MRS GILMORE (10 copies)

cc Chancellor
Sir D Wass
Mr Middleton
Mr Monck
Mr Turnbull
Mr Lennon

Mr Coleby) Bank
Mr Foot)
Mr Quinn)

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NEW MONETARY CONTROL ARRANGEMENTS: BRIEFING

I attach a revised version of the briefing circulated yesterday, now agreed within the Treasury. The Bank are broadly content, though they have not had time for close textual scrutiny. You already have the Statement and Notes to Editors.

2. I also attach (not to all) a note from Mr Turnbull to Mr Monck on the implications for £M3 statistics of the announced changes, and the final version of the Bank paper.

Howard Davies

H J DAVIES
5 August 1981

MONETARY CONTROL: NEW ARRANGEMENTS

Positive

The principal objectives of the new arrangements are described in paragraph 5 of the statement. They represent the conclusion of work which began with the publication of the Green Paper on Monetary Control in March 1980. The broad outlines of the system were described in the Chancellor's statement accompanying his November 1980 package, and amplified in the Budget speech. Since then the Bank of England has been in negotiation with banks and other financial institutions about the detailed arrangements. These negotiations were concluded in July.

By removing the 'bias towards delay' in changing interest rates and allowing the market to play a greater role we hope to improve our ability to control growth in the monetary aggregates. Interest rates will be more responsive to changing market conditions and should therefore act more expeditiously to check swings in monetary growth than in the past.

The changes are beneficial and justified in their own right. No decision has been taken on Monetary Base Control but these changes would, as the Chancellor said in the Budget speech, be consistent with a gradual evolution to MBC.

RECENT INTEREST RATE DEVELOPMENTS

What has been happening to short-term rates?

It is not our practice to comment on day to day movements in interest rates. And that will still apply when the new system comes into full operation.

But it is clear that over the last few weeks short rates have firmed throughout the yield curve. The market has been reacting in large part to overseas developments - in US rates - the exchange rate - the outcome of the Ottawa summit. Rates at three months and longer moved up in response to uncertainty about these and other factors [If pressed] and the Bank dealt at the very short end so as to keep these rates more in line with the longer short term rates.]

The new system a smokescreen for a backdoor rise in interest rates?

No. Important to distinguish clearly between the new techniques, the independent effect on the market of factors such as high US interest rates. It is evident that there is pressure on UK interest rates generally. We have been gradually moving towards the new system in our market dealings so that market pressures have quite properly begun to have an impact on the Bank's dealing rates.

Have the authorities encouraged a rise in rates for exchange rate reasons?

The level of the exchange rate has been a factor influencing market sentiment, and is one of a range of factors we take into account in setting interest rates. But in our market dealings recently we have essentially been responding to market pressures.

Are you satisfied with the present position, with 7 day interbank rates above the bank's intervention levels? (About 13% over 12½%).

Clearly there are dangers if an interest rate structure like this persists (round-tripping). Though there has been little evidence of this so far. We shall need to watch market developments carefully in the coming weeks.

INTEREST RATE DETERMINATION IN THE FUTURE

<u>Is the Government giving up control of short-term interest rates</u>?

The purpose of the new arrangements is to give the market a greater role in signalling the course of interest rates. This necessarily means less influence for the Government particularly at the higher end of short maturities. Does not mean Government has relinquished all control. It will be aiming to keep very short term rates within a band and in some circumstances it will post a rate at which it is prepared to deal for a short period ahead. Ultimately the Government has to ensure that interest rates are at levels which are consistent with its monetary objectives.

<u>Is "giving the market a greater role" a genuine change</u>?

Yes. We are not saying 'the market will set interest rates'. But we do intend to allow market forces a greater role in influencing the Bank's behaviour. We believe that movements in the market rates we do not directly influence - further along the yield curve - can provide useful information for the authorities on the market's view of the course interest rates should take.

<u>What is the purpose of the band? How wide is it? Why is it undisclosed</u>?

The Bank will aim to keep interest rates at the very short end of the market within an undisclosed band which will be moved from time to time. For the Government to declare the limits to the band would be inconsistent with our objective of allowing the market a greater role for the same reasons as continuing to have a posted MLR would be. The band will be wide enough to accommodate fluctuations caused by changes in liquidity conditions in the market, and to allow the Bank some flexibility in its dealing operations.

