DM/£ rate has remained above 4.

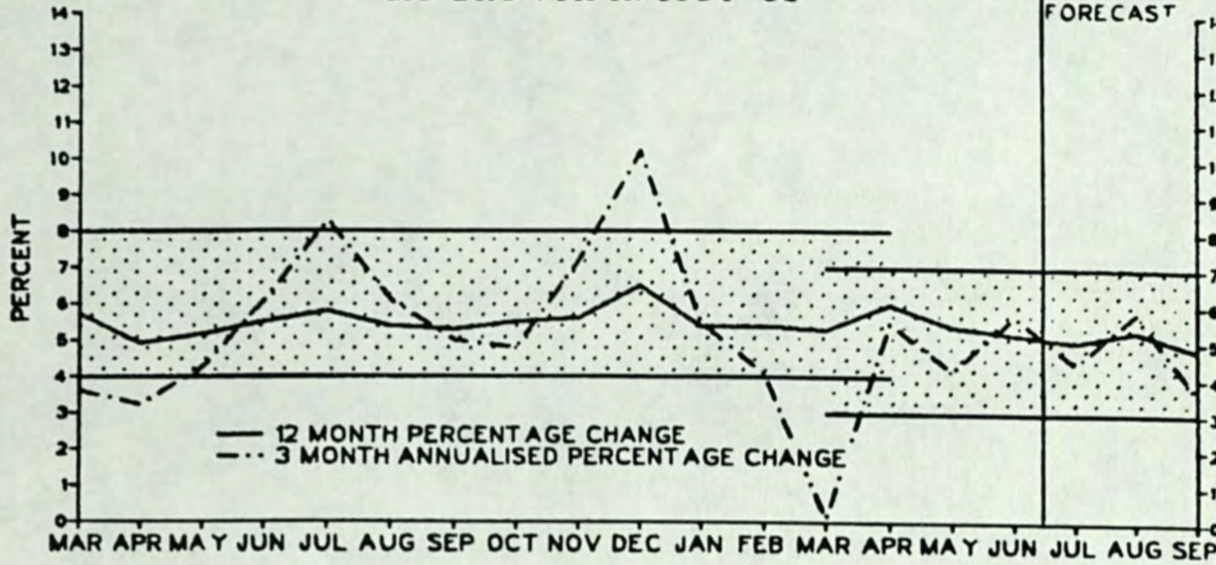
Three month forecast

12. The forecast assumes no change in interest rates (ie. base rates at 12½ per cent). The outlook for MO remains good. With continuing high interest rates the growth of MO is expected to decelerate to ¼ per cent a month from the average growth of just under ½ per cent over the last 3 and 12 months. At end September the 12 month rate is estimated to be 4¾ per cent. However monthly outturns have been erratic and could remain so, while the £1 coin is replacing the note.

13. In complete contrast to MO the outlook for £M3 remains poor. By the end of the forecast period 3 month growth is expected to be 12 per cent (saar), 6 month growth 17.6 per cent (saar) and 12 months 13.7 per cent. These are summarised in table 2.

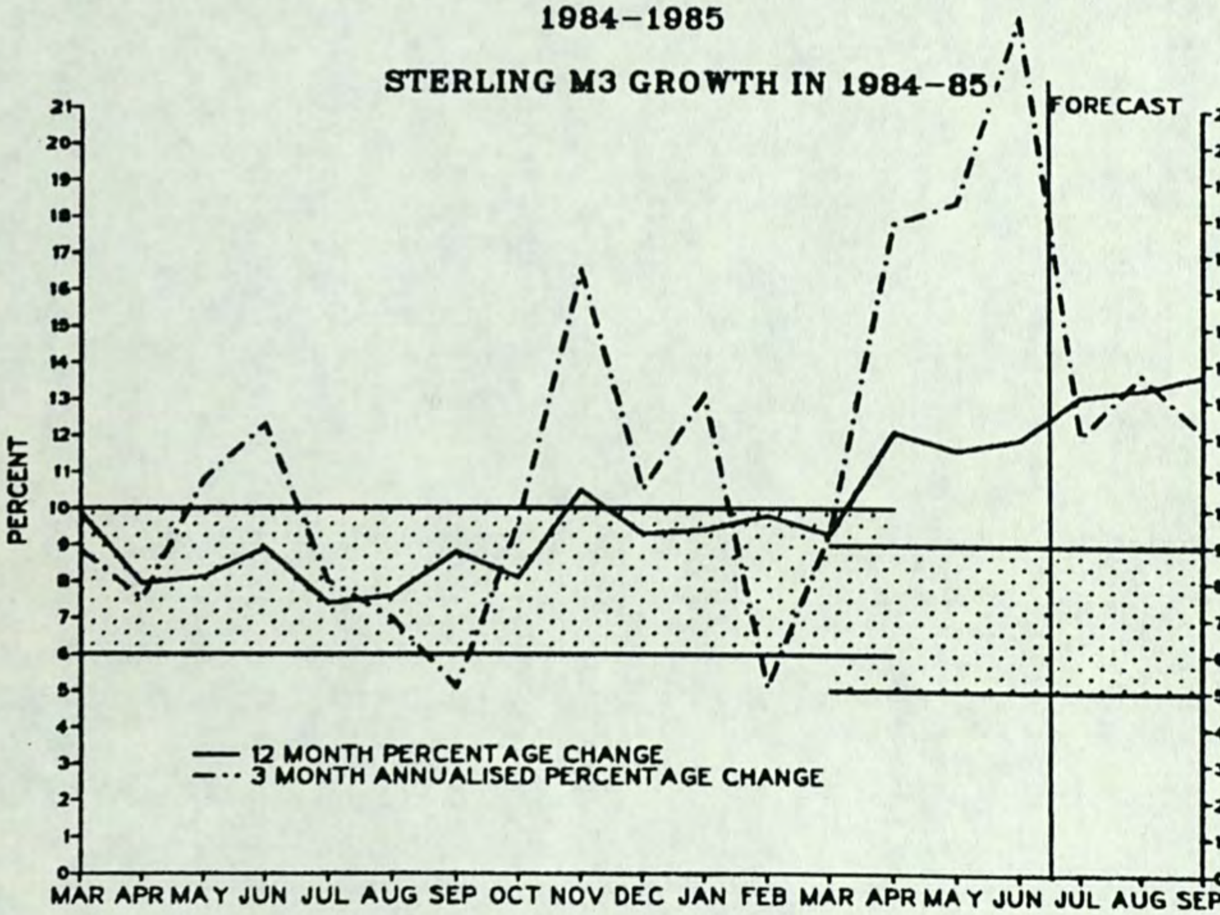
14. During the forecast period the public sector contribution fluctuates from month to month, largely due to assets sales and gilt redemptions. Nevertheless, using the stylised projection of £1¼ billion gross gilt sales a month, which is unlikely to be reached in July, the public sector contribution is flat over the 3 months together, as it was during the last three. (If we sell no more gilts in the remainder of banking July, our £M3 forcast would be about ½ per cent higher.) The main

M0 GROWTH IN 1984-85



1984-1985

STERLING M3 GROWTH IN 1984-85



1984-1985

explanation for continued fast growth is bank lending. The forecasters see no reason to revise down their underlying lending forecast of £1.6 billion which is close to the recent monthly averages. Another contributing factor to the strong 12 month growth of £M3 is the externals. Although projected to be only flat over July-September this is more positive than a year earlier. There must be a chance that in July, with the pound strong, residents could be switching back into sterling, leading to a faster growth than projected, and a faster growth of £M3.

15. We have considered an alternative case, with base rates at 12 per cent rather than 12½ per cent. There is little immediate impact on MO or £M3. MO's 6 month annualised rate might be around ¼ per cent higher by the end of the year, while £M3 growth could be 0.1 per cent lower in August and September - with national savings gaining relative to bank deposits, interest crediting lower, and the externals perhaps less positive. But eventually the growth in bank lending might increase somewhat, leading to faster £M3 growth.

Table 2: Target aggregates: Summary of forecast

per cent s.a.

	MO	£M3
Monthly change		
July	0.4	0.5
August	0.3	0.8
September	0.2	1.6
Growth to mid-June at an annual rate over past:-		
3 months	5.7	23.5
6 months	2.9	16.1
12 months	5.2	11.9
Growth to mid-September at an annual rate over past:-		
3 months	3.6	12.1
6 months	4.6	17.6
12 months	4.8	13.7

Public Sector Borrowing

16. In June the PSBR was £0.9 billion below forecast. This is explained partly by the change in seasonals (the unadjusted forecast was £0.6 billion higher than the outturn), a small underspend on supply and contributions to the EEC, and unexpectedly large repayments of borrowing by PC's, probably the Electricity Council. Although the CGBR in banking June was £250 million above forecast the calendar month outturn was as forecast.

17. The outlook for the path of the PSBR and the CGBR remains uneven month to month even in seasonally adjusted terms. The main explanation is the level of asset sales, with the BT second call, in particular, in banking July. Asset sales apart, July and August are similar (at £0.8 billion) but September remains high. The forecasts for the PSBR are nevertheless consistent with the Summer forecast.

18. Compared with the same period a year ago the CGBR(0) is around £300 million a month lower. This is largely explained by asset sales. However, working the other way is a large (£½ billion) grant to the NCB which will be used to pay off some PWLB borrowing. The LABR is slightly lower than a year earlier, mainly because companies are paying rate income monthly, which they used to pay semi-annually in May and November. The PCBR is also slightly lower than a year earlier, probably as the Electricity Council repays temporary borrowing.

Table 3 Public Sector Borrowing

£ million monthly average

	mid June 1984 -mid June 1985	mid June 85 -mid Sep 85	mid June 84 -mid Sept 84
CGBR (0)	398	606	884
'LABR'	270	79	115
PCBR	95	- 61	-
'PSBR'*	762	625	996

* PSBR less non-bank private sector transactions in other public sector debt.

Debt Sales

(a) Gilts

19. Gross gilt sales in the 5 weeks of banking June totalled £2,178 million compared to a target of £1¼ billion. The £1.2 billion redemption of 3 Treasury 1983, together with some £300 million buying in left net official sales at £713 million. This was more than accounted for by sales to the overseas sector; net sales to the nbps were zero.

20. Table 4 compares the June outturn with performance in the previous year and projections for the forecast period. The forecast for July assumes that the gross sales target of £1¼ billion is achieved. With only 4 working days of the month to go we are still over £800 million short of this target. The worst case - no further sales this month - would push £M3 up by about ½ per cent. With another substantial redemption (£755 million) in July, net sales to the nbps, assuming the gross target is reached, would amount to about £½ billion.

Table 4 Gilts Sales

Banking monthly averages £m

	Actual		Forecast		
	July 84-June 85	June	July	August	Sept
Gross Sales	1345	2178	1250	1250	1250
Redemptions	- 217	-1170	- 705	- 50	- 732
Next Maturities	- 110	- 295	- 16	- 150	-
Net Sales	1018	713	529	1050	518
of which:					
Monetary Sector*	67	18	- 65	100	90
Public Corporations	0	- 35	-	-	-
Overseas	207	730	70	300	195
Non-bank private sector	744	-	525	650	235

* excluding repos

21. The stylised assumption of £1¼ billion gilt sales has been retained for August and September. A high level of overseas purchases is also assumed. A further redemption - 8¾% Treasury Conversion 1985 - reduces net sales in September. Over the forecast period net sales to the nbps are reasonably smooth by

past experience. But, on these assumptions, with continuing heavy sales abroad, net gilt sales to the nbps would average less than two-thirds that achieved both over the last year and in the corresponding 3 months last year.

CTDs

22. Purchases were much as expected in banking June, but surrenders were lower, so CTDs exerted only a very slightly expansionary impact on £M3. With purchases steady at around £50 million per week we expect CTDs to continue to have a mildly expansionary impact over the forecast period as two substantial tax payments occur. In particular, high ACT payments in calendar July are projected to result in surrenders exceeding purchases by £125 million in banking August.

National Savings

23. National Savings contibuted £273 million (£378 million, seasonally adjusted) to funding in banking June, marginally higher than forecast. The major contribution came from accruing interest (£206 million) and from the Income Bond (£84 million). Inflows do not seem to have been distorted to any extent by the impending BT call or by the Abbey Life flotation.

24. Over the forecast period, we expect that accrued interest and the Income Bond will continue to be the only substantial funders. The introduction of the 3rd Index-linked Certificate is forecast to bring in some money, particularly from high rate taxpayers, but this is offset by the poor showing of the Conventional 30th Issue. In the three months to banking September we anticipate that National Savings will contribute £595 million (unadjusted) to funding, of which 72 per cent represents interest accruing.

25. Within these 3 months, we are forecasting a gentle decline in National Savings underlying inflows as tax-efficient purchases of the Certificates fall off slightly. By the end of banking September we may be somewhat below the striking rate required to attain the £3 billion target.

The PSBR and Funding

26. Table 5 summarises net funding over the last 12 months and that implied by the forecast. In June there was an underfund of £½ billion on a seasonally adjusted conventional basis (sacb) due mainly to no sales of gilts to the nbps. Nevertheless over the past year there has been overfunding of £3.6 billion (sacb). In the forecast period there is expected to be a full fund (sacb), but a £1¼ billion overfund in unadjusted terms.

27. In June, as in the last 5 months, there was some contribution to funding from the overseas sector. Indeed since the beginning of 1985 the overseas sector has purchased some £2 billion of gilts.

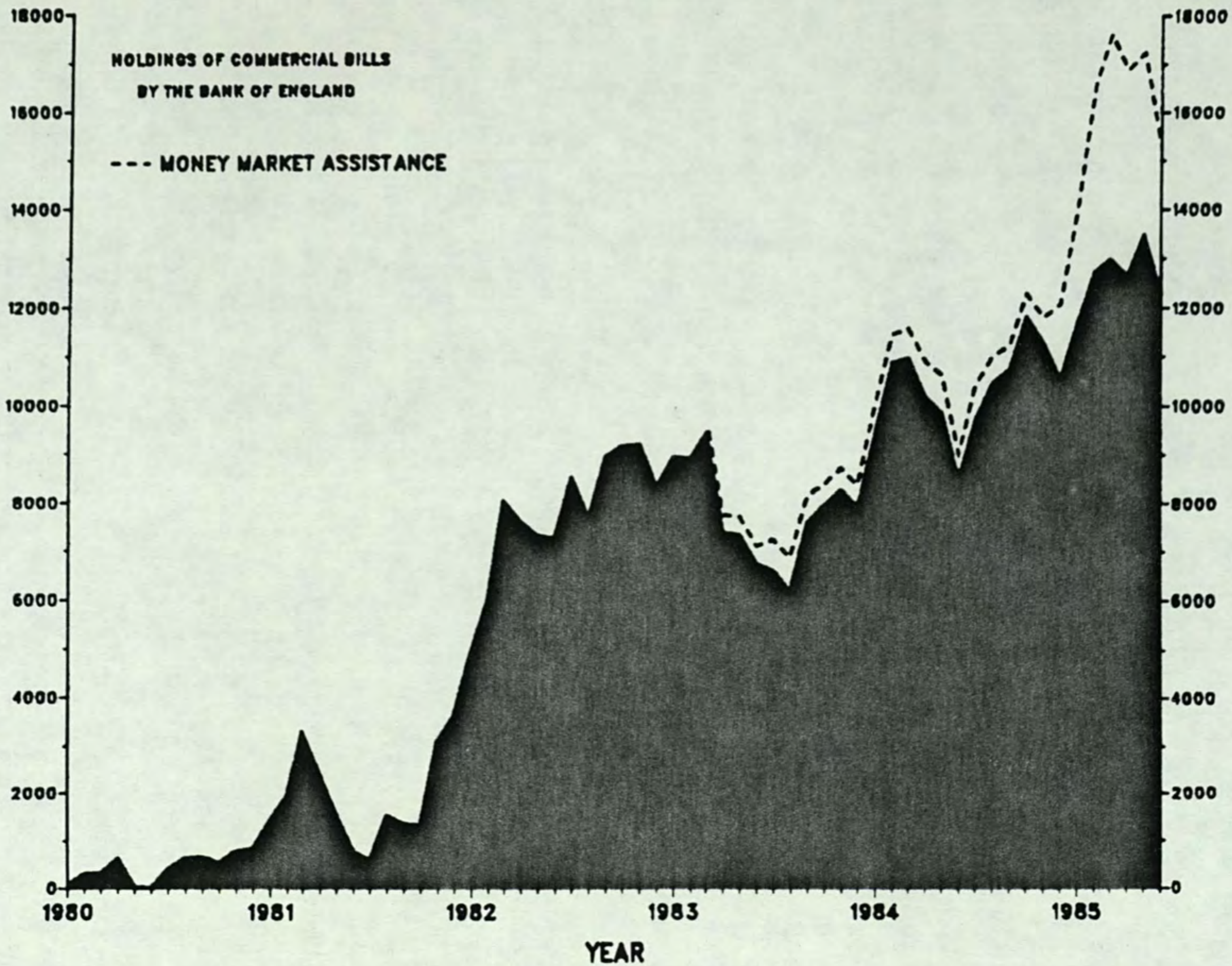
Table 5: The PSBR and funding

£ billion, seasonally adjusted

	Actual mid Jun '84- mid Jun '85	Forecast mid Jun '85 mid Sept '85	mid Jun '84- mid Sept '85
PSBR	9.1	1.9	3.0
Debt sales to nbps	-12.8	- 1.9	- 3.4
of which:			
Gilts	- 8.9	- 1.4	- 2.2
National Savings	- 3.3	- 0.8	- 1.4
CTDs	- 0.8	0.3	0.2
Over(-)/Underfunding(+)	- 3.6	-	- 0.4
(Unadjusted)	(- 2.5)	(- 1.2)	(- 1.0)
External finance of the public sector	- 2.5	- 0.6	- 0.7
Over(-)/Underfunding(+) alternative definition	- 6.1	- 0.6	- 1.2
(Unadjusted)	(- 5.0)	(- 1.7)	(- 1.7)

CHART IV

BILL MOUNTAIN RANGE



Money Market Influences

28. In June there was a large surplus (£2 billion) due mainly to the CGBR and the gilt redemption. The surplus allowed the Bank to reduce outstanding money market assistance to £15.3 billion at the end of June. (The growth of the bill mountain and money market assistance in recent years is shown in Chart 4.) In the forecast period the level of assistance rises sharply to £17.6 billion in July, mainly as a result of the BT second call combined with moderate debt sales. Thereafter it declines to £17.1 billion at the end of September.

