

*Amended*



*This is in response  
to your concern about  
the swap operation  
last week.*

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

*and*

*12*

*9/12*

PRIME MINISTER

I understand you are concerned about the scale of assistance given by the Bank of England to the money markets last week in the form of forward foreign currency swaps, which will have the effect of avoiding problems in the money markets over the banking December make-up day on 10 December.

2. These operations are designed to relieve pressures in the money markets which would otherwise lead to upward pressure on both short term interest rates and the exchange rate. I believe that neither of these is desirable in current circumstances and as you know the Bank, with my approval, has in recent months been providing assistance to the markets on a substantial scale.

3. Much of the assistance this year has been in the form of purely domestic operations, as you know from our exchanges about gilt sale and repurchase agreements, and relatively little in the form of foreign currency swaps. All the methods of giving assistance have the effect of providing the banks with additional reserve assets to enable them to meet their required ratio, and we think that there is little difference in their monetary impact. In practice

/it is likely that





it is likely that failure to provide assistance would actually add to the money supply in the short run rather than reduce it. This is partly because banks would have to bid for funds in the market if the authorities were unwilling to lend, and partly because a sharp rise in short term interest rates would enable operators in the markets to draw on unused overdraft facilities and reinvest the proceeds in the money markets. So I believe that our policy of providing assistance is quite consistent with the need for monetary restraint.

4. All forms of market assistance by the Bank are undertaken on the basis of guidelines which I have laid down. Major tranches of assistance such as the gilt sale and repurchase facilities are subject to explicit approval in advance. The current procedure for foreign currency swaps is that the Bank inform the Treasury as such assistance is being given, but not in advance. Given the operating guidelines which the Bank works to, the precise amount of assistance in this form which is required in any given month is very much a matter of judgement which only those closely involved in the markets are in a position to make. I believe it would be impracticable to require advance notification in each case.

5. The need for market assistance is, of course, very much the result of the operation of the present reserve asset system. In order to avoid the hindrance to monetary control which it entails, we have agreed to phase out this system as soon as adequate prudential arrangements for the banks can be drawn up, and I hope this will be before the Budget.

G.H.

(G.H.)

8 December 1980