<u>What are the factors determining the level of the band</u>?

The principal objective remains to meet the annual monetary target. This means, therefore, that recorded and forecast movements in £M3 are the prime factors. But we shall also take account of market conditions and of the range of indicators referred to by the Chancellor in his Budget speech.* The most important are:

- movements of other monetary aggregates, in particular, M1 and the wide monetary base.

- movements in the exchange rate and costs as indicators of underlying monetary and inflationary conditions.

<u>Market conditions</u>?
(See para 5 of statement.) Market conditions will be taken into account. But monetary targets are not set or achieved by the market alone and the authorities will not always follow the market.

<u>But what weights are attached to these different factors</u>?
It would not be sensible to try to ascribe percentage weights to different factors. Their relative importance will, in any case, change in differing circumstances. It is important to take account of all of them in making a rounded assessment of monetary conditions.

<u>Who will decide the band</u>?
As now the Bank of England with the agreement of the Chancellor.

*relevant sections attached.

[Sir Geoffrey Howe]

special circumstances of last year, the growth of sterling M3—the measure of money used to express the strategy—has been well outside the first year target range of 7-11 per cent. I said in November that I expected it to slow down in the new year. Recent figures, including the preliminary figures for banking February, published today, are fully consistent with that.

MONETARY GROWTH IN 1980-81

The first reason for rapid monetary growth over the year is the abolition of the so-called corset. That was long overdue. All that the corset achieved was to make the published figures artificially low, since its removal last summer those distortions have been reversed, and the figures have been artificially high. By their very nature, such distortions are impossible to measure accurately. They are likely to have been substantial. But purely statistical changes have no implications for future inflation. The distortions have now largely worked their way out of the system. In that respect, sterling M3 will from now on be a better measure.

Again, the growth of sterling M3 was increased last year by the special nature of the recession. Public borrowing increases in a recession, but that is normally offset by lower private sector borrowing. Over the past 12 months, public borrowing has been exceptionally high. But on this occasion bank lending did not fall away as quickly as might have been expected.

Because of the exceptional imbalance between business and personal incomes, both sectors, for different reasons, have borrowed heavily. Faced with an unexpectedly severe recession and the consequences of previous pay increases, businesses borrowed to tide them over while they reduced costs. Many people, on the other hand, have seen their living standards rise to an extent unusual in a recession, and have been willing and able to borrow as well. The combined effect of that borrowing has been an important expansionary influence on sterling M3.

At the same time, there has been a high level of private investment in financial assets. That can be seen as an attempt by the private sector to rebuild its holdings of such assets, whose purchasing power had been sharply eroded by inflation. It has included an increase in holdings of interest-bearing money. But to the extent that it merely involves returning towards a more normal level of financial assets it need not fuel inflation.

Other indicators also suggest that the underlying financial conditions have as the Government intended, been tight. Our Green Paper on monetary control, published a year ago, stressed the need to watch a range of measures of monetary conditions. Over the past 18 months, the narrower measures of money have not grown at all rapidly. The pound has certainly been higher than would be expected from the behaviour of the money supply. That external pressure has reinforced the monetary squeeze and contributed to the fall in inflation. And inflation has fallen so much relative to interest rates that the real cost of borrowing has risen significantly.

Financial behaviour should now revert to a more normal pattern. The private sector has been moderating its borrowing from the banks, and the exceptionally rapid build-up of personal sector liquidity should come to an end as the growth of prices and incomes continues to slow down.

THE MEDIUM-TERM STRATEGY AND THE TAR[...] 1981-82

It is important to express the medium-term [...] terms of a wide measure of money, because it [...] links with public spending and borrowing. [...] maintaining continuity by keeping sterling M[...] yardstick for medium-term policy. The aim re[...] reduce monetary growth to 4-8 per cent. by 198[...] new target range for next year, based on the act[...] for sterlingM3 in banking February, will be an a[...] of 6-10 per cent. over the 14 months to April [...]

The special factors at work last year are unli[...] repeated. In any event, they should have n[...] implications for future inflation. But we cannot [...] that they were the only causes of the rapid grow[...] money supply. So it may be desirable to recove[...] the past year's high monetary growth in the form[...] growth over the medium term. But the most i[...] requirement is a lower growth of the broad me[...] money in the years ahead.