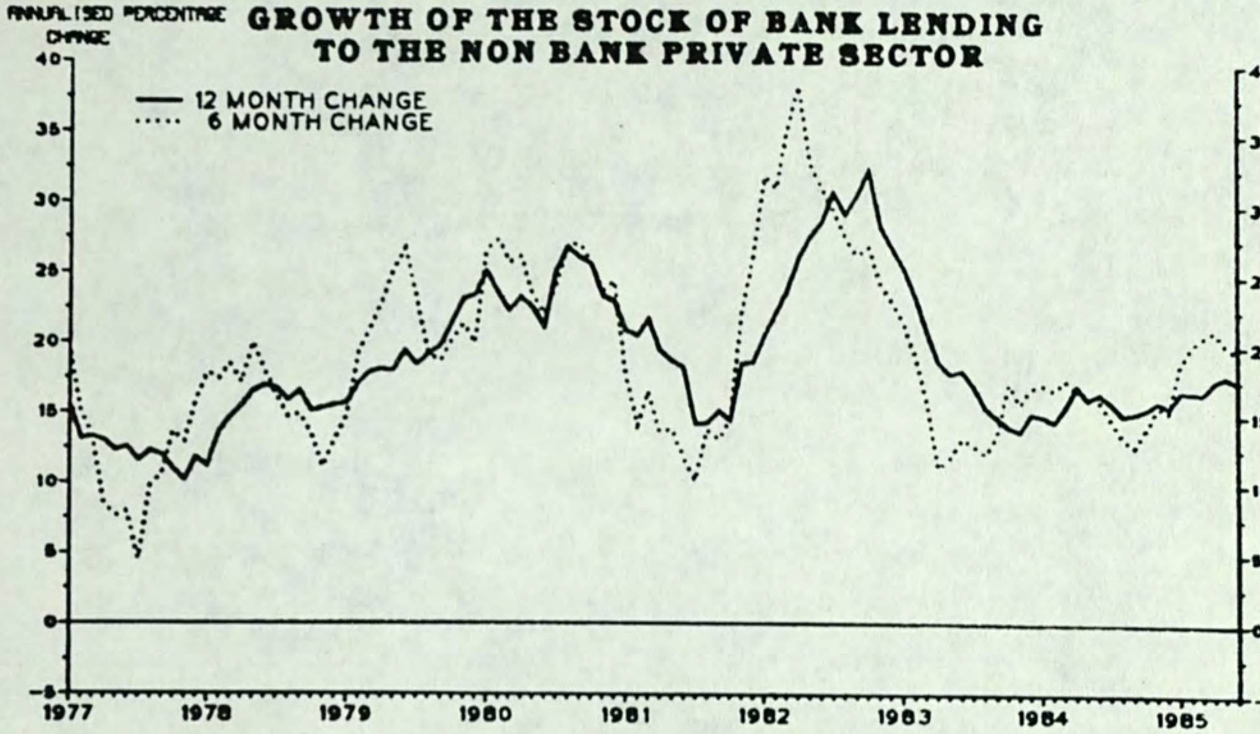
Bank lending to the private sector

29. There are at last signs that the growth in recorded bank lending is slowing down. The 3 and 6 month percentage rates peaked in April at around 22 per cent, while the 12 month rates reached 18 per cent in May (see Table 6). However, we had expected some reduction in recorded lending because of the bringing forward of borrowing to April to take advantage of the 1984-85 rate of capital allowances. In underlying terms lending appears to be growing at around 18 per cent (or about £1600 million a month).

30. The June figures may have been distorted by the Abbey Life oversubscription. Around £4 billion was held on suspense account on make up day and, following the usual rules of thumb, it was assumed that 40 per cent of this amount (ie. £1.6 billion) would be used to run down bank lending. The 60:40 split is based on survey evidence about the eventual run down of relatively small amounts classified as transit terms. There is no reason to suppose the figure is appropriate in this case, particularly since an unusually high proportion of the money appears to have come from the institutions. They are known to have built up £ bank deposits over the last year, so they may not have needed to increase their borrowing greatly to finance their applications. On the other hand, the clearing bank economists claimed in their regular meeting with the Bank that about 50 per cent of the institutions'

CHART V : BANK LENDING AND FT INDEX

GROWTH OF THE STOCK OF BANK LENDING TO THE NON BANK PRIVATE SECTOR



REAL FT ALL SHARE INDEX

applications were financed by borrowing from banks. This is plausible since the Abbey Life issue was only announced about one week in advance and institutional funds may have been committed to 7 day or longer deposits. We decided that on balance there was insufficient evidence either way to support amending the 40:60 rules. Every 10 per cent change in the proportions alters bank lending and £M3 by £400 million. So if the true proportions were 35:75 the growth of £M3 and bank lending would have been under-estimated by £200 million in June and will be over-estimated by the same amount in July.

31. Over the next 3 months we expect <u>recorded</u> lending on average to increase by only around £1.3 billion (or 13 per cent at an annual rate) despite assumed underlying growth of £1600 million (18 per cent at an annual rate). This is partly because some of the lending for investment expected in these months was brought forward to April to get the higher capital allowances; and partly because throughout the period the PSBR is expected to be above trend, thereby reducing companies financing needs. The July figure may be boosted by £100 million extra borrowing to finance a small part of the £1.2 billion second call on BT.

32. So far in banking July there have been no opportunities for profitable bill arbitrage at either the 1 or 3 month levels. As usual we have assumed that no new round-tripping will take place over the forecast period.

33. Net issues by listed UK public companies raised £420 million in calendar June taking the total so far this year to £3.2 billion. This exceeds the annual total even for the record year of 1983. The reduction in the size of the queue suggests that the level of new issues may decline over the forecast period, presumably partly because of the signs that share prices have passed their peak value.

34. Hanson Trust are due to receive £275 million in banking July of the £520 million proceeds of their recent rights issue. The money could be used to reduce their bank borrowing; or

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	19.5	1260	14.9	1328	16.4	1430	16.9	1183	13.9	1251	15.4
	Nov	1716	20.2	1407	16.5	1329	16.1	1746	20.5	1316	15.4	1310	15.9
	Dec	1718	20.0	1373	15.9	1351	16.1	1786	20.9	1318	15.2	1304	15.6
1985	Jan	1687	19.3	1662	19.3	1458	17.4	1801	20.7	1615	18.8	1403	16.8
	Feb	1694	19.1	1705	19.6	1484	17.4	1803	20.4	1775	20.4	1440	16.9
	Mar	1632	18.1	1675	19.0	1486	17.1	1880	21.0	1833	20.9	1454	16.8
	Apr	1657	18.0	1672	18.7	1466	16.7	2027	22.4	1914	21.5	1549	17.6
	May	1617	17.3	1656	18.2	1532	17.3	1940	21.0	1872	20.7	1594	18.0
	June	1589	16.7	1610	17.5	1491	16.6	1800	19.1	1840	20.1	1579	17.6
Forecast													
	Jul	1550	15.9	1603	17.1	1632	18.1	1464	15.0	1746	18.6	1681	18.7
	Aug	1584	16.1	1601	16.8	1653	18.1	1420	14.3	1680	17.6	1728	18.9
	Sept	1590	16.0	1589	16.4	1632	17.7	1307	13.0	1554	16.0	1693	18.4

* Based on stock of recorded lending

might be kept on short term deposit. In the absence of any firm knowledge about the relatively likelihood of these alternatives, we have made no adjustment to bank lending or deposits.

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	
	Q2	509	
1985	Jan	275	1610
	Feb	201	2943
	Mar	723	4100
	Apr	989	4332
	May	620	4350
	June	426	3356**

* Excluding privatisations, currently consisting of British Airways and Britoil

** As of 28 June 1985

Externals and net non-deposit liabilities (NNDL's)

35. These counterparts are now measured under the new definition which includes both sides of the foreign currency nndl's in the externals. In June the externals were again heavily positive (£0.4 billion). The main explanation for this comes from the private sector; the external finance of the public sector was negative for the sixth consecutive month. The private sector externals have been positive by £2½ billion in the latest 3 months compared with an otflow of £1.3 billion over the previous 12 months. The counterparty to the UK non-bank private sector inflows appears to be UK banks - which will have almost certainly

covered any net currency positions through the forward market.

36. Nndl's were more or less flat mainly because of a large positive interbank difference, which is expected to be partly reversed next month. In the forecast period nndl's and externals taken together are negative - a return to the pattern before April. However there must be a risk that the externals will be more positive, particularly in July when the exchange rate has been strong.

Building Socieites and broad liquidity

37. At £1140 million (seasonally adjusted), building society retail inflows were slightly above forecast despite the fact that an estimated £100 million was withdrawn for Abbey Life applications. The considerable distortions over the last 2 months have tended to obscure the strong competitive position of the societies' relative to the banks and to National Savings. We now believe that underlying inflows are running at over £1200 million per month, of which £520 million represents accruing interest.

38. Distortions affecting building societies over the forecast period are discussed in the next section on retail inflows. Taking these distortions into account, we expect that retail inflows, taken together with a fairly stable demand for new mortgages and a moderate level of wholesale funding, should be consistent with a small rise in the liquidity ratio by the end of banking September. (See table 8). Although the forecast suggests that the BSA's figure of £800 million net inflow of principal per month will not be reached, the improving liquidity position seems plausible since:

(a) Interest accruing is running at nearly £100 million per month more than the BSA assumed.

(b) The BSA assumed that the liquidity ratio would be kept at 18 per cent. Lower inflows are required to keep a constant 16.5 per cent ratio than to keep a ratio of 18 per cent.

Table 8

BUILDING SOCIETIES BALANCE SHEET FLOWS

(UNADJUSTED)

£ Million

	Assets				Liabilities			
	Total Flow	Net Advances	Liquid Assets	Fixed Investment	Retail Inflows Principal	Interest Credi ted	Wholesale Inflows	Other (e.g. Reserves)
1983*	1066	911	143 (19.9)	13	570	310	136	50
1984*	1284	1189	79 (18.3)	16	710	387	136	51
1984 Q1*	896	977	-83 (19.2)	1	870	302	33	-309
Q2*	1145	1326	-201 (18.1)	21	598	414	99	34
Q3*	1476	1345	114 (17.6)	17	543	272	278	383
Q4*	1619	1109	486 (18.3)	24	831	560	134	94
1985 Q1*	604	1030	-445 (16,5)	19	504	354	- 68	- 186
Calendar Months								
Jan	-39	942	-999 (17.4)	18	823	726	-102	-1486
Feb	452	967	-533 (16.8)	18	474	64	-138	52
March	1086	1181	-113 (16.5)	18	214	272	151	449
April	1469	1149	302 (16.5)	18	507	417	149	396
May	1756	1301	437 (16.7)	18	615	136	185	820
June+	1243	1174	51 (16.5)	18	420	1045	20	-242
Banking Months								
July	1391	1181	192 (16.5)	18	713	725	81	-128
August	1854	1547	289 (16.5)	18	743	163	136	812
September	1652	1109	525 (16.7)	18	752	301	99	500

*Monthly Average in the period

( ) Brackets indicate liquidity Ratio

\+ Provisional/Forecast

39. Last month's report highlighted the sudden renewal of interest in building society term shares. The figures for June suggest that this may only have been a temporary phenomenon and we expect that for the next 2 months inflows will do no more than match outflows. In banking September it is expected that a tranche of maturing stock will produce a net outflow distorting PSL2 up relative to PSL2A. Table 9 below shows the growth rates of PSL2 and PSL2A relative to that of £M3 over the last 12 months.

Table 9: Growth rates* of monetary aggregates

(12 month growth rates, %)

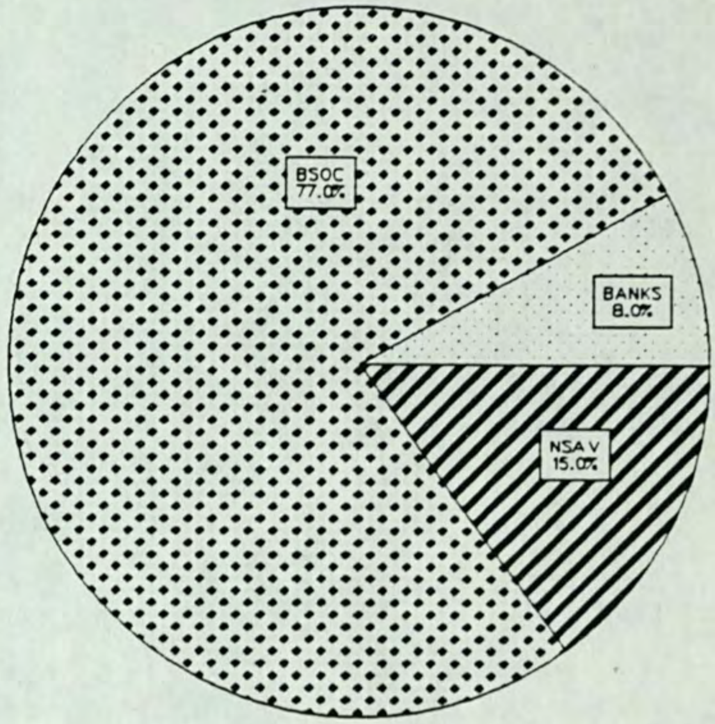
1984	PSL2 - £M3	PSL2A - £M3
Banking:		
July	4.4	4.5
August	4.2	4.3
September	4.1	3.6
October	5.2	4.3
November	4.7	3.1
December	5.0	3.4
1985		
Jan	5.4	3.5
February	5.4	3.3
March	5.4	3.2
April	3.5	1.6
May	3.2	1.8
June	2.5	1.2

* Twelve month growth rates (%)

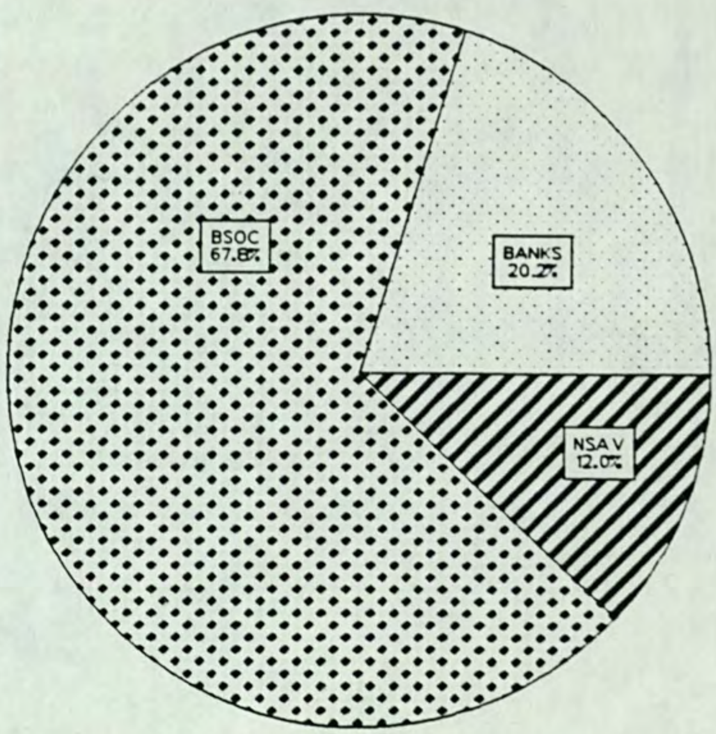
40. The table shows that over the last 3 months the wedge between the rates of growth of £M3 and the PSLs has been reduced. This reflects, in the main, the stronger competitiveness of retail bank deposits in the aftermath of CRT, and in particular the attractiveness of the new high-interest cheque accounts. Chart 6 shows how retail savings have been allocated in the first 5 months of 1985 compared with the same period last year. The salient feature is the improved performance of the banks.

