

Copies to: Mr. McMahon o/r  
Mr. Payton  
Mr. Walker  
Mr. George + PPS  
Mr. Kent

BANK OF ENGLAND  
Threadneedle Street  
London  
EC2R 8AH

30 November 1979.

CCP 6.1

Sir Kenneth Couzens, CB,  
H.M. Treasury,  
Parliament Street,  
London.  
SW1P 3AG.

*Dear Sir Kenneth,*

I understand that you asked Mr. McMahon for our views on whether or not the Euro-sterling market poses an immediate threat to domestic monetary control and, if it does, on whether or not there is scope for preventive action through an agreement with the US that we should each ask our own banks not to undermine the other's domestic monetary policy through offshore operations.

There is no doubt that the abolition of Exchange Control has potentially reduced the effectiveness of the Supplementary Special Deposits scheme by widening the scope for offshore disintermediation by banks in the UK; and we have, of course, discussed this in depth with your Home Finance people. Some such scope existed before the Exchange Control relaxation began - though we doubt that it was significant. But it is now much wider although it does not derive necessarily from the Euro-sterling market, since a similar effect can be achieved by banks either in the UK or overseas taking deposits from and lending to residents in a foreign currency on a swap basis.

The effect of offshore disintermediation would be an expansion of domestic holdings of liquid claims on banks and of bank credit to UK residents that would be outside sterling M3 and its counterparts, and is thus no different from domestic disintermediation, e.g., through the non-bank take-up of bank bills.

Disintermediation is inherent in an SSD type of control which, if the demand for liquidity and credit remains unsatisfied, leads to that demand being satisfied through the most efficient channel that remains unblocked. Most forms of disintermediation including offshore cannot be measured so that assessment of monetary developments is less reliable. It is essentially for this reason that we believe - and this

was made clear in the paper put to Ministers on the Exchange Control decision - that for the longer term it will be necessary to avoid techniques of monetary control (or arrangements for prudential supervision, or a tax regime) that put the controlled institutions at a competitive disadvantage compared with offshore (or foreign currency) operations.

While these considerations are important for the longer term, it was as you know decided to continue with the SSD scheme for a further six months; and the Governor asked for assurances from both British and foreign banks in London that, during the present extension of the SSD scheme, they will not seek to avoid its effects on them by arranging for the relevant transactions to be conducted outside the UK by their branches or associates. This approach we believe will deter the banks from actively exploiting the possibilities now open to them. While therefore we would expect to see some opening up of new channels, if the demand for liquidity and credit remains strong, we do not expect this to become a major problem. Opportunities for domestic disintermediation in these circumstances will of course remain.

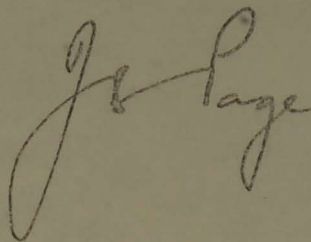
We will of course continue to monitor the development of the Euro-sterling market and the other Euro-currency transactions of UK non-banks as far as we can. At present the B.I.S. collects quarterly data reported through central banks by banks in the G10 countries, Austria, Denmark, Ireland and Switzerland. These provide information about liabilities and claims of banks in each country of the reporting area, in sterling as well as other currencies, with a geographical breakdown and a division of the counterparties between banks and non-banks. So figures are available for the Euro-sterling holdings and borrowings of UK banks and non-bank residents.

The major shortcoming of these statistics is the reporting delay of some 4½ months. However, the Bank are pressing for more timely reporting by the B.I.S. and they also have arrangements with other central banks to receive their contributions to the B.I.S. data in advance. This, together with more current qualitative information from the markets, will enable us to pick up over time any change in the Euro-sterling market's present minor role.

Against this background we have considered whether there would be any advantage to be gained by seeking - on a reciprocal basis - US support. Given the nature of the potential problem for monetary

control outlined above, the question is whether such support would in practice contain offshore disintermediation more effectively - and whether market commentators would believe this to be the case - than the request already made by the Governor. In our judgment it would not. The US banks are not the only banks involved - and perhaps in the Euro-sterling market not the principal banks involved - and an agreement with the US alone would raise obvious questions about the banks in other countries. An attempt to secure the agreement of all the major countries would inevitably take a good deal longer, and would run the risk that it would become mixed up with the wider discussions on monetary control of the Euro-markets the need for which we continue to doubt.

Yours sincerely,

A handwritten signature in dark ink, appearing to read "J. S. Page". The signature is written in a cursive style with a large, looping initial "J".