However, the short-term response of sterli[...] interest rate changes is particularly uncertain an[...] effect can be spread over many months. The [...] measures, which we also monitor, include fewe[...] bearing types of money and are more sensitive to [...] in interest rates. But because they are so sensitive, [...] overstate the effect of interest rate changes on u[...] monetary conditions. Moreover, their relationshi[...] aspects of policy is less clear.

I am taking steps, therefore to improve the in[...] available about the narrower measures. Publi[...] figures for monetary base will begin later thi[...] Arrangements for a new statistical series for [...] deposits of the banking system, M2 are a[...] advanced. That will be publishted later this yea[...]

We shall continue to monitor M1. In doing so [...] take account of its normal tendency to grow q[...] nominal interest rates come down with inflation. [...] reason we may now find M1 growing rather fas[...] time, than it did last year.

PUBLIC SECTOR BORROWING

I turn next to the public sector borrowing require[...] PSBR. Some people, I know, are tempted to re[...] PSBR as something mystical, of interest [...] economists. How I wish that they were right. But [...] is not true. The size of public borrowing is, as it [...] a critically important constraint, for Governmen[...] different from individuals. The PSBR, in plain la[...] is broadly the difference between what the Gov[...] spends, or lends to others, and what they co[...] revenue, mainly through taxation. It necessarily [...] what the nationalised industries borrow. Most [...] comes from the Government and where they borr[...] other sources, the Government stands behind them [...] PSBR is the amount central and local Governmen[...] public corporations have to borrow. It is the expe[...] Governments around the world that if they try to [...] too much either interest rates or inflation, or bo[...] to soar.

Britain's experience tells the same story. If we [...] stay on course for lower inflation and lower intere[...] then we must borrow less. Public borrowi[...] proportion of national income must be brought do[...] is why the medium term financial strategy env[...]

SMOOTHING THE FLOW OF REVENUE

I am proposing some new measures which will help short-term monetary management by smoothing the uneven flow of tax revenue. The most important area is that of North Sea oil taxation, to which I shall come later. Other proposals will be described by my hon. and learned Friend the Minister of State later in this debate, if he is fortunate enough to catch your eye, Mr. Speaker.

MONETARY CONTROL

These initiatives will be accompanied by other improvements in monetary control. Following extensive consultations based on last year's Green Paper I outlined last November some changes that were desirable in their own right and would be consistent with a gradual evolution to monetary base control. These will come into effect during the coming financial year.

The reserve asset ratio has complicated monetary control. The first step in phasing it out was made in January. In the next month or two, at the conclusion of talks now to be undertaken with the banks, the ratio will cease to be a minimum requirement. Thereafter it will be adapted to have a transitional role as a prudential norm round which there will be variation, until the detail of the new arrangements has been settled.

The Bank of England has already made some useful changes in its money market operations. In its dealings with the discount houses it now relies mainly on buying and selling bills. Direct lending to the market has been greatly reduced. The interest rate on this lending is also now generally somewhat above comparable market rates, while the rates at which the Bank conducts its open market operations have become more flexible. In conducting its operations in bills the Bank no longer quotes rates for more than one month ahead. Instead, it responds to bids and offers. This has the great advantage of allowing the market a greater role in determining the structure of short-term interest rates.

Discussions are now to take place with the financial institutions about these and other changes, including the future of the cash ratio. When they are complete, the Bank will aim to keep very short-term interest rates within an unpublished band, and in due course suspend altogeher the practice of having an announced MLR, which would by then have lost its operational significance.

Decisions about short-term interests rates will continue to take account of the whole range of monetary indicators referred to earlier and other factors that affect the significance of the numbers, especially the progress of inflation. Modest reductions in interest rates were made in the second half of last year. Progress in reducing inflation, strongly positive real interest rates, a noticeable slackening in the growth of sterling M3 in recent months, and a marked fall-off in bank lending point towards a further reduction in rates. The increases in taxation that I am proposing in the Budget will make it possible to have an immediate reduction. Accordingly, the Bank of England is today, with my approval, reducing its minimum lending rate by two percentage points.