CHART VI

SHARES IN RETAIL INFLOWS JAN—MAY 1984



SHARES IN RETAIL INFLOWS JAN—MAY 1985



Retail Inflows

41. Table 10 brings together our forecast for retail inflows to National Savings, building societies and banks. Greater uncertainty than usual surrounds the retail projections given the difficulties involved in interpreting the banking June figures.

42. The major problem of interpretation in the case of June relates to the very high figure for retail bank deposits resulting from the Bank's treatment of the money held on suspense accounts on make up day. In addition, retail bank deposits may have benefitted from a tranfer from buildings societies as investors prepared for the BT second call, but this was probably more than offset by the outflow of money unsuccessfully put up for BAe and money paid early in respect of the BT sale. The total effect of these distortions was to raise retail bank deposits by some £2.2 billion above their underlying level. For the building societies the outflow of money for BT and Abbey Life was to some extent counteracted by the length of the banking month which pushed up the positive seasonal still further.

43. Over the forecast period we expect that these distortions will fully unwind. As usual we are assuming that there is no change in interest rates over the forecast period, suggesting little or no change in the underlying pattern of inflows. In the light of the June figures, and in line with the Bank's calendar month forecast, we have revised up our view of the level of underlying building society inflows by £100 million to £1200 million or so per month. This reflects the increasing competitiveness of the smaller building societies and the continuing high level of the larger societies' premium rates. In contrast, we expect to see a gentle fall in National Savings underlying inflows as high-rate taxpayers come up against the holding limits on the tax-free instruments. The forecast implies that total retail inflows will remain fairly constant on a monthly basis at a level somewhat higher than over the last year, reflecting historically high interest rates.

SECRET

Table 10

RETAIL INFLOWS

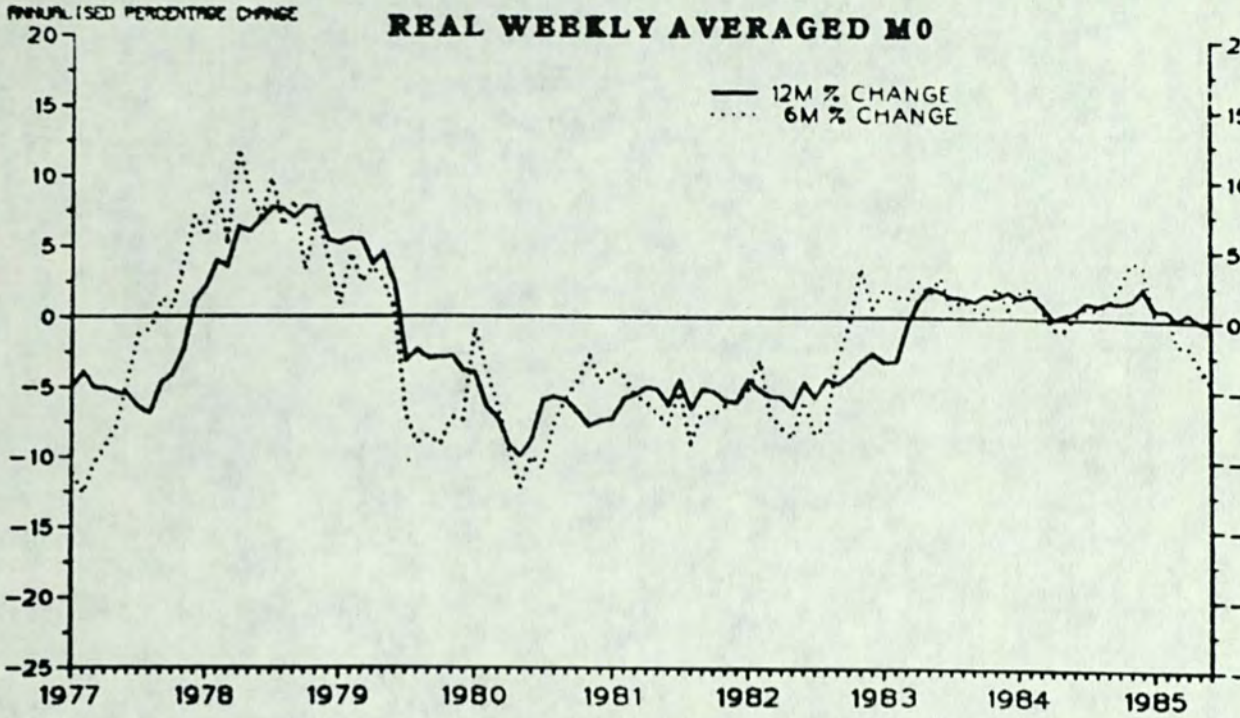
£million (seasonally adjusted)

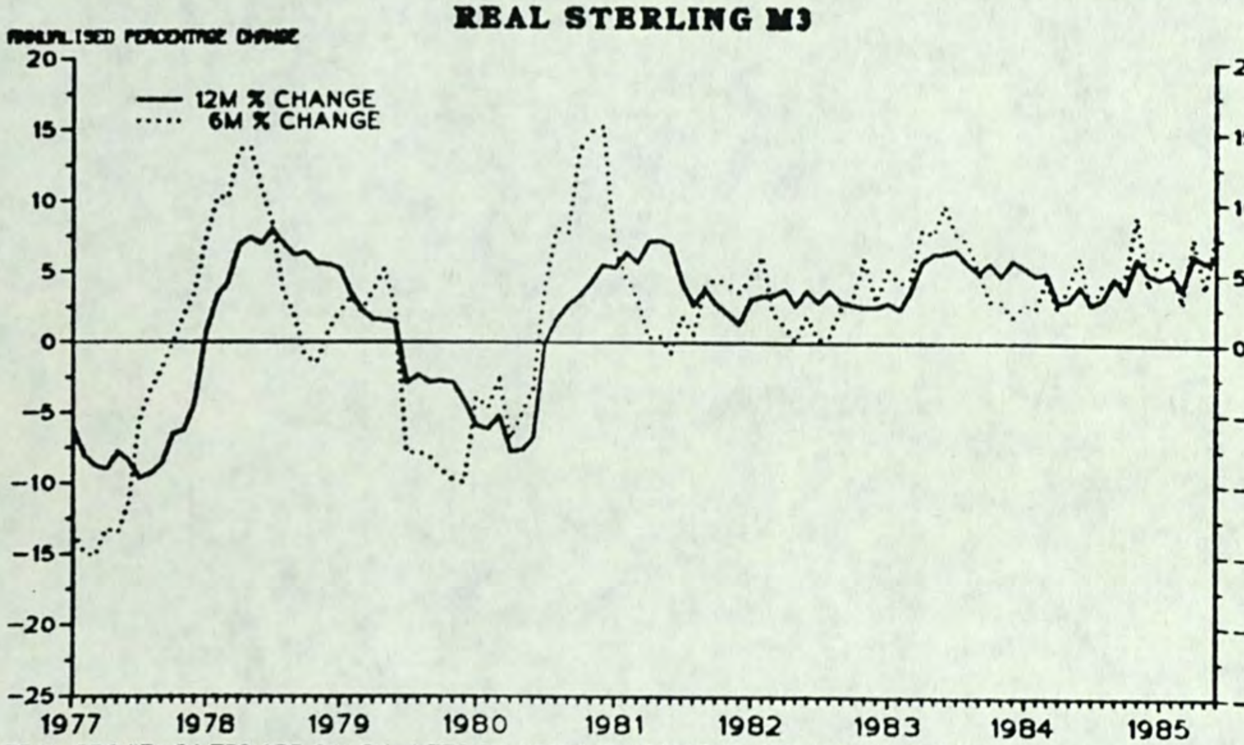
	OUTTURN				FORECAST		
	Average Monthly change since mid-May 1984	MAY	JUNE		JULY	AUGUST	SEPTEMBER
RETAIL BANK DEPOSITS							
NIB SIGHT	229	229	2269				
IB CHEQUABLE	217	529	486		-2430	375	425
IB OTHER	78	-28	-96				
TOTAL BANK	524	730	2659 (425)	[190]	-2430 (425)	375 (425)	425 (425)
BUILDING SOCIETIES	1039	1039	1141 (1210)	[1100]	1225 (1225)	1310 (1230)	1235 (1235)
NATIONAL SAVINGS	271	249	378 (300)	[370]	290 (290)	330 (270)	160 (250)
TOTAL RETAIL	1819	2018	4178 (1935)	[1660]	-915 (1940)	2015 (1925)	1820 (1910)

[ ] Last month's forecast

( ) Underlying inflows

CHART VII: GROWTH RATES OF REAL MONETARY AGGREGATES





REAL GROWTH RATES ARE CALCULATED BY DEFLATING BY THE GROWTH OF THE RPI EXCLUDING THE MORTGAGE ELEMENT

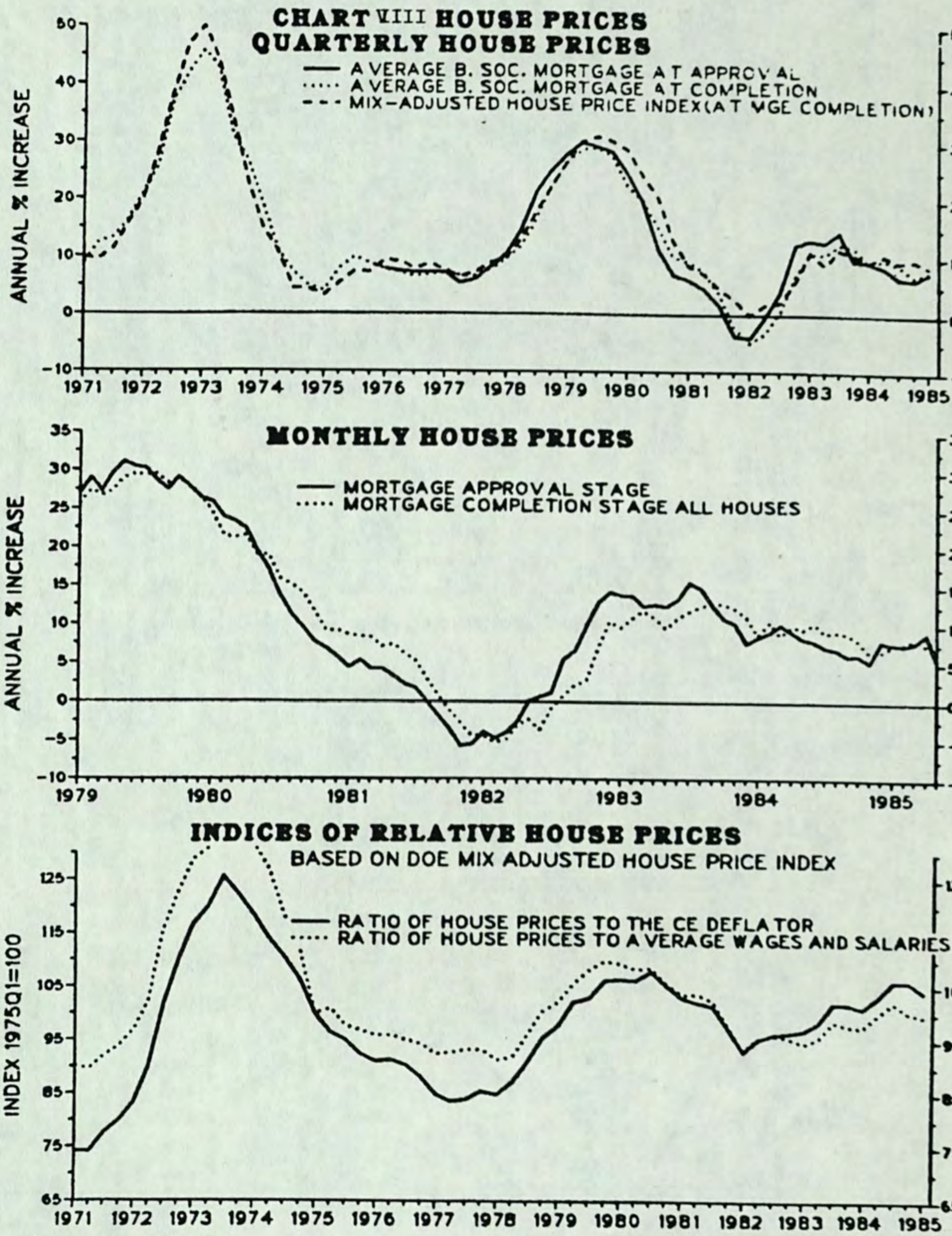
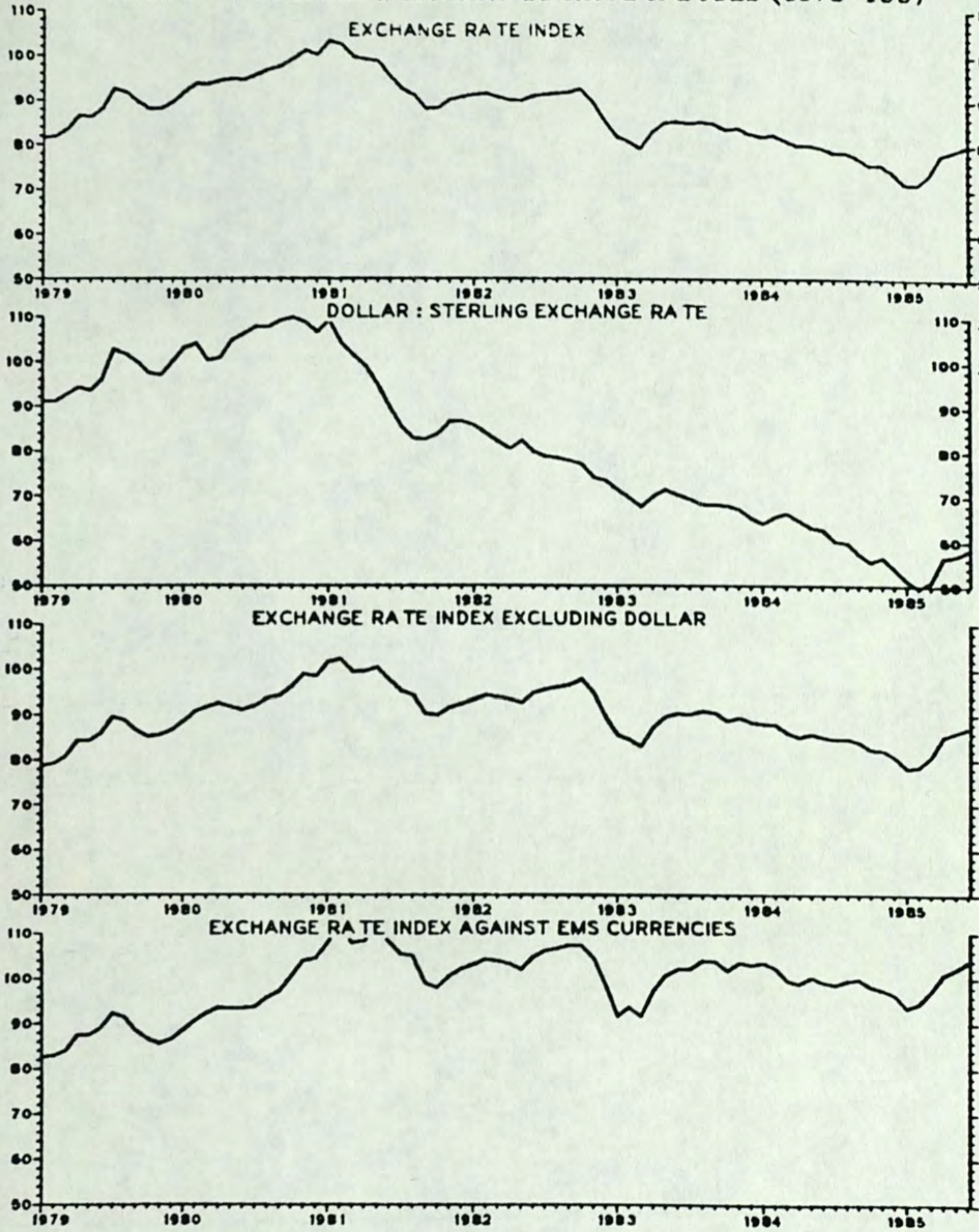


