Monetary control: next steps

This paper was issued by the Bank on 12 March 1981.

Introduction

1 The Bank's Background Note of 24 November[1] described a number of improvements to be made to the existing framework of monetary control. Among these improvements were changes in the Bank's methods of intervention in the money markets. The Background Note explained that it was envisaged that the Bank's intervention would place greater emphasis on open-market operations and less on discount window lending; and that it had been decided that these operations should continue to be conducted in the bill markets rather than through the inter-bank market, and in large part through the existing intermediaries, members of the London Discount Market Association, to whom discount window facilities would remain confined.

2 The Background Note also explained that the reserve asset ratio would be abolished, once consultations with the banking system about adequate holdings of liquid assets had been completed. The Bank is setting out in a separate document[2] the basis on which it will now resume discussions on banks' liquidity. That document discusses the need for banks to have regard to the quality of their liquid assets: but, apart from an interim stage, it does not envisage for prudential purposes any across-the-board ratios or norms for bank holdings of primary liquidity. The problem of ensuring an adequate supply of liquid assets for monetary control purposes is discussed below.

3 The Background Note mentioned that further consideration would be given to the future of the $1\frac{1}{2}\%$ cash ratio which is observed by the London clearing banks, and which has served as a fulcrum for money market management while also providing a substantial part of the resources and income which enable the Bank to carry out its general central banking functions. As was foreshadowed in the Green Paper on Monetary Control,[3] presented to Parliament by the Chancellor of the Exchequer last March, it has now been decided to replace this requirement by one whereby recognised banks and licensed deposit-taking institutions, in each case above a minimum size, will be required to hold cash balances on special non-operational, non-interest-bearing, accounts with the Bank. Although the precise basis of calculation remains to be determined, this requirement will apply uniformly and under present arrangements would amount in total to the equivalent of not more than $\frac{1}{2}\%$ of eligible liabilities. The London clearing banks will then maintain on their ordinary accounts with the Bank of England such balances as are necessary for clearing purposes. More generally, recognised banks and licensed deposit-taking institutions who are customers of the Bank will continue to maintain balances on their ordinary accounts at the Bank appropriate to the business conducted over those accounts.

Bill markets

4 As foreshadowed in the Background Note the Bank is now placing greater emphasis in its money market management on operations in bills rather than in discount window lending. The Bank has only very rarely provided funds through the discount window since the end of November despite the fact that on several days there have been substantial cash shortages in the money markets. Handling these shortages through the purchase of bills has been facilitated by the reduction in the reserve asset ratio on 2 January from $12\frac{1}{2}\%$ to 10%, which released for future sale to the Bank substantial amounts of bills previously held, directly or indirectly, as reserve assets. The Bank is also conducting its open market operations in such a way that market factors have a greater effect than previously on bill rates. The Bank has abandoned the practice of quoting prices at which it will buy Treasury or eligible bills of over one month to maturity and now responds to offers of bills for these longer maturities. The market has adapted readily to these changes and the speed and ease with which it has been possible to move is encouraging.

5 The emphasis in the Bank's open market operations on transactions in bills (Treasury bills, local authority bills and commercial bills) means that there will remain a need for bill markets of adequate size and depth to provide the paper in which the Bank's operations will be conducted. But once the reserve asset ratio is abolished, it is not possible to predict with confidence how banks would adjust the amount and composition of their portfolio of high quality liquid assets and what would be the effect of any adjustment on money placed with the discount houses, who are the main market-makers in bills. The banks will of course need to have regard to the Bank's evolving prudential liquidity arrangements but these will permit greater flexibility over the size and composition of high quality liquid assets than the existing reserve asset ratio requirements. It is likely that considerable amounts of funds would be available to the discount houses. The banks would continue to benefit from the fact that the liquidity provided by these funds will be

(1) Reproduced in the December 1980 *Bulletin*, page 428.
(2) Reproduced on page 40.
(3) *Monetary Control* (HM Stationery Office, Cmnd. 7858).

greater than that provided by some other liquid assets, and from the fact that funds placed with the discount houses are capital certain whereas a holding of bills is not. But there is a possibility that the availability of such funds might in practice, at least at the outset, not suffice to provide a market in bills of the size necessary for the Bank's open market operations. The Bank is concerned to ensure that this situation should not arise.

6 Increased reliance on open market operations in eligible commercial bills will require an adequate supply of these bills. In this connexion the Bank has felt for some time that the present list of eligible names needs to be extended. The present list consists broadly of the London and Scottish clearing banks, the members of the Accepting Houses Committee and the major British Overseas and Commonwealth banks. It dates from a time when the Bank's supervisory arrangements were primarily concerned with British banks. Apart from being a British bank of the requisite standing, the main criterion for inclusion on the list was that the acceptor should have a broadly based and substantial acceptance business which commanded the finest rates in the market.

7 In recent years there have been major changes in the Bank's supervisory arrangements and the number of foreign banks in London has increased. The Bank has concluded that these developments should be recognised in extending the criteria for eligibility.

8 At the same time, the Bank considers that it would be right to link the criteria for eligibility with the arrangements for ensuring an adequate availability of funds to the bill markets. Eligible acceptors have an interest in ensuring that the bill markets function efficiently, which complements the Bank's interest in ensuring that its open market operations can be conducted effectively. The Bank would therefore like to discuss arrangements which would incorporate a link between eligibility and an undertaking to make available, at least initially, secured funds to the discount houses in such a way as to help them fulfil their role as market-makers in those and other bills. The undertaking might be in the form of an agreed average level of funds placed with the discount houses, with a lower minimum level. If it appeared in time that such an undertaking was no longer necessary or the intermediating role of the discount market became less important, the arrangements could, as seen fit, be progressively reduced in scale.

9 During the later stages of the 12½% reserve asset ratio the amount of reserve asset call money placed with the discount houses totalled over £4½ billion. But the Bank judges that an appropriate assured average level of funds made available to the discount houses under the arrangements described above, to enable them to provide a sufficiently broad market in bills, would at present be around £3 billion. It would represent the equivalent of around 5% of eligible liabilities of the major British and foreign banks if they were to participate in the arrangements. Such funds placed with the discount houses would of course be regarded as high quality liquid assets for prudential purposes.

10 On this basis, the Bank will, at its discretion, be willing to extend the criteria for eligibility to other recognised banks which have and maintain a broadly based and substantial acceptance business in the United Kingdom and which can command the finest rates in the market, provided, in the case of foreign-owned banks, that British banks enjoy reciprocal opportunities in their domestic markets. The Bank may wish to set limits on its holdings of any particular name, which will take account of the bank's position in the market. In the case of recognised banks which are branches of overseas banks, such limits will take account also of the bank's current level of sterling business in the United Kingdom in relation to its total business.

The gilt-edged market

11 The Bank is also concerned that there should be an adequate availability of funds to enable the gilt-edged market to continue to function efficiently. The Bank will therefore wish to explore the possibility of similar arrangements being made to ensure that suitably secured funds continue as at present to be made available to the Stock Exchange money brokers (within limits set, as now, by the Bank) and to the gilt-edged jobbers.