PUBLIC EXPENDITURE

Further progress towards lower inflation a interest rates does not depend primarily on imp in funding techniques or in managing the mone important though these are. The overriding n more effective restraint of public spending. In th public expenditure has put a severe strain on th Much of the increased spending has been caus effects of the recession being worse than expect has been an increase of £3¾ billion in spe unemployment benefit and on special em measures, notably the temporary short-time scheme. On many central Government prograr expected shortfall in expenditure has not happen the total has been higher than expected.

The recession has also—inevitably—had a effect on the financial situation of most na industries. It has meant an increase in the total industries' external financing limits for 1980-81 £900 million, over half of which has been for industry. Some of the nationalised industries taking steps to reduce the overmanning and in which have built up over the years. But that too more money initially.

These, however, have not been the only s upward pressure. On defence there has been s overspending—to the tune of £260 million— above a cash limit that had already been increased million. Local authorities' total cash spending a have been a good deal higher than allowed in Budget—and the position would have been mu without the firm action taken by my right hon. F Secretary of State for the Environment.

Because of all these developments we have able, in the course of 1980-81, to secure the full 5 cut at which we were aiming in our predecessors' volume of expenditure. We have nevertheless ac reduction of about 3½ per cent.—or £3½ billion. M since the Government came into office numbers e in the Civil Service have fallen by 35,000, an equivalent of about 40,000 full-time staff government.

THE COMING YEAR

In the coming year, some of the upward pres public sector spending are bound to remain with u in mind, for example, last November's decision more on industrial support and on special emp measures to ease the effects of recession. Next cost of special employment measures will be no £1 billion. This will make it possible to offe unemployed school leaver a place on the opportunites programme by Christmas. And we offer other 16 and 17-year-olds, unemployed f months, places within a further three months. 440,000 opportunities will be offered—twice as in 1979-80. In addition, the temporary short-time compensation scheme is currently supporting 700,000 people.

However, this need to spend more on programmes cannot justify accepting the wron balance. That is why we took the decisions announced last November to reduce most Government's other programmes by £1,400 millio Those substantial cuts will go a good deal of the

MINIMUM LENDING RATE

Why has MLR ceased to be posted?

It is an essential feature of the new arrangements that the Bank should not, as a matter of course, announce in advance the rates at which it will deal in the money market. By changing from a posted rate to an undisclosed band we shall allow the market a greater role in determining interest rates.

What does this mean to borrowers, whether companies or individuals?

The suspension of MLR will in itself have no effect. Banks will still set their base rates, and associated rates for all borrowers, in the same way as before e.g. in relation to their cost of funds. In essence the change is simply that the Bank will no longer announce in advance the rates at which it will deal in short-term money.

Does the suspension of MLR mean base rates will rise?

No. Nothing in what we announce on the structure of monetary control today carries any implications for the level of interest rates. But the banks and other financial institutions will need to make their own judgments to a greater extent than before.

Will interest rates be more volatile than in the past?

Possibly. We don't expect to see anything like the volatility seen in the US. Our system is ~~quite~~ different (see Q and A on US-UK differences). But it is likely that there will be more frequent moves in both directions. This is a good thing if it removes the bias for delay, and improves our ability to control monetary growth.

What kind of circumstances would require advance announcement of the minimum rate at which the Bank would deal?

There are a number of possible circumstances in which the Authorities might wish to announce in advance that rates are to be ~~moved~~ up or down. As part of a Budget or package of economic measures, for example. Or perhaps as a response to rapid movement in the exchange rate. It is clearly sensible to retain a backup power to signal dealing rates in advance.

Is MLR not used in legislation?

There are very few cases where legislative provisions depend exclusively on MLR. Where necessary amending orders will be brought forward in due course.

What about the use of MLR in contracts?

This is a matter for the contracting parties, who must reach agreement on an alternative reference rate. It may be that interbank rates provide the most appropriate benchmark. The Bank of England will of course be ready to help in any way they can by advising on the choice of suitable rates but will not be publishing any new alternative interest rate series for this purpose.

MONETARY BASE CONTROL

Has any decision been taken about Monetary Base Control?

No. There remain considerable uncertainties about the way in which an MBC system would operate in the UK and, indeed, what the advantages of such a system might be. The new system will allow us to learn more about MBC, though that is not the main objective of this change.

What do the new arrangements enable you to learn relevant to a decision on MBC?

