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Chancellor of the Exchequer

cc Financial Secretary
Sir Douglas Wass
Mr Burns
Sir Kenneth Couzens
Mr Monck
Mr Britton
Mr Lavelle
Mrs Lomax
Mr Peretz
Mr H Davies
Mr Pirie
Mr Ridley
Mrs Gilmore

Governor)
Deputy Governor)
Mr Fforde) B/Eng
Mr Coleby)
Mr George)

MONETARY CONTROL: DRAFT STATEMENT

1. I attach a possible statement which would need to be issued by 5 August. The draft incorporates comments from the Financial Secretary, from the Bank and from within the Treasury. There are two points to which I might draw your attention:

a. There are two possible forms of words to describe the circumstances in which we should wish to bring back something akin to MLR. The Bank prefer the former; we rather incline to the latter.

b. There is a general preference for spelling out a little the considerations to be taken into account in setting interest rates on the lines of page 3 of the statement. These were deliberately left rather obscure in the Budget Speech which has to be read with great diligence to come up with this list. There is an argument for being clearer about the criteria assuming that we reach agreement at the seminar. On the other hand, as the Financial Secretary has pointed out, it does not add a great deal to what was said in the Budget Statement and could raise more questions than it answers.

2. The statement assumes the outcome of the discussion with the Prime Minister. If it goes the way we hope, there should not be much difficulty in resolving the two points referred to above.

E. F. Clarke
P E MIDDLETON
30 July 1981

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DRAFT 30.7.81



1. The Chancellor of the Exchequer said in the Budget Speech that a number of improvements in monetary control would come into effect later in the financial year. The Bank of England has now completed its discussions with the financial institutions; and the agreed detailed arrangements are set out in a note issued by the Bank today. They will come into effect on 20 August - the first day of banking September.

The Reserve Asset Ratio

2. Among the changes to come into effect on that day is the abolition of the requirement that the banks should maintain a minimum reserve asset ratio. The institutions to which it has been applied will discuss in advance with the Bank, as part of normal prudential supervision, any changes in their policies on liquidity management.

The Cash Requirement

3. The previous requirement on the London clearing banks to hold $1\frac{1}{2}\%$ of their eligible liabilities with the Bank in non-interest bearing form will also be abolished. Instead there will be a uniform requirement on all banks and licensed deposit-takers to hold $\frac{1}{2}\%$ of their eligible liabilities with the Bank. The fulcrum for the Bank's money market operations will in future be the balances - over and above the $\frac{1}{2}\%$ requirement - which the clearing banks hold voluntarily with the Bank for clearing purposes.

Money Market Operations

4. Besides these changes, 20 August will mark a stage in a period of transition which we have been going through since last November. The Bank now relies mainly on open market operations - buying and selling bills - rather than on direct lending to the money markets. Dealing rates are no longer quoted; the Bank responds to bids and offers from the market, making public the rate at which it has done business. In future, 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.

5. The new arrangements are intended to reduce the "bias to delay" in changing interest rates - in both directions - which was identified in the Green Paper on Monetary Control. And the market will have a greater role in determining the term structure of short interest rates. Market pressure will show itself mainly in movements in rates at the longer maturities which the Bank does not influence so directly - and this experience of market conditions will be one of the factors taken into account in deciding on the position of the interest rate band.

Minimum Lending Rate

6. A continuous posted Minimum Lending Rate would be inconsistent with the (objective of the) new arrangements to give the market more influence over the structure of interest rates. MLR will be suspended from 20 August. The option will, however, be retained should circumstances warrant for use in

special circumstances⁷ of announcing in advance the minimum rate which, for a short period ahead, the Bank would apply to any lending to the market. H

Changes in the Interest Rate Band

7. The undisclosed interest rate band will be changed by the Bank with the agreement of the Chancellor of the Exchequer primarily in response to the requirements of the annual monetary targets together with the range of factors referred to in the Budget Speech. The principal indicators which will be taken into account are thus:

- the current and prospective trend of £M^3 ;
- movements of other monetary aggregates, in particular, M1 and the wide monetary base;
- the growth of nominal incomes, as measured by the value of gross domestic product at current prices;
- movements in the exchange rate and costs as indicators of underlying monetary and inflationary conditions.