1116
(F86)

CONFIDENTIAL

1. Mr F[illegible] 31/8
To be aware
2. cc.

H M Treasury
Parliament Street London SW1P 3AG
Switchboard 01-233 3000
Direct Dialling 01-233 4178

P E Middleton
Under Secretary

30 August 1979

JWL 31/8

J B Page Esq
Chief Cashier
Bank of England
Threadneedle Street
LONDON EC2

Dear John

Exchange Controls and Offshore Banking

I think it is agreed that there would be no dramatic consequences for the UK money supply from a further relaxation of exchange controls, even if this went so far as complete abolition. There is however one problem which we need to examine carefully to ensure that we are not setting up forces which we might subsequently regret. That is the possibility of stimulating offshore banking.

The main problem is likely to arise if one considers a complete relaxation of exchange controls in conjunction with the application of supply side controls to limit the growth of the money stock, either by a continued use of the corset or perhaps by moving to new methods of control. We have prepared the attached short note which might serve to focus discussion. I find it difficult to to decide whether there is a problem of any significance or not. In some ways it is rather surprising that banks have not already tried to shift their non-resident deposits and lending offshore in order to ease their position under the corset. Perhaps few banks have a suitable combination of assets and liabilities even though the banking system as a whole seems to have.

The key issues seem to be the following:

a. How much of a risk is there that a complete abolition of exchange controls would result in a significant increase in offshore banking?

b. Might this pose a threat to our monetary or prudential controls?

c. Whether or not there is a problem, is this a development which we would want to risk encouraging given the apprehensions about offshore banking which we have seen from the German and United States monetary authorities?

d. Would it justify retaining exchange controls to prevent UK residents borrowing sterling bank deposits overseas? The note does not consider the point, on which you might also have views, that this might fit oddly with our general position on euromarkets.

We should be grateful for your views. I am copying this letter to Payton and Dawkins.

Yours ever

Peter Middleton.

P E MIDDLETON

Enc

EXCHANGE CONTROL RELAXATIONS AND MONETARY CONTROL

1. This note considers what the implications might be for monetary control if all the remaining exchange controls were lifted.

2. The UK authorities have not found it possible to attempt to control the money supply without resorting from time to time to the use of direct controls. Direct monetary controls in effect operate by taxing the domestic banking system. Banks are required to hold certain assets which, given free portfolio allocation, they might not otherwise wish to hold. In the United States and Germany these assets include substantial non-interest bearing reserve requirements. In the United Kingdom they include the $12\frac{1}{2}\%$ reserve asset requirement which is currently under consideration and supplementary special deposits. Moving banking business offshore is a means of avoiding these restrictions and avoiding the costs they impose. Offshore business can build up very rapidly as is illustrated by the experiences of the United States and Germany. Up until now UK exchange controls have prevented any similar moves by the UK banking system.

only some ?

Sterling Deposits Overseas

3. The main problems stem from a relaxation of the present rules preventing UK residents from holding sterling bank deposits outside the UK. If residents were allowed to hold sterling accounts overseas it would be very easy, for instance, for a bank which was experiencing difficulties with the corset to persuade some of its customers to switch their deposits to an overseas branch. The branch could then lend the money to customers in the UK.

bank c'd also borrow from non-res & lend to res (as it can now)

4. This is another way of intermediating funds outside the UK banking system, comparable for instance to the commercial bill leak. But it is a particularly simple one to carry out. All that is needed is a brass plate branch in an offshore centre with the books and records kept at the London head office. A customer is told that his deposit is with Barclay's (Cayman Islands) but so far as he is concerned it is little different in terms of ease and convenience to a deposit with Barclays London. US banks have been operating these sorts of transactions with their branches in the Bahamas very successfully - in their case to avoid the non interest bearing reserve requirements on domestic deposits.

5. The pressure for banks to switch some of their business offshore could come whenever the corset became effective. Even if the corset were not in place there might still be some switch to offshore business as a result of the other requirements placed on UK banks. But the pressure on this score is not likely to be very great. More important, if it is decided to move in the direction of supply side control such as monetary base then there would again be pressure to switch business offshore so that the supply of base money could be spread wider.

Monetary Statistics

6. Switching deposits offshore would of course add to the distortions in the series for £M3 - and for some other monetary aggregates (though probably not the non interest bearing part of M1). This would make the focus of monetary policy less sharp. While it would in principle be possible to define new aggregates which did include UK residents' offshore sterling deposits, the problems of collecting the necessary statistics would not be easy to overcome.

Prudential Control

7. An increase in offshore deposits would not necessarily create a problem for prudential control. UK supervision is now being based on a consolidation of a bank's worldwide activities through its branches and subsidiaries overseas. There is little difference in the potential exposure of a UK bank between borrowing from a customer and lending to ICI via its London office or via its Cayman Islands branch or its Luxembourg subsidiary. We should probably not face the same problems as those faced by the Germans, where their prudential control does not extend properly to business carried on by German banks' subsidiaries in Luxembourg. But there could be problems over getting the relevant information about offshore business as easily and as quickly as for domestic business.

Possible Adjustments to Monetary Control

8. If exchange control was abolished we might consider one or more of the following in order to prevent offshore business expanding:

a. rely more than at present on discretionary changes in interest rates to influence monetary growth. Even on the most optimistic assessments about success in containing the PSBR, it is difficult to believe that we shall be able to manage without some corset type of control.

b. abandon further work on developing supply side controls such as monetary base. This seems neither practicable nor desirable.

c. tax offshore business in some way. If it is a tax on the domestic system which is driving business offshore we could try to tax offshore business as it touched UK shores. This might involve levying a higher rate of tax in interest earned on sterling deposits overseas or disallowing interest on sterling borrowed from overseas as an expense against UK taxes. Both would probably involve legislation and raise practical problems.

d. extend the UK direct controls. It does not seem very likely that we could include a bank's worldwide sterling liabilities towards the corset or any other supply side control.

Are Any Other Exchange Controls Relevant?

9. Any relaxation of the exchange controls on banks' foreign currency positions should not affect domestic monetary control: a net "switched in" position in sterling is already counted towards eligible liabilities. If controls on UK residents' foreign currency deposits and loans and on forward deals were lifted then it would in principle be possible for banks to dress up sterling intermediation as foreign currency intermediation: a bank could agree with its customers that what was really a sterling deposit or loan was nominally a foreign currency one with an agreed exchange rate for conversion. But unless the penalties on increased sterling intermediation were very large it seems unlikely that this would be a loophole that would be exploited significantly - it introduces added complication and inconvenience. This seems true also of various other loopholes which could emerge - complete freedom for UK residents to borrow sterling from overseas could, for instance, encourage banks to persuade non-residents to switch their deposits to overseas branches or to offset forward demand for sterling by switching into sterling at their branches overseas rather than at their London offices.

Conclusion

10. [To be drafted after discussion with the Bank on the significance and magnitude of the problem.]