The banks will now voluntarily be holding operational cash balances whereas in the past they were constrained by the cash ratio, and levels of bank balances did not necessarily reveal anything about the banks demand for base money. Over time, therefore, we shall now begin to build up a picture of the behaviour of the base and its relation to the other aggregates, and inflation.

Will the new system be like the US arrangements?

No. The difference is that the US authorities operate a quantity-based system. They estimate an amount of intervention (non borrowed reserves) consistent with their targets for growth in the monetary aggregates, and interest rates must then find their level consistent with the amount of intervention, within the limit of a range that is very wide.

THE BANK'S INCOME

Will the new arrangements allow the Bank to make an even larger profit as all deposit taking institutions and not just the clearers are required to hold non-interest-bearing deposits? (This year's gross profit figure was £47 million up from £19 million in 1980.)

The provisions set out in the Bank's paper on monetary control issued today have been designed to provide, initially, broadly the same amount of non-interest-bearing balances (operational and non-operational combined) as did the previous arrangements with the London clearing banks alone.

(Questions on the Bank's income should of course be referred to the Bank if possible.)

PRUDENTIAL CONSIDERATIONS

Does the abolition of the Reserve Asset Ratio weaken the Bank's prudential control?

No. The RAR was not intended primarily as an instrument of prudential control. Prudential supervision by the Bank under the Banking Act 1979 of all deposit-taking institutions will remain unaffected. The Bank will continue to ensure that all such institutions maintain adequate liquidity to meet their obligations. Those institutions to which the RAR applied have given the assurances mentioned in the Budget speech that they will discuss with the Bank in advance changes in their policies for the management of their liquidity and its composition.

A new prudential regime?

The Bank is resuming discussions with the banks on a new prudential régime, on the basis of a new paper on liquidity measurement.

OTHER ISSUES

<u>The Budget Speech referred to a new statistical series for the deposits of the banking system - M2. Is this going ahead?</u>

Yes. Agreement has been reached with the banks on the basis of the new series. Publication will begin later this year.

<u>What about the new short gilt</u>?

Work is continuing on the appropriate characteristics of a new short-term Government funding instrument. But no firm decision on its issue has yet been reached.

MR MONCK

NEW MONETARY SECTOR: IMPLICATIONS FOR £M3 TARGET

I have spoken to Mr Foot who has relayed the following from Mr Coleby.

(i) The provisions paper still contains the reference in para 22 "As soon as possible thereafter (probably in respect of make up day in banking November) currently reporting institutions will be asked to produce figures for one reporting date both on the basis used hitherto and on the basis of the enlarged list of institutions comprising the new monetary sector." Seventy institutions not on the list will join the reporting network. This cannot be retrieved - 4,000 copies have been printed and are ready for distribution (final version attached).

(ii) There is no reference in the Bank's Press Notice or Notes to Editors to the date of the transition and Bank briefing will be very low key and stress that no final commitment has been made.

(iii) To delay beyond November would cause an outcry.

(a) it would delay the date at which the new institutions begin paying the "tax".

(b) those paying would complain first about the inequity of this and secondly that the quantum on which their balances was being calculated was not correct, i.e. no allowance was being made for funds deposited with the new entrants.

The Bank very much hope the question can be put aside for today. They see no reason why it has to be settled right now.

p.p. A TURNBULL
5 August 1981

MONETARY CONTROL - PROVISIONS

Introduction

1 On 24 November 1980, the Bank published a Background Note describing a number of improvements to be made to the existing framework of monetary control. On 12 March this year, in a paper entitled "Monetary control: next steps", more detailed proposals on a number of the subjects covered in the Background Note were sent to all recognised banks and licensed deposit-takers (LDTs). The present paper sets out the provisions resulting from discussions since then with the various associations, as well as with a number of individual institutions.

The cash ratio

2 A substantial part of the Bank's resources and income in recent years has been provided by the average of 1 1/2% of Eligible Liabilities (ELs) maintained by the London clearing banks in non-interest-bearing accounts at the Bank. This sum has also served as a fulcrum for money market management. The Bank's paper in March proposed that this latter purpose should in future be served by the volume of operational funds which the London clearing banks would retain voluntarily at the Bank for clearing purposes, while the Bank's resources and income should additionally be secured primarily by a uniform requirement on all banks and LDTs to hold non-operational, non-interest-bearing deposits with the Bank. The provisions set out in this section have accordingly been designed to provide, in aggregate, broadly the same amount of non-interest-bearing funds initially as did the previous arrangements with the London clearing banks alone.