CHART VIII HOUSE PRICES
QUARTERLY HOUSE PRICES
AVERAGE B. SOC. MORTGAGE AT APPROVAL
AVERAGE B. SOC. MORTGAGE AT COMPLETION
MIX-ADJUSTED HOUSE PRICE INDEX(AT MGE COMPLETION)
ANNUAL % INCREASE
50
40
30
20
10
0
-10
1971 1972 1973 1974 1975 1976 1977 1978 1979 1980 1981 1982 1983 1984 1985
MONTHLY HOUSE PRICES
MORTGAGE APPROVAL STAGE
MORTGAGE COMPLETION STAGE ALL HOUSES
ANNUAL % INCREASE
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
INDEX 1975Q1=100
125
115
105
95
85
75
65
1971 1972 1973 1974 1975 1976 1977 1978 1979 1980 1981 1982 1983 1984 1985

CHART IX: STERLING EXCHANGE RATE INDICES (1975=100)



NOTE : ALL SCALES ARE EQUIVALENT

[Mr. Guy Barnett]

teachers, are voting with their feet? How often has the right hon. Gentleman met the teachers to discover those facts for himself?

Sir Keith Joseph: I am in the habit of accepting practically every opportunity given me to meet teachers. When I visit schools I always make plain my willingness to meet deputations of the staff. The hon. Gentleman should take account of the doubts expressed by some of my hon. Friends. Do all teachers know the shape of what the Government are offering? I wonder whether they do.

Johnson Matthey Bankers

3.51 pm

The Chancellor of the Exchequer (Mr. Nigel Lawson): With permission, Mr. Speaker, I should like to make a statement. I told the House on 20 June that if further investigations into the affairs of Johnson Matthey Bankers were to turn up any evidence of fraud, appropriate action would be taken. Investigations have been continuing since then. Although, strictly speaking, they have not so far established prima facie evidence of fraud, they have revealed serious and unexplained gaps in the records of Johnson Matthey Bankers, including the possibility of missing documents relating to substantial past transactions on certain accounts that are the subject of large losses.

In the light of that, Johnson Matthey Bankers has today requested the Commissioner of the City of London police to conduct a preliminary inquiry with a view to establishing whether any criminal offences may have been committed. The result of the inquiry will be reported to the Director of Public Prosecutions, who will advise what, if any, further action should be taken. The House will, of course, be kept informed.

Mr. Roy Hattersley (Birmingham, Sparkbrook): The Chancellor of the Exchequer was wholly right to inform the House of this latest development in the Johnson Matthey affair at the first opportunity, and I thank him for that. Obviously, it is not possible to speculate about the outcome of the police inquiry — [HON. MEMBERS: "But."] It is, however, essential to clarify the procedure which now follows. Will the Chancellor of the Exchequer confirm that two prosecutions may now result from the unhappy affair: first, regarding the auditors, about which he told the House a month ago, and now Johnson Matthey Bankers? What is more, because of their mutual mismanagement, the Bank of England and the Government are involved in the whole episode. It grows increasingly difficult to answer the question why Johnson Matthey Bankers was bailed out in the first place, and so quickly.

Does the Chancellor of the Exchequer agree that the fullest revelation of all the facts is essential? Will he promise that after the police inquiries there will be a general inquiry into the whole Johnson Matthey Bankers' scandal, either by a Select Committee of the House or under the Tribunals of Inquiry of (Evidence) Act 1921?

Mr. Lawson: I am grateful to the right hon. Member for Birmingham, Sparkbrook (Mr. Hattersley) for his initial welcome. He referred to the two matters which are now under way as if they are somehow similar. In fact, they are very different. There is the prospect of civil action by JMB, which is now a wholly owned subsidiary of the Bank of England, against the auditors Arthur Young McClelland Moores and Co. Secondly, there is the separate preliminary police inquiry.

The right hon. Gentleman asked why Johnson Matthey Bankers was bailed out. I gave a full explanation of that when I made my statement on 20 June, and the matter was covered fully in the annual report of the Bank of England. As for what might happen in future, I think that it is better at this stage to wait and see.

Sir William Clark (Croydon, South): Is my right hon. Friend aware that his statement will be very welcome, so that the whole affair can be cleared up once and for all? Does he agree that if the Bank of England had not intervened in the Johnson Matthey affair there could have been a loss of confidence in the City, which would have been detrimental to the invisibles sector of the economy?

Mr. Lawson: My hon. Friend is right. There were obvious dangers to the London gold market especially, which was a special and important feature of the case. It is striking how open the Government have been in revealing to the House details of this matter, in sharp contrast to what happened under the previous Labour Government during the lifeboat incident.

Mr. Richard Wainwright (Colne Valley): Will the Chancellor of the Exchequer explain to the House why it is only now that he is able to tell the House that serious and unexplained gaps in the records have come to light, when various skilled teams of investigators have been engaged in the Johnson Matthey investigation over the past six months? How much longer does he think it will take possibly to produce prima facie evidence?

Mr. Lawson: The fact that the documents were missing was not established until quite recently. Since the Bank of England took over Johnson Matthey it has stopped further out-flows and has been working to establish the full extent of the bad debts, which I reported to the House on 20 June. It has been engaged also in getting Johnson Matthey Bankers back into a shipshape and saleable condition, so as to protect taxpayers' and the Bank of England's money and that of the indemnifiers. The inquiry is not the only matter in which the Bank of England has been engaged, but I am satisfied that it is diligently pursuing the inquiry with the aid of its advisers. I am sure that it is as anxious as the House to have a prosecution for fraud if any evidence of fraud should be found.

Sir Anthony Grant (Cambridgeshire, South-West): Is my right hon. Friend aware that the deplorable goings on at Johnson Matthey Bankers have caused the most acute embarrassment to many of my constituents who work successfully and honourably with the chemical division of Johnson Matthey? Will he emphasise that the two companies are quite separate, and in so doing wish every success to those who work in Johnson Matthey chemicals?

Mr. Lawson: I did so when my hon. Friend properly raised the matter on 20 June, and I gladly do so again now.

Mr. Dennis Skinner (Bolsover) *rose*——

Hon. Members: Hear, hear.

Mr. Skinner: Is the Chancellor of the Exchequer aware that if the Attorney-General had acted on 12 November 1984 when I asked him a question about the fraud squad's investigation of this matter there is a fair chance that some of the tracks that have probably since been covered up would have been found and explored thoroughly by the fraud squad?

The right hon. Gentleman will be aware that in the Crown Agents' affair very few people were trapped at the end because there was too long a delay. In the London and Counties Security scandal, Gerald Kaplan managed to get to America because of the delay. The result is that he has got off scot-free. In other words, he has obtained an amnesty. If the right hon. Gentleman compares the Johnson Matthey Bankers' affair with the Slater, Walker fiasco, and all the others that arose at about that time, he will find that most of those involved got off scot-free. Against that background, is he not open to the charge that, because he has delayed matters and refused to answer my questions and those of my hon. Friends, people such as James Firth, a director, whose son was employed by one of the largest borrowers from Johnson Matthey, have been able to cover up all their tracks? The borrower is a personal friend of the Prime Minister and of the Secretary of State for Trade and Industry.

Is it not a scandal that the Chancellor has come to the House eight months after Johnson Matthey's exposure on 30 September? The result is that we will be lucky to get hold of any of the culprits, yet there are so many people to pick on. Why does the right hon. Gentleman not act against the Governor of the Bank of England? Why is the Governor not charged with the fact that he allowed so much neglect to take place? What about Michael Arnold, who worked for the auditors and apparently could not discover anything throughout 1984? One of those auditors is now in charge of looking after the NUM's funds. What a scandal this is.

Is it not a fact——

Mr. Speaker: Order. The House knows that the hon. Member for Bolsover (Mr. Skinner) has taken a special interest in this matter, but he must not make a speech.

Mr. Skinner: Is it not a fact that, by being so laggardly, the Chancellor and the Attorney-General, with the connivance of the Prime Minister, will allow these people to get off scot-free while miners have been locked up in gaol for doing absolutely nothing?

Mr. Lawson: I resent and reject the hon. Gentleman's allegations. I had hoped that he would welcome my statement.

Mr. John Maples (Lewisham, West): Does my right hon. Friend agree that one of the most difficult decisions that a central bank has to make from time to time is whether to rescue a particular financial institution? It is, by contrast, extremely easy for the Opposition to cast doubt on those decisions in ignorance of the full facts.

Mr. Lawson: My hon. Friend is correct, but, strictly speaking, that is not the issue before the House. This is a serious matter. It concerns the fact that the Bank of England, through Johnson Matthey Bankers, has reached the point where sufficient suspicion has arisen through the missing documents to lead the Bank of England to feel justified in asking the City fraud squad to make a preliminary inquiry.

Mr. Robert Sheldon (Ashton-under-Lyne): Is it not clear that the rescue of Johnson Matthey Bankers, by comparison with a large number of firms which have been allowed to go to the wall, represents an error of judgment by the Chancellor? Does the right hon. Gentleman agree that Johnson Matthey Bankers has shown itself to be the unacceptable face of capitalism, whereas the Chancellor's actions have shown themselves to be the unacceptable face of Government intervention?

Mr. Lawson: The right hon. Gentleman is wrong on both counts. First, the decision to rescue JMB was not my decision, but that of the Governor of the Bank of England. Secondly, it was not an incorrect decision. In my judgment, the Governor of the Bank of England was correct in taking that decision.

Mr. Anthony Beaumont-Dark (Birmingham, Selly Oak): Does my right hon. Friend accept that most of us will think that he was right to make this statement, because the invisible earnings of the City of London are important to our balance of payments? Does my right hon. Friend accept that what has happened at Johnson Matthey is a scandal which should be investigated, wherever it goes, and whatever its results? Bearing in mind the City revolution to come, the loss of confidence in the City by events such as the Johnson Matthey incident and the fact that Lloyd's has cast a great cloud over many people's views of the City's reputation, should not the same strictures be applied to Lloyd's, as a police investigation would bear heavily upon many people involved in some of the disgraces there?

Mr. Lawson: My hon. Friend will know that investigations into Lloyd's are going on. The prosperity and future of our people are threatened by the unacceptable face of Socialism. Whereas we are acting properly against what the right hon. Member for Ashton-under-Lyne (Mr. Sheldon) called the "unacceptable face of capitalism", the unacceptable face of Socialism is publicly embraced by the Leader of the Opposition.

Mr. Brian Sedgemore (Hackney, South and Shoreditch): Is the Chancellor aware that Mr. Michael Hepker, the chairman of a public company, Sumrie Clothes Ltd., who today left the country, has been leading the Bank of England auditors, Graham Mark and Robin Collier, up the garden path ever since the collapse of Johnson Matthey in relation to a £1·5 million loan made to Ravensbury Investments, an offshore Isle of Man company, which loan involved a whole series of frauds, including a fraud on Johnson Matthey? Will the right hon. Gentleman confirm that on 29 June 1982 Eric Ellen, the director of the International Bureau of Maritime Fraud, went to see Ian Fraser, a director of Johnson Matthey, to tell him about various proven misdemeanours in which Mr. Mahmud Sipra, who controls the El Saeed empire which led to the collapse of Johnson Matthey, had been involved? Will the right hon. Gentleman confirm that, on 12 December 1982, he telephoned Mr. Fraser to tell him that Mr. Sipra was caught up in a £3 million fraud and that it was ridiculous to continue to lend him money, only to be met with the reply by Mr. Fraser, "You chaps are all the same. You don't give anyone a chance."? Will the Chancellor give a guarantee that he will come to the House next week, when I hope to present further details of fraud at Johnson Matthey?

Mr. Lawson: If the hon. Gentleman has any relevant evidence, I hope that he will immediately make it available to the police.

Mr. Eric Cockeram (Ludlow): Will my right hon. Friend accept that his assurance that if any fraud is uncovered the matter will be brought to the attention of the Director of Public Prosecutions is little comfort, in view of the repeated lethargy of that Department? I remind my right hon. Friend that fraud at Lloyd's was uncovered more than 12 months ago, yet no action has been brought by the DPP.

Mr. Speaker: Order. Wide questions promote wide answers.

Dr. Oonagh McDonald (Thurrock): Is the Chancellor aware that his statement makes nonsense of the Prime Minister's reply to me last Thursday, which was reinforced in her Monday letter to me, when she said that she saw no purpose in an inquiry into the relationship between Johnson Matthey and companies to which loans had been made? Does not everything that the Chancellor has said today underline the need for such an inquiry? What will the right hon. Gentleman do to shake the Prime Minister's complacency about Johnson Matthey?

Mr. Lawson: There is no question of complacency on the part of my right hon. Friend the Prime Minister, myself, any member of the Government or the Governor of the Bank of England. We have acted throughout on all the evidence that has been made available. It was impossible to act before there was any evidence. Now that further facts have come to light, the Bank of England and Johnson Matthey Bankers, without any delay, have called in the police, who will report to the Director of Public Prosecutions.

Mr. John Stokes (Halesowen and Stourbridge): Disregarding much of what the Opposition have said, is my right hon. Friend aware that the honesty and integrity of the City of London is at stake? We look to my right hon. Friend to help us in every possible way.

Mr. Lawson: I agree with my hon. Friend that the honesty and integrity of the City of London are of the first importance. As I made clear in my statement of 20 June, it would be wholly wrong to assume that the shambles, and worse, at Johnson Matthey Bankers was in any way characteristic or typical of banking in the City of London. It does no good to this country to pretend otherwise.

Mr. Laurie Pavitt (Brent, South): Is the right hon. Gentleman aware that, apart from the large companies which were caught, a large number of small businesses are affected? I know of the tragedy of a small concern in Norfolk which had been built up over 30 years and which has gone to the wall. Does the Chancellor's announcement offer any hope that, after a lifetime of work, these small businesses will be rescued from bankruptcy?

Mr. Speaker: Order. That question has nothing to do with Johnson Matthey.

Viscount Cranborne (Dorset, South): Now that my right hon. Friend has set such a good example in dealing with white collar fraud, can we expect him to encourage the responsible authorities to promote similar investigations into the Lloyd's insurance market?

Mr. Speaker: Order. That question is no good, either.

Mr. D. N. Campbell-Savours (Workington): May I ask the Chancellor to give an assurance that every penny of public money expended on rescuing that bank will be returned to the public purse before the company is again privatised? May we now have a copy of the Price Waterhouse report?

