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:

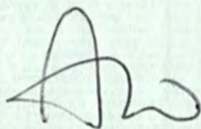
1. Ending overfunding - the Treasury (Paper I) cogently puts the points. In my judgment, an overt policy simply to "fund-the-borrowing-only" will generate confidence in the markets. They will know what to expect in terms of the quantity of funding.

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 <u>the use of penalty rates</u> as in Germany and the United States. We need to proceed slowly one step at a time, but there must be a <u>first</u> step, and we ought to confirm that we want to see one designed by the Treasury and Bank.



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15 July 1985

Andrew Turnbull Esq
10 Downing Street
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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.

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.