3 This non-operational requirement will be 1/2% of an institution's ELs and will apply to institutions covered in paragraph 16(i)-(iii) below having ELs which average £10 million or more in the latest period over which the requirement is calculated. The level of an institution's non-operational balance will be set twice a year in relation to its average ELs in the previous six months[1].

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[1] A deposit calculated in, say, May would relate to the monthly average of ELs from November to April inclusive.

4 For institutions not on the present statistical list of banks and whose business mainly comprises the provision of fixed rate finance for periods in excess of one year, the Bank accepts that the introduction of the 1/2% cash ratio may present a special transitional problem. The Bank will be prepared to consider individual representations from such institutions for some temporary alleviation of the requirement. In addition, in recognition of the special conditions in Northern Ireland, the Bank has reduced to 1/4% the cash ratio to be observed by institutions for which Northern Ireland is the principal place of business in the United Kingdom. This concession will apply in respect only of the ELs of their Northern Ireland offices and will run for two years, when it will be reviewed.

5 ELs are to be redefined to reflect the changes set out in this paper. In future, offsets will be allowed in the calculation of ELs in respect of:

(i) funds (other than cash ratio deposits or Special Deposits placed with the Bank) lent by one institution in the newly defined monetary sector [1] to any other;

(ii) money at call placed with money brokers and gilt-edged jobbers in the Stock Exchange, and secured on gilt-edged stocks, Treasury bills, local authority bills and eligible bank bills.

6 ELs will be calculated in uniform fashion for all reporting institutions[2] except:

(i) members of the London Discount Market Association (LDMA), whose ELs will be calculated as the total of sterling deposits other than from institutions within the monetary sector and from money-brokers and gilt-edged jobbers in the Stock Exchange.

(ii) certain banks with money trading departments, who will be allowed to omit from their ELs secured money at call placed by other banks with these departments, up to a limit set by the Bank.[3]

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[1] See paragraph 16 below.

[2] The present arrangements for those finance houses which have observed a 10% reserve asset ratio since 1971 will lapse accordingly.

[3] The banks concerned are: Algemene Bank Nederland, Banque Belge, Charterhouse Japhet, Leopold Joseph and Samuel Montagu. Hitherto, funds placed on this basis, up to a limit set by the Bank, have counted as reserve assets.

Undertakings by eligible banks

11 From 20 August 1981, each eligible bank undertakes to maintain secured money with members of the LDMA and/or secured call money with money brokers and gilt-edged jobbers[1] - all at market rates appropriate to the nature of the lending - such that:

(i) the total funds so held normally average 6% of that bank's ELs (as defined in paragraph 5);

(ii) the amount held in the form of secured money with members of the LDMA does not normally fall below 4% of ELs (as defined in paragraph 5) on any day.

12 In relation to the above undertaking, each eligible bank will

(i) aim to meet the daily average ratio over either six or twelve month periods (having first notified the Bank of its choice of period), the ratio on any particular day in a banking month being calculated as a proportion of ELs at the last but one make-up day.[2]

and

(ii) to provide monthly returns of its daily figures, which the Bank will use to assess the bank's performance relative to its long-term commitment.

A bank will go below the minimum only in exceptional circumstances and will be ready to explain such action to the Bank when the relevant monthly return is made.

13 The Bank will be prepared to review these undertakings, in consultation with eligible banks and the LDMA, when sufficient experience of the operation of the arrangements has been gained, covering at least a year. The Bank will also be prepared to discuss particular difficulties, as they arise, with any party to the arrangements.

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[1] The Bank's concern with the adequate availability of funds for the efficient functioning of the gilt-edged market was noted in "Monetary control: next steps". There are six recognised money-brokers - James Capel & Co, Cazenove & Co, Hoare Govett (Moneybroking) Limited, Laurie Milbank & Co, Rowe & Pitman Money Broking and Sheppards and Chase. Secured call money with these firms has hitherto counted as a reserve asset. The amount of such money which these firms can take will continue to be limited by the Bank.

[2] For example, the relevant ELs figure for each day in banking September will be those as at make-up day in banking July.

