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**SECRET**

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N. B. P.M.
the subject is
raised again.
BHP
18/6

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

18 June 1990

Barry Potter Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

Dear Barry

**MONEY MARKET MARKETS: SPECIAL DEPOSITS**

In your letter to me of 22 May you recorded the Prime Minister's reservations about the proposals on special deposits in the Treasury paper on credit growth and new techniques of monetary control. The Prime Minister wanted to be satisfied that the introduction of a special deposits requirement would not, of itself, increase the upward pressures on interest rates; and that in the light of earlier policy statements such a step could not be attacked as representing a reversal of previous policy.

There are two kinds of special deposits regime. In the first the Bank would pay interest on deposits obligatorily made with them; on the second they would either pay no interest on the deposits, or a less than market rate of interest. It is a special deposits regime of the former not the latter kind whose merits the Chancellor was canvassing in his discussion with the Prime Minister.

Special deposits of this kind, on which the Bank would pay a market rate of interest, would of themselves exert no upward pressure on interest rates. The Bank would simply use them as an alternative or supplement to Treasury Bills, as a mechanism for creating market shortages so as to reinforce their control of short-term interest rates.

But special deposits on which the Bank paid no interest, or interest at a rate below market rates, <u>might</u> exert some upward pressure on interest rates, since this new cost to the banks would

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reduce their profits unless passed on to the customer in the shape of either higher lending rates or lower deposit rates.

Special deposits of the former variety, ie those which do not penalise the banks, would be unlikely to be controversial and could not easily be represented as a reversal of previous policy (indeed, they are <u>part</u> of our current arrangements: the Bank and the banks have a published agreement that the Bank may require interest-bearing special deposits, at its discretion).

The Chancellor thinks that a special deposits regime of this kind is a necessary back-up technique for the Bank of England, to ensure that in all money market circumstances they retain their control over short-term interest rates. But he thinks it unlikely that the in foreseeable future such a special deposits regime will need to be brought out of reserve, given the present money market prospects. He is content therefore not to pursue the suggestion in the Treasury paper at the present time.

Yours

JSG.

**JOHN GIEVE**
Principal Private Secretary

Econ Pol: Domestic Monetary Policy Pt22