Mr. Lawson: As I made clear to the hon. Gentleman earlier, the Price Waterhouse report contains details which, because of the law relating to banking confidentiality, cannot be revealed. It also bears upon the legal action which the Bank of England and Johnson Matthey Bankers contemplate against Arthur Young McClelland Moores and Co. On the hon. Gentleman's point about money being returned before privatisation, the money that will be received by the Bank of England as a result of the privatisation of Johnson Matthey Bankers will play an important part in the recovery of funds which have been expended.

Mr. Tam Dalyell (Linlithgow): Did it come to the Chancellor's ears from around the gold market and elsewhere in the City before Christmas that there was a likelihood of fraud being involved? On what date, before or after Christmas, were Sir Robert Armstrong, the Prime Minister and the Chancellor warned of the likelihood of fraud in the Johnson Matthey Bankers case?

Mr. Lawson: I received no such warning at any time. The Bank of England discovered the documents to be missing last week.

Mr. Robert C. Brown (Newcastle upon Tyne, North): As it becomes increasingly apparant that a large sum of public money has been involved in fraud, will the Chancellor give the House an assurance that if, after the fraud squad's inquiries, the Director of Public Prosecutions reveals that the villians have fled, he will dismiss the Governor of the Bank of England, and resign?

Mr. Lawson: No, Sir.

Mr. Hattersley: Does the Chancellor agree that the exchanges of the past few minutes confirm the need for a general inquiry? At some point, must he not answer the question why, when my hon. Friends below the Gangway suspected fraud six months ago, the Bank of England suspected it only yesterday?

Mr. Lawson: The right hon. Gentleman's colleagues below the Gangway suspect fraud on every occasion, whether or not there happens to be any evidence of it.

Wages Councils

4.11 pm

Mr. John Prescott (Kingston upon Hull, East): On a point of order, Mr. Speaker. The substance of the statement on wages councils which is about to be given to the House was reported in *The London Standard* at 2 o'clock this afternoon. I wonder whether you can say what rules govern these matters, because many Opposition Members read in the evening paper what the Minister was going to say.

Mr. Speaker: The House will be aware that I have the greatest sympathy with what the hon. Member has said. If statements which are embargoed are issued to the press, they should not be printed.

The Secretary of State for Employment (Mr. Tom King) *indicated dissent.*

Mr. Speaker: If they are embargoed, they should not be printed before the statement is given to the House.

Mr. King: Further to that point of order, Mr. Speaker. In case there is any misunderstanding, may I say that I share the feelings of the hon. Member for Kingston upon Hull, East (Mr. Prescott) about this matter. No embargoed statement was issued to the press. The House will have to draw its own conclusions as to whether there has been a leak. I take the strongest exception to leaks from my Department. I bitterly regret the fact that this has happened.

Mr. Prescott: Further to that point of order, Mr. Speaker. The Secretary of State has acted honourably in giving that statement. Will he look into the matter further and tell us later how the report occurred.

Mr. King: If I can, because I should dearly love to do so.

Mr. Speaker: Mr. King, to make his statement.

4.13 pm

Mr. Tom King: With permission, Mr. Speaker. I should like to make a statement concerning the Government's intentions on the future of wages councils and on international labour convention No. 26.

As the House will know, I published in March a consultation paper on the future of wages councils. That canvassed two main opinions: either total abolition or reform of the system. Including, in particular the limitation of their powers and duties and the removal of young people from the scope of wages councils.

In addition to the report from the Select Committee on Employment, over 700 organisations and individuals responded to the consultation paper. While the TUC and individual trade unions favoured retention, the consultations confirmed that there is a widespread dissatisfaction among employers with the present wages council system. The majority of them favoured a range of substantial reforms to meet these concerns. I promised to inform the House as soon as the Government had taken decisions on those matters, following the ending of the consultative period.

The Government's overriding concern is to promote employment and to remove any excessive burdens on employers. The present system inhibits the creation of more jobs and that is especially true in the case of young

Pdy

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STATEMENT ON JOHNSON MATTHEY BANKERS

I told the House on 20 June that if further investigations into the affairs of Johnson Matthey Bankers were to turn up any evidence of fraud appropriate action would be taken. Investigations have been continuing since then. Although, strictly speaking, they have not so far established prima facie evidence of fraud, they have revealed serious and unexplained gaps in the records of Johnson Matthey Bankers including the possibility of missing documents relating to substantial past transactions on certain accounts that are the subject of large losses.

In the light of this, Johnson Matthey Bankers have today requested the Commissioner of the City of London Police to conduct a preliminary inquiry with a view to establishing whether any criminal offences may have been committed. The result of this inquiry will be reported to the Director of Public Prosecutions who will advise what, if any, further action should be taken. The House will of course be kept informed.

Private Secretary to
the Chancellor of the Exchequer,

Six persons were arrested this morning on suspicion of offences of dishonesty relating to borrowings from Johnson Matthey Bankers. They are as follows:

STEPHEN DALTRY - Managing Director of Cross Oceans

HARRY NEWBY - Commercial Director

BENNY VAN PRAAG - Director

RAYMOND OLIVER "

HENRY LEGGE - Former Company Secretary

CHIEF ADEYEMI LAWSON - Director

The investigation relates to money obtained from ECGD and Samuel Montague by using false documents in relation to the financing of a carpet factory in Nigeria alleged that documentation was false. Approx Loss £7 million

The matter is now sub-judice within the terms of the Contempt of Court Act 1981. But Parliament applies its own rules. It may be desirable to inform the Speaker of this development so that he can intervene, if appropriate, to prevent questioning straying beyond the fact of the arrests. The Chancellor can properly say that there is at present no connection between these arrests and the inquiry now being commenced at the request of JMB.

S.J. WOOLER,
Law Officers Department.

17 July 1985

File RAM

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cc MASTER SET

10 DOWNING STREET

From the Private Secretary

16 July, 1985

Dear Rachel,

MONETARY POLICY

The Prime Minister held a meeting today to discuss various issues of monetary policy. Present were the Chancellor of the Exchequer, the Economic Secretary, Sir Peter Middleton, Sir Terry Burns, Mr. Cassell, Governor of the Bank of England, Deputy Governor Mr. George, and Mr. Flemming, Sir Alan Walters and Mr. Willetts.

Over-funding and £M3

The Chancellor said he believed that over-funding was no longer helpful in maintaining monetary control. He therefore recommended that funding should not exceed what was necessary to meet the PSBR. This would not represent a new policy but a decision to put into effect the policy he had announced in his 1983 Mansion House speech.

In discussion it was argued that cumulative over-funding over an extended period was likely to become less and less effective. Financial flows would adjust to off-set the initial impact. While ending over-funding might have little effect on the control of £M3 in the long run it was, however, likely to produce a period in which the growth of £M3 accelerated. Financial commentators were increasingly down-grading the importance of £M3 which had been growing very rapidly in recent months. The strength of the exchange rate gave assurance to the markets that monetary conditions were not too loose. A corollary of ending over-funding was that short-term interest rates would have to be somewhat higher than would otherwise have been the case.

Summing up this part of the discussion, the Prime Minister said it was agreed that funding as defined in the Treasury/Bank paper should be cut back to no more than was necessary to cover the PSBR. This would not be the subject of an early announcement (though markets were likely to detect a change in approach by the Government Broker). The Chancellor should consider setting out the background to the change in policy in his Mansion House speech in October.

Reducing the Bill Mountain

It was pointed out that over-funding was not the only factor behind the growth of the bill mountain. Another factor was the extent to which other parts of the public sector borrowed from the banks rather than from central government. The Treasury and Bank were seeking to improve NLF/PWLB facilities to reverse this trend. Even when the bill mountain had been prevented from growing the problem of rolling over the existing stock of £17 billion would remain. This would continue to distort money market operations. One possibility was for the Bank to replace its holdings of bills with deposits with the banking system. There were, however, a number of difficulties with this proposals. The Bank would be making unsecured deposits and would need to ensure that they were made only with financially sound banks. The process of selecting such banks would, however, be seen as conferring a seal of approval on them. It was agreed that the Treasury and Bank should examine further how such an arrangement might work.

Money Market Operations

It was agreed that the objective should be to return as far as possible to the spirit of the 1981 arrangements, under which the Bank confined its operations to short-dated bills. It was recognised that this could not be achieved immediately but was dependent upon first ending the growth in the bill mountain and secondly on reducing it.

It was argued that within the 1981 arrangements there was already provision for assistance to be made available on penalty rates, when appropriate. For example, the facilities for borrowing from the Bank late in the day were available only on terms which were less favourable than those in the market generally.

Sir Alan Walters said it had originally been envisaged that the 1981 arrangements could be further developed and he suggested that work should be undertaken to design a system which would place greater reliance on retaining money market assistance. Under such a system short-term interest rates could at times rise very sharply which would encourage banks to hold greater operational balances with the Bank.

It was noted, however, that such a system could not be introduced immediately, even if the authorities wanted to, as they would not have an adequate basis for assessing the demand for operational balances and hence for the money market assistance that should be supplied.

Summing up this part of the discussion, the Prime Minister said the aim should be to return as far as possible to the 1981 arrangements in which the Bank operated mainly at the short-term end of the market. Within those arrangements an element of penalty should be retained where market participants sought late assistance. In conjunction with the study of measures to reduce the bill mountain, the Treasury and Bank should examine whether there were any features of money market operations in the United States or Germany which could be adopted to improve monetary control in Britain.

I am copying this letter to John Bartlett (Bank of England) and Sir Alan Walters.

Yours sincerely
Andrew

(Andrew Turnbull)

Mrs R. Lomax,
HM Treasury.

cc Mr Turnbull -

10 DOWNING STREET

Sir Peter Middleton KCB
Permanent Secretary
HM Treasury
Parliament Street
LONDON SW1

16 July 1985

Dear Peter

The paper on Bank Lending Recent Developments (referred to as Paper III) for today's meeting contains an, albeit understandable, misrepresentation of the aims of the "penal" rate system that I suggested in my note of 7 June.

Paper III argues that the penalty rate is meant to penalise the individual bank for "excessive" lending. It suggests that the individual bank would revert to the interbank market and drive up the rates in the wholesale market for "all-comers" so that penalty rates "would not be likely to provide a significant direct constraint, or discipline, on individual banks".

This is a misconception. The penalty rate is a market mechanism and is not aimed at individual banks (that is a matter for prudential control). The penalty rate applies because the banking system is anxious to borrow more reserves or high-powered money than the authorities - pursuing a control of the monetary base - wish to lend. All banks that want to borrow a lot and lend little will find it expensive, just as those banks that are net lenders on the interbank market will make profits from the rise in interbank rates. The penalty rate must filter through very quickly into the interbank market (the latter may even anticipate the former, as in the days of the old Bank Rate). It may well be that only a little borrowing at the penalty rate (if the penalty is sufficiently high, as in Germany) may be sufficient to promote the adjustment needed in the interbank market to choke off demand and maintain the quantitative target growth of the base.

To those who argue that our existing system could theoretically be used in this way, one must agree. True, but hardly relevant. The market knows that in practice it can get all the funds it wants at the going rate, and that movements of the going rate are a consequence of (often) long-resisted market pressure. Rates are administered and inflexible. We move up in large jumps and down in small steps, so that the political exposure on rises is at a maximum; whereas the small steps down are discredited by CBI, media, etc, as too little and too late. It is better to be able to attribute movements in interest rates to the market.

I am sending a copy of this letter to Eddie George at the Bank of England.

Yours ever
Alan

ALAN WALTERS

PRIME MINISTER 15 July 1985

MONETARY POLICY - OBJECTIVES OF MEETING ON 16 JULY

The main objective should be to restore the 1981 system. This implies:

1. Ending overfunding - the Treasury (Paper I) cogently puts the points. In my judgment, an overt policy simply to "fund-the-borrowing-only" will generate confidence in the markets. They will know what to expect in terms of the quantity of funding.

2. Reducing the bill mountain. Not overfunding may stop it growing, but will not bring it down - perhaps public deposits in the banks are the least objectionable alternative.

3. The Bank to operate only in the 7-day bill market, and allow the market to determine the rates on longer maturities - we ought to reopen the idea of the flexibility of the 7-day rate within the band (as in 1981).

4. Let the sun set on £M3 targetting - I suspect the market has already written it off and it can be left to die, confirming it as "another indicator", but not targetted, at the next MTFS review.

5. Explore further steps to be taken towards MBC, particularly the use of penalty rates as in Germany and the United States. We need to proceed slowly one step at a time, but there must be a *first* step, and we ought to confirm that we want to see one designed by the Treasury and Bank.

ALAN WALTERS

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SECRET

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

15 July 1985

Andrew Turnbull Esq
10 Downing Street
London SW1

Dear Andrew

MONETARY POLICY

I attach a further note, on the way the Bank currently operates in the money markets, as background to the Prime Minister's meeting tomorrow. It was prepared jointly by the Treasury and the Bank.

I am copying this to John Bartlett (Private Secretary to the Governor).

Yours ever
Rachel.

RACHEL LOMAX

LENDER OF FIRST RESORT

Introduction

1. The current arrangements for the Bank's money market operations are sometimes depicted as a system of "lender of first resort", with the implication that the Bank is prepared to provide unlimited amounts of money market assistance on easy terms, and that this encourages the banks to expand their lending without constraint.

2. This note sets out the structure of the present arrangements and describes how they in fact operate in practice. It then explores some possible alternative arrangements, designed to ration our money market assistance, or provide it only at (more) penal rates, with the aim of constraining the supply of bank lending, and explains why we do not believe they could work as their proponents suggest.

The present arrangements

3. The Bank undertakes open market operations in bills to offset the daily cash flows between the Bank and the money markets, leaving the operational balances which the commercial banks maintain at the Bank broadly unchanged in aggregate from day to day. This means that the Bank buys money market assets whenever there would otherwise be a net flow of cash to the Bank - for example if sales of central government debt exceeded the CGBR.

4. The Bank's operations in the money markets are thus limited in amount, to the size of the cash shortage. Within this quantitative framework the banking system, through the discount houses, compete among themselves for the cash available from the Bank by offering very short-term paper. Clearly the discount houses would not bid the Bank for cash if it could be obtained more cheaply in the market: in this sense all the Bank's assistance is provided on penal terms.

5. The system incorporates a safety valve. If, after the Bank has completed its bill operations, the cash needs of some market participants remain unsatisfied (eg, because the cash shortage in the market was in fact larger than the Bank's estimates suggested), they can make use of limited borrowing facilities at the Bank. But the 1981 arrangements recognised that this should not be a soft option for those wishing to side-step the competitive bill operations, and the terms for borrowing are usually somewhat above the comparable market rates arrived at through bill operations, ie they carry a further element of penalty.

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6. The 1981 framework therefore provided for the Bank's money market assistance to be both limited in amount and given on penal terms (in relation to the market). This framework remains exactly as it was created in 1981.

7. What has changed dramatically is the context in which it is operated, as a result of the systematic money market shortages, created in part by "overfunding" and cumulating in the "bill mountain". The 1981 arrangements had assumed that there would be no systematic tendency for a net flow of cash between the banking system and the Bank in either direction. In practice the daily cash shortage has typically been in the range of £1/2-1 billion in recent months.

8. Although it is still true that the Bank only provides sufficient cash day by day to relieve the estimated shortage (and still quite frequently refuses, or cuts down, the offers of bills), the scale of the daily assistance required means that there is no longer any sense of scarcity in its provision. It is no doubt partly this development that gives the impression of being "lender of first resort".

9. Moreover, in order to provide the quantities of assistance required the Bank has been obliged to deal more or less continuously in bills throughout the maturity range out to three months, and the pattern of our dealing rates has inevitably

become unduly rigid. Interbank rates remain free to fluctuate around our bill dealing rates so that even now there is still greater scope for market influence over the term structure and general level of short-term interest rates than there was before 1981 (see paragraph 20 of the Bank's original submission to the Prime Minister). It is only if, as a deliberate policy decision, the authorities are seeking to resist upwards pressure on rates generally that we can find ourselves providing money market assistance on terms which are more favourable than can be obtained in the market, for periods out to three months.