Prudential considerations

14 The Bank has received the assurances required in its paper of 12 March "The liquidity of banks", and mentioned in the Chancellor's Budget Speech, that those institutions in the United Kingdom to whom the reserve asset ratio has applied will discuss with the Bank, in advance, changes in their policies for the management of their liquidity and its composition. The Bank is resuming discussions with the banks on the measurement of liquidity as the basis for continuing supervision.

Statistical changes

15 The present banking sector, as defined for the purposes of calculating the monetary aggregates, contains those institutions included in the statistical list of banks and the list of discount market institutions. These lists were drawn up prior to the Banking Act and are no longer appropriate to current circumstances. They exclude a number of recognised banks, many LDTs, and also the trustee savings banks[1] (who will become subject to cash ratio and Special Deposit requirements when they are authorised under the Banking Act).

16 A new monetary sector will therefore be defined, to include

(i) all recognised banks and LDTs;

(ii) National Girobank;

(iii) those banks in the Channel Islands and the Isle of Man which opt to join the cash ratio scheme described earlier in this paper;

(iv) the trustee savings banks (TSBs);

(v) the Banking Department of the Bank.

17 Although the population of the monetary sector will be considerably larger than that of the "statistical list", the statistical effect will be comparatively modest since the present business of many of the new contributors is relatively small. In total, the

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[1] The Central Trustee Savings Bank (CTSB) is a recognised bank.

initial once-for-all adjustment to the stock of the main monetary aggregate, £M3, will probably be of the order of £8 billion (13%), of which the TSBs account for around £6 billion (9 1/2%).

18 Institutions in the monetary sector having either eligible liabilities totalling £10 million or more, or a balance sheet of £100 million or more, will be asked to supply the full range of statistics (comprising both the monthly and other returns); other institutions will be asked to report only at end-calendar quarters.[(1)]

The timetable for change and the transitional arrangements

19 The essential features of the new arrangements can be brought rapidly into effect. This section sets out the sequence of developments.

20 On 20 August 1981:

(i) the Reserve Asset Ratio will be abolished;

(ii) the acceptances of all banks in the first list (attached) of eligible banks will become eligible for discount at the Bank;

(iii) all the banks covered in (ii) above will begin to observe the undertakings set out in paragraph 11 above;

(iv) the agreement with the London clearing banks, whereby they keep an average of 1 1/2% of their ELs at the Bank, will lapse;

(v) the Bank will receive the first deposits under the cash ratio requirement.

21 On this date, the first cash deposits will be placed by institutions on the present statistical list of banks and by members of the LDMA; the statistics necessary to include other institutions are not yet available. These initial deposits will relate to the average of institutions' ELs on the monthly make-up days in the period January-June 1981 inclusive, ELs being defined on a transitional basis: ie calculated for 'statistical banks' as at present except that offsets will be allowed in respect of all lending to the discount market and all secured money

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(1) The TSBs will continue, for the time being, to make returns on the existing consolidated basis.

at call placed with money-brokers and gilt-edged jobbers and money-trading banks.[1] These initial deposits will remain unchanged until sufficient figures using the new definition of ELs are available (see paragraph 22 below). Thereafter, these deposits will be adjusted every six months. The undertakings by eligible banks as set out in paragraph 11 will take effect on 20 August 1981, based on the transitional definition of ELs and in respect of their level as at 15 July.

22 As soon as possible thereafter, (probably in respect of the make-up day in banking November) currently reporting institutions will be asked to produce figures for one reporting date both on the basis used hitherto and on the basis of the enlarged list of institutions comprising the new monetary sector. At the same time, those seventy or so institutions which are not currently on the statistical list of banks and which are above the cut-off points for full statistical reporting will join the full reporting network. They will be asked to place cash deposits with the Bank when two months' figures have been obtained, if their ELs are £10 million or more on average.

23 Monetary aggregates will be calculated on both bases for this one reporting date; thereafter statistics will only be collected on the basis of the new monetary sector.

24 The remaining institutions not currently reporting and below the cut-off points set out in paragraph 18 will be brought into the reporting network only when the current review of banking statistics has been completed (which is unlikely to be before the second half of 1982).

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(1) The Bank can calculate these offsets for listed banks from statistics already provided. The ELs of members of the LDMA will be calculated as set out in paragraph 6 above, except that no allowance will be possible in this transitional period for deposits by money-brokers and gilt-edged jobbers in the Stock Exchange.