ALC's new paragraph attached

SECRET

GE 1/16A

18.6.80.

MR GOODHART (B/ENG)

cc Mr Bridgeman
Mr Britton
Mr Lavelle
Mrs Lomax
Mr Peretz
Mr Bell
Mr Shields
Mr Williams

Mr Coleby)
Mr George)
Mr Sangster) B/Eng.
Mr Townend)
Mr Latter)

INTERVENTION AND THE MONEY SUPPLY IN MAY

As I explained yesterday the Financial Secretary has asked for a note on the way in which the Bank chose to relieve pressure in the money markets in banking May and the effect this had on the money supply. I attach a draft and would appreciate your comments and those of copy recipients. I think it would also be sensible to have a concluding paragraph on the relative merits of different forms of relief, and the factors governing which method is chosen on particular occasions. In view of my ignorance of the issues involved could I ask Mr Coleby to supply a paragraph.

2. I would like to get the note up to the Financial Secretary by Thursday night if possible, so could I please have comments and contributions by lunch on Thursday.

B C Arnold

pp C J RILEY
18 June 1980

SECRET

ALC 18/6

DRAFT MINUTE TO FINANCIAL SECRETARY

INTERVENTION AND THE MONEY SUPPLY IN MAY

In his minute of 11 June Mr Peretz discussed the Bank's use of forward currency swaps over the May make-up day as a means of relieving liquidity pressures in the domestic money market, and Mr Locke's minute of 12 June recorded your view that it is clearly undesirable to relieve money market pressure in a way that increases monetary growth. This note discusses in a little more detail the monetary impact of the market relief given on this occasion.

2. The Bank has a number of means of relieving money market pressures at its disposal. These include, in addition to Special Deposits, gilt sale and repurchase agreements with the clearers, forward foreign currency swaps over make-up day, and buying in commercial bills temporarily from the banks. In May the total amount of relief given was about £[ ] billion. The Special Deposit recall schedule for 14 May was cancelled, and both the outstanding gilt sale and repurchase agreements were rolled forward into banking June. But on this occasion there was also a switch in the form of part of the relief given: the Issue Department ran down its holdings of commercial bills by about £600 million and replaced them by forward currency swaps amounting to about £550 million.

3. The Bank have made use of currency swaps for this purpose in the past, and as far as one can tell this has not produced substantial effects on the money supply or the external and foreign currency adjustment. The counterparty to the swaps has appeared generally to be the banks, who have switched into sterling, thus offsetting the impact of the temporary increase in reserves and leaving the external adjustment and the money supply unchanged. On this occasion, however, the banks actually switched out of sterling by over £150 million, and the external adjustment for the month, even after allowing for the fall which occurred in sterling lending overseas, was positive for the first time since December and only the second time in fourteen months.

4. The positive external could in principle have resulted from the Bank overdoing the amount of relief they gave to the market, thus enabling the banks to pass on some of the swaps to the non-bank private sector. But it may instead have reflected an improvement in the current account of the balance of payments, an interpretation supported by the May trade figures, or inflows into the company sector in response to mounting pressure on company liquidity.

5. Whether or not the way the Bank chose to give relief to the market on this occasion added to the money supply is difficult to judge. Insofar as too much or too little

relief was given in total there probably would have been effects on the recorded money supply, but it seems quite likely that the switch in the form of relief had the effect of making the external adjustment more positive while at the same time reducing DCE. There is some evidence of this from the weekly figures, and from the behaviour of the commercial bill leak.

6. The large sales of commercial bills by the Issue Department could well have been responsible in large measure for the £300 million increase in the bill leak which occurred during banking May, as yields on commercial bills were forced up relative to yields on other short term paper. But whereas one normally thinks of the non-bank private sector being induced to take up the bills, there is some anecdotal evidence that many of the bills were taken up by overseas residents, and this may be part of the explanation for the positive external adjustment. Thus the change in the form of relief may simply have led to a reduction in bank lending via the bill leak and an offsetting increase in the external adjustment, with little effect on the recorded money supply. Insofar as overseas residents took up less than all the additional £300 million of leaked bills the recorded money supply would actually have been reduced, but insofar as the swaps were passed on to the non-bank private sector the reverse would have been the case. Given the paucity of information on overseas holdings of commercial bills we are unlikely to

be able to throw much more light on what happened, but there is no strong reason for thinking that the monetary effect went either way."

[Concluding paragraph on relative merits of different forms of relief, and their relative monetary effects.]