10. It is not true therefore that the present arrangements provide for unlimited money market assistance, nor, generally, that such assistance is provided on easy terms. It is true, however, that there is no direct relationship between the amount of assistance either required by the money market or provided by the Bank on the one hand and the rate of expansion of bank lending on the other. The scale of assistance depends on the size of the cash flow from the banking system to the Bank, and this need not be affected at all by an increase in bank lending to their private sector customers. Such lending simply enables payments to be made to the accounts of other commercial bank customers and therefore need not, of itself, have any effect on the operational balances which the banks collectively maintain with the Bank of England. Any reduction in those operational balances would only occur indirectly, for example, if the Bank sold more government debt in order to offset the expansionary impact of the bank lending on £M3. To influence the bank lending itself, the present arrangements work through changes in the general level of interest rates on the private sector's demand for bank credit.

Possible alternative arrangements

11. It is probably in this area that the confusion about "lender of first resort" arises. Those who depict the present arrangements in this way assume either that there is, or that there should be, some automatic relationship between the growth

of bank lending and the banks' need for money market assistance. If there were such a relationship, it is argued, the growth of bank lending could be constrained by limiting the amount of money market assistance that the authorities were prepared to provide, without the need for the authorities themselves to be concerned with interest rates, which would be determined entirely by the markets.

12. This, intellectually attractive, general proposition comes in a number of forms. One is that it is possible to ration the supply of money market assistance, or provide it only at a penal interest rate, to an individual bank whose lending is growing particularly fast. This is a red herring. It would only be the case in an undeveloped and fragmented financial system in which banks do not lend to each other. In the UK this possibility is excluded by the highly developed interbank market through which banks can borrow from each other until such interbank borrowing becomes as expensive as borrowing at the Bank of England. However much penalty was built into the system of providing money market assistance, therefore, it could not bite on individual borrowers without raising the general level of interest rates.

13. It would in principle be possible to apply such arrangements to rationing money market assistance generally rather than to individual banks. The difficulty with this approach has always been that we would not know, at least for some considerable time, how much assistance to provide because we would not know, in a new regime where the banks could not assume that we would smooth out the daily cash flow between the banking system and the Bank, what level of operational balances they would wish to hold. It seems likely that banks would wish to hold larger balances at the Bank to protect themselves against more variable interest rates; and we would have to provide this through additional money market assistance; but it would be some time before we could judge how much such additional assistance to give for this purpose. We would, possibly for some years, be operating in the dark.

14. If we were eventually able to identify a reasonably stable demand function for bankers operational balances, and could operate our money market intervention on that basis, we would still not see this as affecting directly the supply of bank lending. That would only occur in a relatively unsophisticated environment where most bank lending was at fixed rates of interest. In this country the banks, whose lending is predominantly at variable interest rates, would still find it profitable to lend so long as they could find creditworthy borrowers prepared to pay an appropriate margin over the cost to the banks of their funds.

15. Ultimately therefore even this system would operate through the effect of higher interest rates on borrowers' demand for credit, just as at present; and this interest rate effect would be no more certain or predictable than it is now. We can achieve an upwards adjustment of interest rates, in response to an acceleration in the rate of growth of broad money associated with an expansion in bank lending, more directly and easily with our present arrangements, if that is what we wish to see, without the disruption to the financial structure which a change of system would involve.

PRIME MINISTER 12 July 1985

MONETARY POLICY

Your last meeting killed over-funding as an instrument of monetary policy. Tuesday's meeting is the funeral and the reading of the will.

If we fund less, without raising interest rates, the crucial questions are:

- **Will £M_3 carry on rising rapidly?**
  Probably in the short run. But in the long run, companies might at last come back to the capital markets for funds, and borrow less from banks.

- **Will the City care?**
  Not much. £M_3 now has little weight as a measure of financial conditions. The exchange rate is more important.

- **Will it threaten higher inflation?**
  Probably not. After the crucial turning point in January, sterling continues to strengthen. A stronger pound is essential for the politically crucial objective of getting inflation well below 5% by the next Election. So we should be very cautious about reducing interest rates - but because of the exchange rate, rather than £M_3.

It then remains to decide whether the $£M_3$ target should formally be abandoned now, or whether a final decision should be taken at the next Budget. Publicly abandoning it now would be an unnecessary gesture. The market is at last beginning to understand the Chancellor's policy of a Nelsonian eye. He can stick with that.

But ending over-funding will not end the problem of structural shortages in the money markets. Simply turning over the existing stock of £17 billion of commercial bills as they mature guarantees money market shortages from here till kingdom come.

The Chancellor's preferred course is for nationalised industries and local authorities to raise more of their funds from the NLF so that there are lower money market shortages for any given level of gilt sales. But it is unclear whether this will be enough on its own.

So the Chancellor also needs to pursue his second option of unloading the existing stock of bills back onto the private sector. This would probably increase banks' balance sheets, but would not represent a relaxation of monetary conditions, as it would merely be a shift in ownership of lending that has already taken place.

David Willetts

DAVID WILLETTS

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SECRET

PRIME MINISTER

You are meeting (1½ hours) with the Chancellor and Governor on Tuesday afternoon, preceded by ¾ hour with Alan Walters in the morning.

The papers are:-

(i) Overfunding

(ii) Money market operations and interest rates (to come on Monday)

(iii) Background note on bank lending.

The priority for the meeting is to secure a decision on funding policy which is needed for immediate operational needs. The Bank are nervous about the faster growth of £M3 which may result; Treasury feel now is a good time to change policy. £M3 is not giving a good indication of monetary conditions which are better represented by the strength of the exchange rate. Any acceleration in £M3 is likely to be temporary, as has been the benefit of using overfunding in the first place.

The meeting can then debate the issue of penalty lending in the money markets, on which papers will be put to you on Monday. The bank lending rate does not need to be discussed separately.

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12 July, 1985.

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

12 July 1985

Andrew Turnbull Esq
10 Downing Street
London SW1

Dear Andrew

MONETARY POLICY

I attach a joint Treasury/Bank paper on ending overfunding, and a background note on bank lending (also a joint production), as commissioned in your letter to me on 25 June.

I am copying this letter to John Bartlett (Private Secretary to the Governor).

Yours ever
Rachel

RACHEL LOMAX

Paper III cc AW

BANK LENDING

A Recent Developments

Bank lending to the private sector has grown at an average rate of about 20.5% per annum since 1979/80, see Table 1. Despite some partial offsets*, there is little doubt that bank lending has provided the main thrust to the growth of £M3, see Graph 1. In order to hold £M3 to a much lower average rate of growth, at about 12 1/2% - though that was still on average well in excess of the annual targets - the authorities have resorted to heavy funding.

As shown in Table 1, the fastest area of growth, at least until 1982/83, has been lending to the personal sector, which has grown by 28% pa. Of this, the fastest growing element has been bank lending for house mortgage: the banks entered this market aggressively in 1981/82, and such lending represented a major element in the surge in lending to the personal sector in 1981/82 and 1982/83, before tailing off somewhat thereafter. The current state of competition, eg on relative interest rates, between banks and building societies is, however, such that there could well be room for the banks to regain a larger share of mortgage lending, thus raising £M3 relative to PSL2.

Meanwhile, lending to Other Financial Institutions has continued to grow fast but much of it has represented lending channelled to the company sector, notably via leasing companies, whose bank borrowing has expanded by 31% pa, as the fiscal framework made such indirect routing of funds tax efficient. Thus the fact that lending to ICCs has grown considerably less fast, (with the exception of this last year, 1984/85) should not be taken at face value.**

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*Some bank lending provides funds to finance private sector purchases of gilts or of foreign assets, so it does not necessarily feed through one-for-one on to higher bank deposits. A larger proportion of the funds generated by gross bank lending allows other bank borrowers to repay existing overdrafts: the data, however, only show the net increase in bank lending, after netting out such induced repayments.

**Table 1 includes leasing with ICCs, rather than, as in the published statistics, with OFIs.

In several respects the most surprising feature of recent history is that it took the banks so long to enter into the house mortgage market. The conditions in this market, with a massive unsatisfied demand, encouraged by fiscal advantages, and low default risk, with rising house prices and mortgage interest payments guaranteed at times of financial stress on the borrower by the tax-payer via supplementary benefits, meant that such lending was highly profitable and involved low risks. By entering this market, the banks raised both the average quality and quantity of their loans. Probably the reasons why banks had not been more aggressive in catering for personal loans before then, (not only for mortgages, but also consumer credit), was the combination of ceiling-type constraints on lending (the "corset") together with a failure to appreciate how far their retail deposit base was being eroded by their absence from the personal loans market.

Leaving aside their lending to overseas sovereign and other borrowers - which is mostly in currency and has no material effect on domestic monetary conditions - the riskiest segment of banks' £ loan book in recent years has been their loans to manufacturing and to small businesses of all kinds. Manufacturing companies were under particular pressures in the early 1980s, and the banks have had large numbers of such companies in their 'intensive care units'. Small, newly-founded businesses are always particularly at risk, as the Government has recognised by introducing the Loan Guarantee Scheme.

In the context of the early 1980s, market pressures led to considerable distress borrowing, as companies had to finance their deficits, and also sought to build up their liquidity as a precaution against continuing difficult conditions. It is much less easy to understand the causes of the continuing strong demand by companies, either directly or via OFIs, for such external funds. In the last couple of years profitability and liquidity appear to have been very comfortable and in the most recent quarters, companies have obtained additional large volumes of external finance from equity issues on the capital market. Nevertheless company bank borrowing has surged again. Analysis of the reasons for this is made virtually impossible by the parlous state of the company sector statistics, which, in 1984, showed an unidentified net outflow of funds of some £10 bn - greater than the size of total company sector bank borrowing in the same period. In particular it may be that the pace of investment abroad by the corporate sector is very much larger than is recorded in the statistics.

As described earlier, until 1980 with the abolition of the corset following exchange controls in 1979, banks were generally prevented by direct ceiling controls, or the fear of them, from using their full efficiency to compete for business. The most obvious effect of giving banks freedom to compete was their entry into the mortgage market. More generally, however, such competition, for example by reducing the spread between deposit rates and lending rates, will have increased the volume of financial flows passing through the banking system, both by substitution from other channels, eg from trade credit, and by raising the total volume of such flows. It is impossible, however, to quantify such effects, or the theory that bank intermediation has been increased by a widening disparity between cash-rich and cash-deficient companies.

What can be said is that the rise in sterling bank lending to domestic borrowers in recent years has not correspondingly increased the prudential risks faced by banks. Their support of manufacturing companies in difficulty and of small businesses undoubtedly raised the loss provisions which were necessary in the early 1980s. But, with the recent upsurge in corporate profitability the worst of this problem appears to have passed; while the diversification of their business represented by the banks' increased penetration of the personal credit market has brought a large volume of assets onto their books which have normally carried a low risk of loss.

B Means of Control

Insofar as bank lending was restrained before 1980 by direct ceiling-type controls, is there a case for reverting to them? In the absence of exchange control, there would be a risk that their effect would be almost entirely cosmetic - except on small borrowers - since the financial flows would simply move offshore: nor would £M3 necessarily be much benefited, since the deposits would be on-lent to offshore subsidiaries which would lend back to UK companies. It would mainly serve to lessen the efficiency and profitability of the UK banking system to the advantage of the foreigner, and the illusory nature of the control would be obvious. Other measures, which had the effect of artifically raising the cost of bank intermediation, such as imposing mandatory cash ratios, or capital adequacy ratios in excess of perceived prudential needs, would similarly have their effect through reducing the efficiency and profitability of British banking, and would also lead to a shift of business offshore.

Avoidance of credit restraint by moving offshore would hardly be feasible for small borrowers, because of the transaction costs, and could be further prevented by making any such offshore borrowing deals unenforceable in UK courts. But it is increasingly possible for personal borrowers to obtain funds from mortgage borrowing for uses other than on house investment. Unless mortgage lending were included within the ambit of any consumer credit control, it would be widely avoided and give rise to distortions and inequities.

One, generally unattractive, way of reducing the scale of bank intermediation is thus artificially to make banks less efficient: an alternative approach is to remove barriers to efficient use of other non-bank channels of finance. A further step along this latter route involves removing the barriers to the establishment of a commercial paper market; this is being actively pursued.

Banks are increasingly lending money on a variable rate basis, and also to some extent matching the maturing of their liabilities to that of their loans, through their operations in the wholesale money markets. Consequently, they are taking steps to protect themselves from interest rate risk. Such risk is mainly passed on to customers. Nor is it possible to penalise an <u>individual</u> bank, or institution, for 'excessive' lending by charging it a 'penalty' rate: any attempt to do so would cause the bank upon whom the penalty was to fall to revert to the inter-bank market, until rates in the wholesale market for all-comers were driven into equality with the penalty rate. Under these circumstances the prospect of cash shortages only being relieved at penalty rates, and of greater variability of short-term rates, would not be likely to provide a significant direct constraint, or discipline, on <u>individual</u> banks: ie it would not make them less willing to lend money to willing borrowers at the going rate.

There might, however, be an exception in the case of overdrafts, since greater variability in the cost of overnight money might enable such borrowers, when overnight rates were raised by penalty charges, to round-trip at a profit against the banks: to prevent this, banks might have to refuse overdraft facilities to customers in a position to take advantage of round-tripping opportunities. Indeed anyone from whom funds would be withdrawn at call, eg the discount market, would be put at greater risk from more volatile short-term interest rates, and would have to respond by some combination of providing fewer, or no, such facilities and/or a widened spread on such business.

A move towards greater variability of short-term rates could, therefore, lead banks to seek to shift loans increasingly from overdrafts and fixed interest forms to a variable rate term basis, which would protect them from interest rate risk. With bank lending increasingly in this latter format already, there would then be little further direct, supply-side, effect on banks.

Instead any impact of greater variability in, and of any higher level of, interest rates would impact on the bank customer. If bank borrowers did come to reckon that this form of borrowing had become riskier, there might be a (transitional) fall in demand for bank borrowing vis a vis other sources of funds. Once borrowers had adapted to the riskier nature of bank borrowing, their demand would then again come to depend on the expected cost over the lifetime of the borrowing. So, there might be a transitional effect on the demand for borrowing by making interest rates more volatile and uncertain, but the longer term rate of growth of demand would still depend on the (expected) level of interest rates.

Conclusion

There are three main conclusions to draw from the above. First, we judge that influence over bank lending is best achieved through the operation of interest rates upon the demand for bank credit. Second, there may be something in the arguments for greater short-term variability of interest rates; but, if the approach were carried very far it would generate uncertainty throughout the economy over the cost of money without providing clear offsetting benefits. Finally, it is worth exploring, as a matter of urgency, the development of a commercial paper market which non-banks could use (thereby reducing their dependence on the banking system); this is in hand.

