

Prime Minister 2

Sir Robert Armstrong
C. A. Herbertson



The Treasury are
not disposed to
supplying sterling
customers off-
market. Now

Treasury Chambers, Parliament Street, SW1P 3AG
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but the upward
pressure on sterling

T. Lankester, Esq.,
No.10, Downing Street

has gone away,

Agreed

I suggest we
don't press them
further at this
stage.

Dear Tim,

CUSTOMER TRANSACTIONS

At her meeting with the Chancellor on 12 November, the Prime Minister asked us to consider switching Bank customer transactions off market again.

No one could say for sure what effect putting more transactions through the market in recent months has had on the exchange rate. They can have a noticeable effect on an individual day but over time there seems no reason why they should have more weight than any other flow of equal size.

On the other hand supplying sterling to customers off market has much the same money supply implications as other intervention: at various times in the past it has led to very substantial additions to the money supply. Changing the line would, in short, by no means be costless at a time when we may already be running some risks in this area. It would also arguably be inconsistent with our views about market determination of the rate: and not seem to fit too well with the policy of limiting sterling balances.

Having outlined some of the arguments as we see them, I should say that the Chancellor's preference is not to take a final view at this stage but to see first how the markets behave in the light of the various policy statements now in prospect for next week. If, for example, upward pressure were to develop we might wish to consider the position further. If I may, therefore, I will come back to you on this a little later on.

Perhaps, however, I could take the opportunity of this interim reply to comment on a related technical question you put to me in your letter of 6 November about the

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consistency of the Bank turning away customer transactions but being ready to provide assistance to the money markets.

The short answer here is that if the Bank supplies sterling to one of its overseas customers this very likely increases money supply: whereas the Bank's assistance to the banking system is intended to work to the opposite direction, to prevent an increase in the money supply.

It hasn't always had that effect!

It is true that a lot of the sterling supplied by the Bank to a customer ends up in the banking system, so increasing its holdings of reserve assets. But this is an indirect effect and the whole process carries a money supply cost. If the customer had instead had to go to the open market, some of the sterling would have been supplied by residents out of their bank accounts, so actually reducing the money supply.

The Bank's assistance to the money market, e.g. by a release of special deposits does not increase the money supply but acts to prevent an artificial short term increase in both the money supply and interest rates, arising from the way the reserve assets ratio works. It does so by lessening the need of banks to bid more aggressively for deposits and by reducing the danger of round tripping (because of a rise in market rates relative to banks' base rates). It is because the present Reserve Assets Ratio has these undesirable effects, while contributing nothing to monetary control, that the decision has been taken to abolish it.

Yours

John

A.J. WIGGINS