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Prime Minister ²

I asked Alan on his return this week to ensure he was contacted with the Treasury's

9 June 1989

planned technical changes to market management; you will be pleased to see that he is.

PRIME MINISTER

MONEY MARKET ASSISTANCE AND FUNDING POLICY

A. MONEY, BILLS AND RATES

1. Short term interest rates are controlled primarily by selling and buying bills - supplying money to, or draining money from the market on a daily basis. The money market participants must carry a stock of bills so that, when they are short of money, the Bank can buy them and inject cash into the system. Such money market assistance must also be considered as one element in the funding process.

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The money market
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2. As a consequence of our policy of over-funding up to 1985, the private sector purchases of gilts drained cash out of the system; we were induced to inject cash through buying bills in order to restrain interest rates. Thus we acquired a bill mountain of over £17 bn. From 1985, however, we ceased over-funding and adopted a full funding policy. The idea behind our 1985 policy of full funding was to ensure that public sector financial operations do not have any net effect on liquidity (M3 or M4).

3. This, inter alia, not only reduced the need for these injections of money; but, on balance, since 1985, we sold bills to drain money out of the market. The bill mountain has all but melted away.

B. POLICIES

4. To restore our ability to control short-term interest rates, the Treasury is likely to propose a two-pronged strategy:

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First, we should adjust the funding rule so as to maintain a marginal demand for cash. The market would then supply bills to the Bank, building up a modest bill hill, enabling us to control interest rates. A number of other helpful measures have also already been taken - such as lengthening bill maturities.

Secondly, the Treasury will develop a policy to deal with the Local Authorities subsidised borrowing from the PWLB. The subsidy has induced over-borrowing and the LAs have profited by depositing the money at the higher market rates. They have behaved like financial intermediaries and have increased the cash surpluses on the money markets.

5. Both policies seem to be appropriate. The first policy proposed is about the minimum we need to ensure control of interest rates. The funding change should not affect the term structure of interest rates to any significant extent. The second policy, aimed at reducing or eliminating the subsidised LA borrowing from the PWLB, is desirable in its own terms as well as in its effects on money market operations; but this will take time to explore and implement.

C. REJECTING MONETARY BASE CONTROL

6. In their work on funding rules, the Treasury also demonstrated that it would be possible to feed the money markets to produce a target monetary base (M0), leaving short-term interest rates to be determined entirely by market forces. But officials rejected such a rule on the grounds that ministers would never wish to relinquish their powers to control interest rates, even if the target M0 was under strict control.

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D. CONCLUSION

7. The Treasury's policies meet the needs of the day. I believe they should be supported. The rejection of MBC, if not the rationalization, is also appropriate - at least for the foreseeable future. Adopting Treasury's recommendation will result in minimum upset to the rather uneasy markets.

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ALAN WALTERS

cc Professor Brian Griffiths

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SIR ALAN WALTERS

MONEY MARKET ASSISTANCE AND FUNDING POLICY

The Prime Minister was most grateful
for your minute of 9 June which she has
noted.

PAUL GRAY

12 June 1989

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