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TABLE 1

Not seasonally adjusted

£ bn (% in brackets)

	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85	Average % over 1979/80-1984/85
Increase in bank lending to private sector*	9.3 (23.9)	9.2 (19.1)	14.9 (26.0)	14.4 (18.8)	15.4 (16.9)	18.8 (17.6)	20.4%
o/w ICCs (incl leasing**)	4.0 (17.6)	3.8 (14.2)	6.9 (22.5)	3.4 (8.9)	4.1 (9.9)	8.7 (19.1)	15.4%
OFIs	2.0 (38.7)	1.6 (22.8)	0.6 (6.7)	1.4 (14.9)	3.3 (30.5)	2.8 (19.8)	22.1%
Personal	3.3 (29.8)	3.8 (26.2)	7.4 (41.1)	9.5 (34.3)	8.0 (21.3)	7.3 (16.0)	28.1%
of which for house mortgage	0.6 (32.4)	0.7 (29.9)	3.1 (98.7)	4.8 (71.8)	3.8 (28.2)	2.5 (16.1)	46.2%
£M3	6.5 (12.7)	10.3 (17.7)	9.8 (14.3)	9.8 (11.3)	7.6 (7.8)	12.0 (11.5)	12.5%
% target≠	[7-11]	[7-11]	[6-10]	[8-12]	[7-11]	[6-10]	

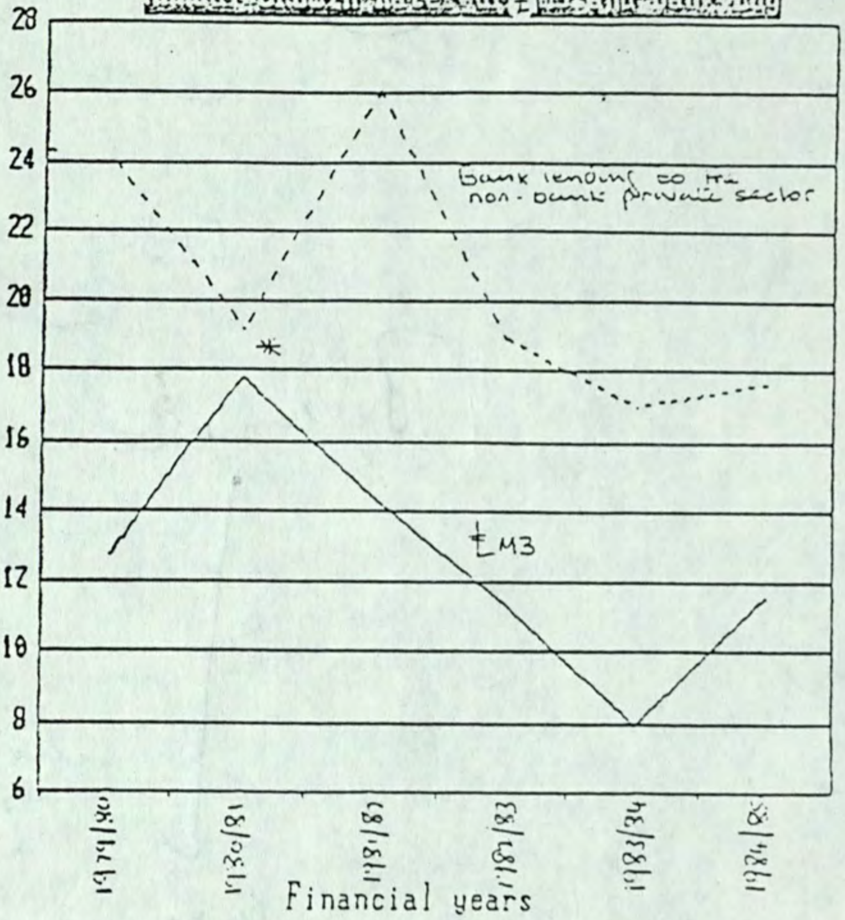
* including changes in Issue Department's holdings of commercial bills.

** these figures should be treated with caution. In particular leasing figures were not separately available until 1981/2 and - when they did become available - were recorded with OFI lending, not with ICCs. The figures in this line have therefore been constructed from a number of not wholly consistent sources.

≠ Targets are for 14 month target periods (Feb to April) except for 1979/80 where the period was June 1979 to October 1980.

GRAPH 1

Annual Growth Rates of £M3 and Bank Ldg



NOTES:

Data not seasonally adjusted.

Including changes in Issue Dept. holdings of commercial bills.

* Distorted by the Civil Service strike which had the effects of increasing the PSBR, and providing companies with additional liquidity which allowed them to reduce bank borrowing.

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Paper I cc AW

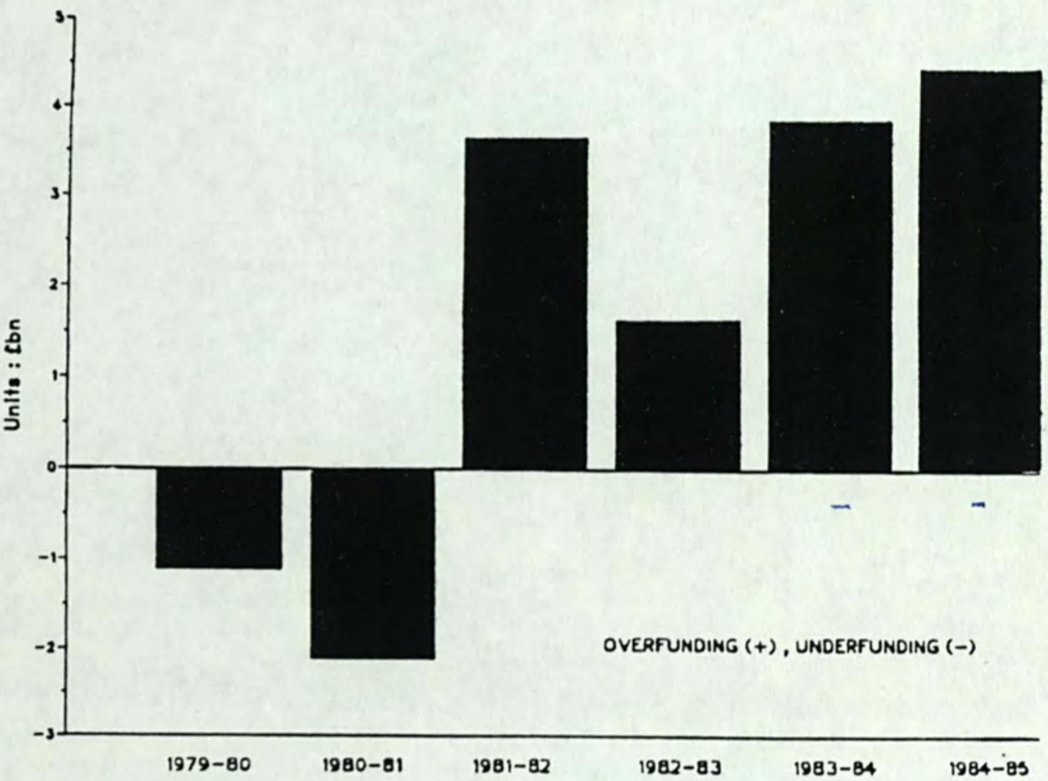
SECRET

ENDING OVERFUNDING

The following chart shows the extent of overfunding in recent years:-

OVERFUNDING

Defined as the excess over the PSBR of sales of public sector debt outside the banking system*



2. The aim of funding in the first place is to finance the Government's borrowing in a non-inflationary way - in particular by avoiding borrowing from banks or by printing money.

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*This definition of overfunding is that implied by the Chancellor in his 1983 Mansion House speech. See Annex for other definitions.

Overfunding goes further and seeks to offset the growth of liquidity in the economy that would result from non-government influences, particularly bank lending to the private sector. In terms of present policies, overfunding has been directed at containing the growth of £M3. But as well as reducing the liquidity of the economy, over-funding drains cash from the money markets - which has to be replaced by the Bank (usually through purchases of commercial bills).

3. It is obviously desirable to prevent the economy becoming over-liquid. Though high liquidity need have no immediate consequences for inflation, it leaves the economy vulnerable to inflationary shocks. There has been a substantial growth of liquidity in the UK in the past five years. This can be seen in the fall in the velocity of £M3 since 1980, shown in the attached chart. This high growth of liquidity, however, occurred from a low base (reflecting the distortions of the corset) and seems in large part the result of financial liberalisation and the high real rates of return available on liquid assets. The private sector, freed from distorting controls, has wanted to hold larger stocks of liquid assets in relation to its spending. The rapid growth of £M3 and broader measures of liquidity has been consistent with falling inflation and, as again can be seen from the chart, there is no evidence that the economy is, by historic standards, overliquid.

4. Funding is a form of insurance against the risks that go with high liquidity. But it has a price, and a balance has to be struck. A lower level of insurance would be appropriate if we have the means of reacting speedily to any sudden onset of inflationary pressure, and there is confidence that we will take the necessary action. In practical terms this means a readiness to raise short-term interest rates in response to any early warnings of inflation from MO, asset prices or the exchange rate.

5. The extent of overfunding in recent years has caused several problems:-

i. The operation is not well understood. Many commentators regard it as a means of massaging the numbers. The extent of overfunding in recent years and the sheer scale of the bill mountain are damaging the credibility of government policy.

ii. It has been the main cause of the growth of the bill mountain. The stock of money market assistance given by the Bank, mainly in the form of bill purchases, has risen from a negligible amount in 1979 to around £17 billion today. The maturing of these bills causes huge cash shortages in the money markets on most days. This makes the Bank's job of managing the money markets more difficult and can at times give rise to differentials between bill rates and inter-bank rates that encourage round-tripping.

iii. Over time, it probably adds to bank lending by raising long-term interest rates and crowding private sector borrowers out of capital markets, so increasing reliance on bank credit. Consequently, its beneficial effects on £M3 almost certainly diminish with time.

iv. It increases gross debt interest payments by the Government, adding to recorded general government expenditure. There is an offsetting rise in government receipts of interest on the bills the Bank holds. But in most recent years there will also have been a modest net interest cost to the PSBR. The operation involves borrowing long and lending short, and only becomes profitable when - as at present - interest rates on short term bills rise above the rates at which the additional gilts were sold.

6. If present policies of overfunding to constrain £M3 growth continue, these problems will persist and the likelihood is that the bill mountain will go on growing rapidly.

Effects of stopping overfunding

7. Stopping overfunding could have the following effects:-

i. £M3 would grow faster. Our very rough calculations suggest that a cut of £4 billion in gilts sales over a year might be expected to add something of the broad order of 3 per cent to £M3 growth. That was more or less the scale of overfunding last year (but see Annex for different definitions): and at present the prospects for 1985-86 look rather similar.

ii. The effects of this faster growth of £M3 would depend crucially on how markets reacted to it. If it led to a deterioration in confidence and a weakening of the exchange rate, it would add to inflation. If a rise in £M3 brought about in this way left confidence undisturbed it would have little effect on the economy and inflation. In this context, the market's calm response to the 5 per cent rise in £M3 over the past three months is encouraging.

iii. Depending on these influences on confidence, there might at one extreme be little effect on short term interest rates, and a fall in longer term rates; or at the other, if expectations and the exchange rate were adversely affected, a rise in short rates and possibly in longer rates as well.

iv. How long-lasting the effect in i. above would be would depend on the behaviour of bank lending and external flows. An important factor would be how the institutions used the cashflow which would otherwise have gone into gilts. Their choice would lie between holding more bank deposits and investing in overseas assets, property or company securities. The last of these could lead to a helpful switch of company financing away from the banks.

8. The relationships in the Treasury and most other macro-economic models imply that faster £M3 growth brought about by lower funding rather than lower short term interest rates does not increase inflation. It would be unwise to put much weight on this. Nonetheless, it is not implausible that changes in £M3 growth brought about in one way should have different effects from those brought about in another.

9. The key question in practice is what would be the impact of a further £M3 overshoot on market confidence and inflationary expectations. A sharp adverse effect would bring a rise in short term interest rates which it would be counter-productive to resist. It could also bring about a rise in longer rates too - more than offsetting the effect of lower gilts sales. The Bank attach more weight to the risks than do the Treasury. Much would depend on our own presentation. And it should not be forgotten that the alternative is a continuation of overfunding, which is beginning to call into question the credibility of policy.

10. It is clear that the effect on confidence would depend on the conditions prevailing when the policy change became known and on how we were expected to respond to developments. We could watch the market reaction carefully. If we thought that inflationary expectations were rising, we would need to raise short term interest rates. We would not expect this to bring £M3 growth back within its range. But it should raise the exchange rate, probably reduce MO growth, and so keep monetary conditions tight as measured by the balance of indicators. In this way we could keep inflationary expectations down and maintain pressure for a fall in the underlying rate of inflation.

Bill mountain and definitions of overfunding

11. Stopping overfunding would not of itself reduce the size of the bill mountain, and would not even necessarily prevent further growth, although it would clearly reduce its rate of

growth. (The effect would partly depend on the precise definition of overfunding adopted; there are several possibilities, discussed in the Annex.)

12. So we would be left with a stock of money market assistance of at least around £17 billion. It would thus remain desirable to seek ways of tackling some of the operational problems this has created by reducing the size of the bill portfolio.

A revised approach to funding

13. In practical terms a possible way ahead would be:-

14. First, we should for the rest of 1985-86 exercise restraint in selling gilts, aiming not to overfund over the year as a whole at least on the narrowest definition (see Annex).

15. Second, this would mean accepting a growth of £M3, at least initially, faster than it would have been had overfunding continued. The aim would be to keep policy tight as measured by the balance of indicators, including M0 and the exchange rate. Short term interest rates would remain relatively high. Our actions and words would need to convince the markets that, despite the £M3 overshoot, policy was tight and was intended to remain so.

16. Third, before next year's Budget we should consider whether to raise the £M3 target for future years, to allow for changes in velocity, or whether to abandon targetting it altogether, announcing instead that we would take it into account along with other indicators. In the light of that we should also consider whether to set out a more specific target for funding policy, and if so which definition to adopt.

17. Fourth, whatever other steps are taken we also need to consider technical measures for reducing the size of the Bank's bill portfolio. These include:

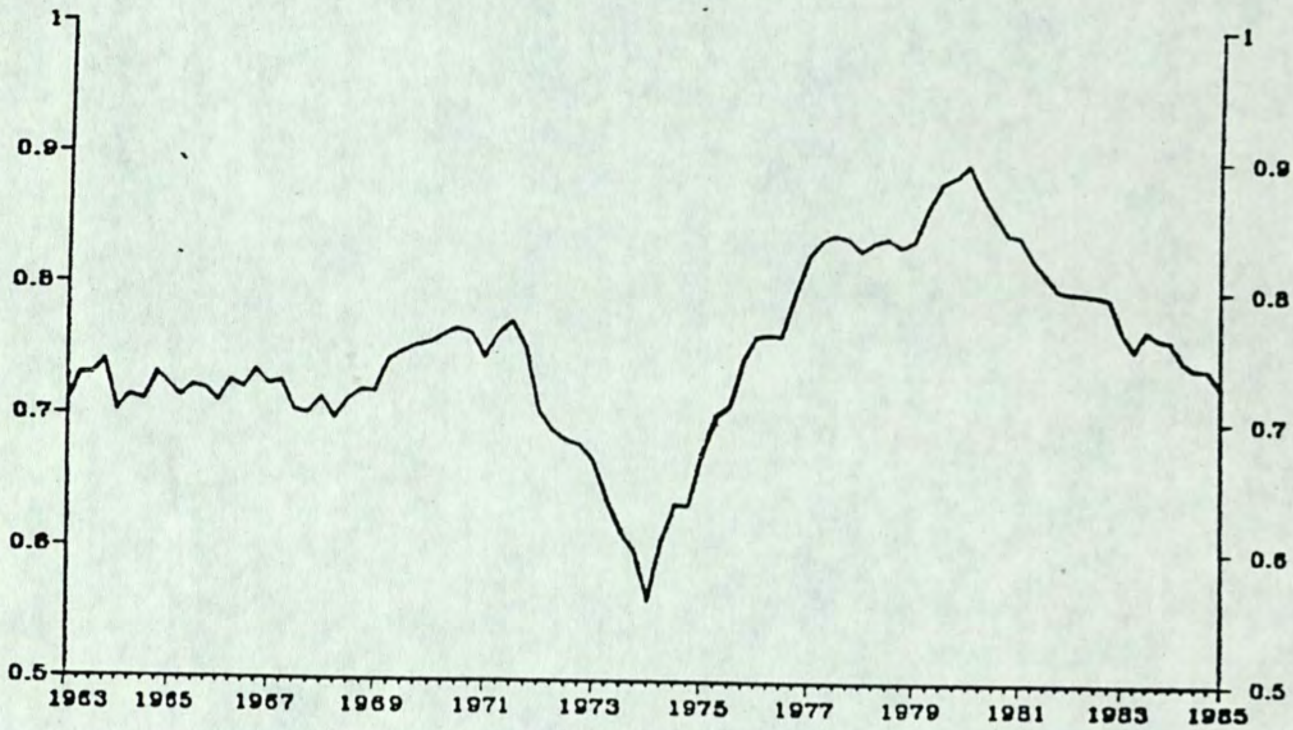
i. The package we are nearly ready to announce to encourage nationalised industries and local authorities to raise more of their finance from the NLF and less from the banks. This will reduce the need for money market assistance for a given level of gilts sales.

ii. Measures to shift a greater proportion of the outstanding stock of money market assistance into forms easier to manage than bill holdings which turn over every 4-6 weeks. Two possibilities are buying export credit paper from the banks, and placing deposits with the banks; neither, however, is without its own difficulties.

18. This whole approach depends for its success on the Government's policy stance being perceived to be sufficiently tight to keep downward pressure on inflation. This will above all require a strong exchange rate, which has implications for the level of short-term interest rates.

July 1985

VELOCITY OF £M3



The chart shows the ratio of money GDP (by calendar quarter) to the stock of £M3. Velocity measures the rate at which the money stock turns over. A fall in velocity, as in 1971-74 or 1980-85, means that £M3 is rising faster than money GDP.

ANNEX

Definition of overfunding

If the object is to eliminate overfunding altogether, we will have to decide which definition to use. The main possibilities are:-

(i) The "conventional" definition. That is to fund the PSBR with sales of public sector debt in the UK other than to banks.

(ii) The "wider" definition, illustrated in paragraph 1 of the paper. That would imply funding the PSBR by raising finance outside the banking system and from external flows.

(iii) A definition focussed on the growth of the monetary base. This would imply funding the PSBR in any way that did not involve an addition to the growth of MO greater than that allowed for in the target set for it. But it would allow additional gilt sales to offset the monetary effects of any local authority or nationalised industry borrowing from the banks.

(iv) A definition focussed on the level of money market assistance (MMA), ie. a level of funding that would not add to the stock of MMA. The difference between this and (iii) - assuming MO growth is on target - is that there would be no attempt to offset nationalised industry and local authority borrowing from the banks by additional gilts sales.

On the narrowest definition (i) we would have had no overfunding last year with £2.3bn lower sales of gilts. But the bill mountain would still have risen by £3.3bn. To have achieved no growth in MMA (definition (iv)) would have required debt sales £5.6bn less than we actually achieved. The table attached shows the degree of overfunding on each definition in 1984-85, and the relationship between them.

At present the prospects for this year and next look not dissimilar to the 1984-85 pattern. To remain in sight of meeting the £M3 target we may need to contemplate overfunding and a growth in the bill mountain similar to last year. So in relation to this prospect, a decision to end overfunding would represent a large step even on the narrowest definition: and we would not achieve the aim of preventing further growth in the bill mountain - let alone reduce its size - without going a good deal further than that.

Table: Different definitions of overfunding in 1984/85

£bn

		Excess debt sales
PSBR	10.6	
- Debt sales to UK non-bank private sector	- 12.9	
(i) Conventional definition of of overfunding	- 2.3	2.3
- external finance of the public sector	- 2.2	
(ii) Wider definition of overfunding	- 4.4	4.4
- debt sales to banks and other sectors	0.6	
- allowance for target MO growth	- 0.7	
(iii) "Monetary base" definition	- 4.5	4.5
- local authority and nationalised industry contribution to above	- 1.5	
other finance	0.5	
(iv) Increase in money market assistance	- 5.6	5.6

10 DOWNING STREET

Prime Minister ②

Although you saw John Redwood's minute, it is not clear whether you saw Sir Walters memo which was attached.

AT
5/7

Rh

FROM: J W GRICE

DATE: 5 July 1985

CSR 5/7

1. MR RILEY
2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr Bailey
Mr Anson
Mr Cassell
Mr Monck
Mr Wicks
Mr H P Evans
Mr Lankester
Mr Odling-Smee
Mr Culpin
Mr S Davies
Miss Peirson
Mr Riley
Mr Salveson
(+1 for No.10)
Mr Page
Mr Allum
Mr Hannah
Mr Vernon
Mr Pickering
Mr Davies
Mr Cropper
Mr Lord

SIMON AND COATES: JULY ECONOMICS ANALYST

Simon and Coates' latest bulletin contains an article - which could attract media comment - on public spending, tax cuts and privatisation.

2. It argues that the scope for further tax cuts in 1986-87 and later years may now be small. It also moralises about the dangers of using public asset sales to finance tax reductions. The attached note appraises their arguments and suggests a line to take.

J. W. Grice

J W GRICE

SIMON AND COATES: JULY ECONOMICS ANALYST

The above publication is due for release at 00.01 am on Monday 8 July. It contains an article on public expenditure, tax cuts and the privatisation programme.

Summary of the Simon and Coates Argument

1. In the current financial year, about £3-3½ billion of the £5 billion Reserve has already been earmarked. An emergency package of spending cuts will not prove necessary.

2. In 1986-87:

a) the public expenditure planning total will overrun by £2½ billion compared to the 1985 FSBR figure;

b) tax revenues will be £2 billion below target (mainly because of lower North Sea revenues);

c) this £4½ billion shortfall could well be offset by:

- Reserve reduced from £6 billion to £4½ billion:	£1½ billion
- Asset sales increased from £2 billion to £3 billion:	£1 billion
- PSBR raised from £7½ billion to £8½ billion:	£1 billion
- Tax cuts reduced from £3½ billion to £2½ billion:	£1 billion
	£4½ billion

3. Similar pressures on the latitude for tax cuts in later years make for temptation to expand the privatisation programme. Some have argued that this could be stepped up virtually without limit to safeguard the tax cuts. But this would be dangerous:

(i) annual asset sales of £4 billion - double those outlined in the FSBR - would imply institutions using a third of their cash-flow for purchase of new equities. This seems a high proportion and recent experience shows the difficulties of selling equities on a falling market;

(ii) unless the PSBR is reduced by the full extent of asset sales - so that debt interest is saved equal to the lost profits of the privatised assets - the public sector's long term financial position is weakened. Thus funding tax cuts by increased asset sales is dangerous "unless, of course, the present government is willing to put short-term political expediency above the long-term financial health of the public sector."

Appraisal

4. As the last quotation makes clear, this is yet another contribution from Simon and Coates motivated as much from political preconception as from a desire to inform the public debate.

5. With respect to 1985-86, the June Internal Forecast suggests that the Reserve will be underspent by a small amount. This would not be significantly at variance with Simon and Coates' assessment.

6. But in 1986-87, our forecast would suggest that Simon and Coates are too pessimistic. They appear not to have taken into account adequately the effect of higher expected prices and earnings in boosting on-shore revenues - though this presumably underlies their projection of increased public spending. Thus even if North Sea revenues prove less buoyant than those assumed in the FSBR there is no reason to suppose - with asset sales unchanged - that the scope for fiscal adjustment is significantly different from that outlined in the FSBR.

7. We would accept that using asset sales to finance tax cuts runs the risk of weakening the public sector's financial position, because the public sector foregoes the returns from the assets sold. Indeed, this is one reason for taking into account the level of asset sales in setting the PSBR - and since the 1984 MTFS we have made it clear that we do this. But we have also made it clear that the main purpose of asset sales is microeconomic: to increase competition, widen ownership and so on. Thus a privatised asset may be worth more in private sector hands than in

the public sector and contribute more to the economy's productive capacity. Setting the PSBR and deciding the scope for tax cuts takes these factors into consideration as well, alongside other relevant factors.

8. We would also accept that, in principle, too rapid a rate of asset sales could result in indigestion in the equity market. Very heavy offerings of public assets could force up equity yields making the price unattractively low. But, far from suggesting that this is a tight constraint in current circumstances, Simon and Coate' own calculations suggest that the market leeway for increased asset sales is consideraable. On their figures, double the level of asset sales projected in the FSBR would require institutions to use about a third of their new money to buy equities. But the institutions' present portfolio preference is to hold more than half their funds in the UK equities. Thus even higher sales of public assets than this would not be likely to meet with any great resistance from the institutions.

Line to Take

1. Agree that public expenditure in the current year is under control and that the PSBR is on course.

2. Reject suggestion that higher special asset sales will be needed in later years to maintain the fiscal adjustment outlined in the FSBR, though clearly great uncertainty at this stage. No reason to suppose substantial tax reductions will not still be possible provided government maintains its firm control of public spending. Wrong to concentrate on North Sea revenues and ignore other developments.

3. Reaffirm purpose of special asset sales as major element in government strategy to increase efficiency, improve incentives and widen ownership.

4. Note that their level is taken into account in setting the PSBR target path.

PRIME MINISTER (4) 4 July 1985

AT 5/7

I met today Mr Adams, who is an expert on the relationship between tax rates, the growth in wealth and activity, and tax revenues collected.

He says he sent you a large number of proposals in 1977, and he has now brought these up-to-date for me.

His main argument is simple. The best marginal rate of tax throughout the higher income spectrum is 40%. At this level, people go out to earn more; they declare more income; you collect more tax in; and the economy grows faster. He bases his argument on study of a range of nations, including the US, Japan and European countries over a long time period. He sees recent high marginal tax rates in the Western European countries as unusual and particularly damaging.

I explained to him that you had done a great deal which required political courage since 1979 to lower the marginal rate of tax on higher earnings. Any further reduction would lead to accusations of helping the rich at a time when there was a large number of people without work and on quite low earnings. But he wished his view to be strongly represented to you, and he has done a great deal of work to research its truth.

MT

JOHN REDWOOD

cc MASTER SET.

RECORD OF MEETING BETWEEN THE PRIME MINISTER AND DR. LEUTWILER ON THURSDAY 4 JULY 1985 AT 10 DOWNING STREET

The Prime Minister said she was concerned about the development of monetary policy in Britain. The broad aggregates were growing very rapidly despite the fact that there was heavy overfunding which, in turn, was leading to a bill mountain. She believed banks would continue to expand their lending so long as they thought the Bank would continue to provide the liquidity required. She also suspected that standards of capital adequacy had been allowed to decline.

Dr. Leutwiler argued that central banks could not control the money supply if the commercial banks had free access to liquidity - what he described as "self-service". The Swiss Central Bank ensured that it provided liquidity only at its own discretion. He recognised that this would, on occasions, cause short term interest rates to rise but he believed this would affect only the very short term rates for a limited period. In the longer term such a policy would lead to lower interest rates.

Dr. Leutwiler said it was not easy to see exactly what the priorities of the Government and the Bank were. Were they to control interest rates, monetary growth or the exchange rate? The Prime Minister said the Government's objective was to bring down inflation which, after correcting for the distortions caused by mortgage interest rates, had been on a plateau of 5% for about two years. The Prime Minister said she favoured a strong exchange rate which would put companies under some pressure to become more competitive and would limit the extent to which they would pass on costs in higher prices. She was happy to contemplate a further rise in the exchange rate to say \$1.40. She had been extremely concerned at the relaxed attitude some people had taken when sterling had fallen towards parity.

Concluding the discussion, the Prime Minister thanked Dr. Leutwiler for his advice and said she was always happy to hear from him. The conclusion she drew was that the Government should be prepared to allow short term interest rates to rise if monetary conditions were to be brought under control.

AT

(Andrew Turnbull)

4 July 1985

PRIME MINISTER

VISIT OF DR. LEUTWILER

I MONETARY POLICY IN THE UK

You will want to ask Dr. Leutwiler for his observations on the conduct of monetary policy in the UK.

- Does he have any feel for whether monetary conditions have been or, perhaps, still are too lax?

- What view does he take of the very rapid growth of the broad aggregates and bank lending, combined with slow growth of the narrow aggregates?

- Does he have any comments to make on the way money market operations are conducted here? (You should beware of analogies based on the Swiss model. Switzerland has virtually no domestic money market, in part because Government borrowing has been negligible over the years. The Central Bank conducts its operations by foreign exchange swops rather than by purchases and sales of bills.

II INTERNATIONAL DEBT

Dr. Leutwiler is known to be concerned about the slow progress some countries are making to improve their debt position. He mistrusts the short-term expedients which have been used in the case of Argentina and supports the UK in having no part in them. You could ask him what he thinks governments of the industrial countries should now be doing.

III THE US FISCAL AND MONETARY POLICY

Although short-term rates have come down substantially - three month Euro dollar rates are now $7^{3}/_{4}$% - long term rates remain high - a 20 year bond is about $10\frac{1}{2}$%. This reflects continuing concern about the size of the US budget deficit. The two Houses have produced different budget amendments and when Congress resumes after the 4 July break the budget will go into the conference procedure. Each House has put forward deficit reduction measures of about $50 billion though the composition varies, with different emphasis on military savings and cuts in social security. Many observers are concerned, however, that these reductions will do no more than offset the effects of slower growth of the economy. The deficit could thus remain over $200 billion.

AT

(Andrew Turnbull)

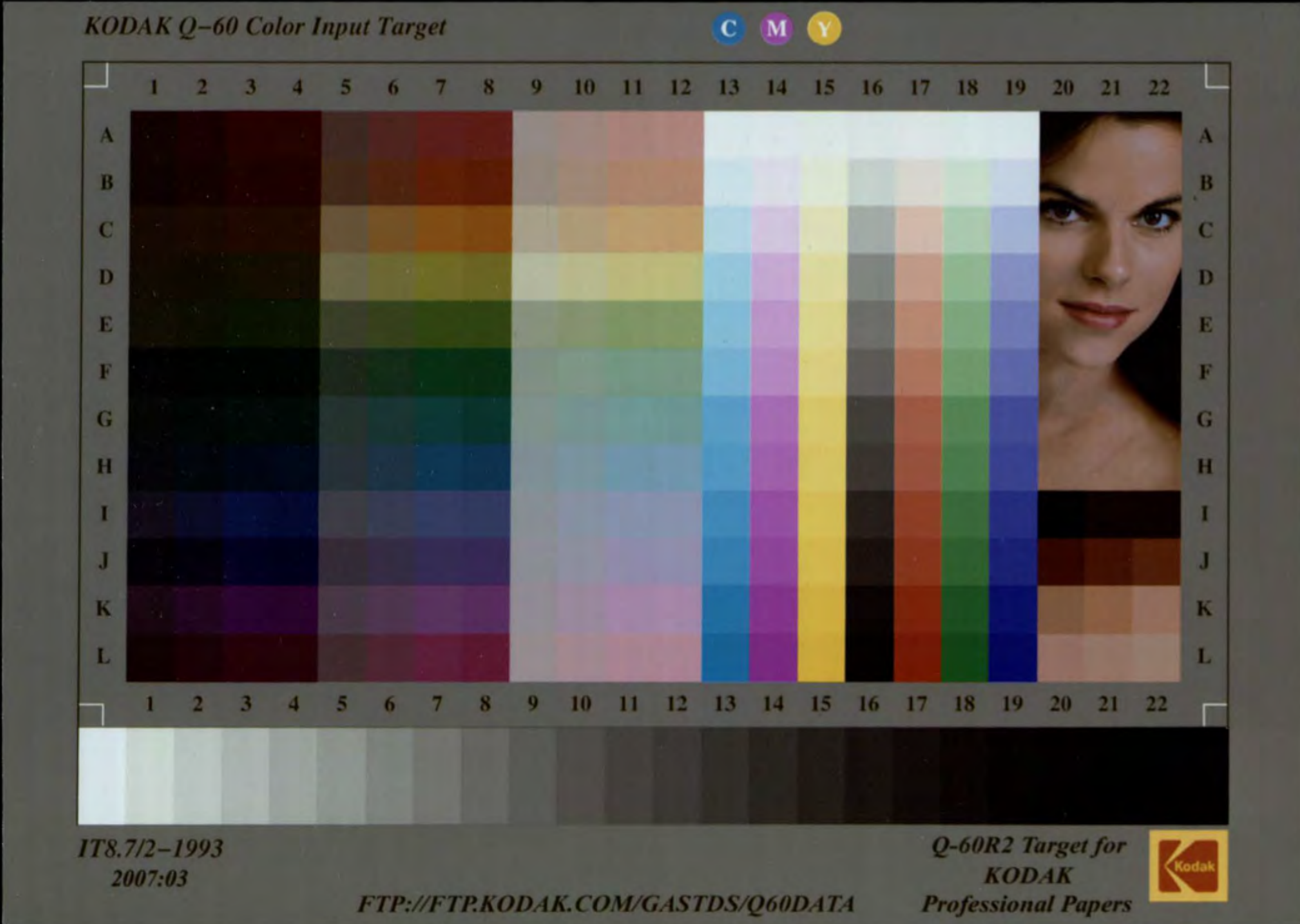
3 July 1985

PART ~~14~~ 13 ends:-

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

PART 14 begins:-

AT to PM 3/7/85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