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Part - A

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PART A

Chancellor's (Lawson) Papers:
TREASURY BILL TENDER

DD's: 25 Years

D Anderson
25/10/95

3881B/021

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FROM: C W KELLY

DATE: 2 July 1987

ECONOMIC SECRETARY

cc: Chancellor
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Peretz
Mr Culpin
Mr Grice
Mr Watts
Mr Richardson

TREASURY BILL TENDER

The Bank promised at the last funding meeting to make proposals about handling the Treasury bill tender over the next few months. I attach a copy of the paper they have now sent across.

2. To recap, the practice for some years has been to offer for sale by tender only £100 million of Treasury bills each week - the aim being mainly to keep the machinery in good working order. In May, however, your predecessor agreed an increase first to £250 million and then to £400 million as a way of taking money out of the market. The purpose was to raise the level of assistance required, thus helping to prevent a temporary fall in the bill mountain to an uncomfortably low level. We need under present arrangements to keep at least a bill "hill" if the Bank are to keep control of short-term interest rates through money market operations. We had envisaged at the time that once the temporary dip in the bill mountain passed the tender would revert to its traditional level.

3. That is still the intention. But having thought about it further the Bank now see some advantage in phasing the reduction over a period of months. The reason is that this would help to smooth the build up in the bill mountain to its seasonal peak next January.

4. Specifically, they are proposing that:

i. Next week's tender, to be announced tomorrow, should continue at the level of £400 million. The tender should continue at that level the following week, and perhaps also the week after that.

ii. But by the tender for the last week in July or first week in August, there should be a reduction to £300 million a week.

iii. Further reductions, successively to £200 million and £100 million should take place no later than October. The increase in the outstanding stock of bills above the traditional level will then run off completely by the end of the year, when money market assistance is expected to be at its peak.

The precise phasing of the reductions would depend upon circumstances at the time.

5. We do not believe the case for this kind of phased reduction to be an overwhelming one. We doubt that the Bank would be proposing use of the tender for smoothing purposes if the opportunity to do so had not presented itself as a result of what we did in May. But, on the face of it, ironing out part of the fluctuations in the size of the bill mountain could help in a small way to prevent some of the distortions which might otherwise take place. If the Bank judge that it would be helpful to money market management, we see no reason to stand in their way provided that it does not cost us any money.

6. In practice, this last condition, which implies that the market yield on the Treasury bills we sell should be below, or at least not above, what we pay on the commercial bills the Bank buy, should be met in all normal circumstances. Indeed it would be odd if this were not the case. Our own credit ought to be superior to that of those issuing commercial bills or accepting them unless we were substantially distorting the market through our operations.

7. We cannot say for certain that the yield on Treasury bills has never been above that on eligible commercial bills of comparable maturity. But we have looked as a test at the position at the time of each of the tenders for the first six months of this year. On every occasion the yield of the tender was, as expected, below that on eligible bills at the same time.

8. This raises the question of why, if we can make a profit on the transaction, we do not make a practice of issuing more Treasury bills on a regular basis. I think the answer is basically that the existence of the bill mountain already distorts the market. It would be wrong deliberately to set about increasing the size of the distortion simply to make a profit. There is also the point that there is in principle a credit risk, albeit a small one, associated with the Bank's holdings of commercial bills.

9. The immediate question is the size of next week's Treasury bill tender, to be announced tomorrow. We recommend that we should accept the Bank's proposal that this should be set at £400 million. We also propose to accept their suggestions for a gradual run down in the size of the tender, beginning with a first reduction to $300 million around the end of July. If you are content, we would propose to agree the precise timing of the phasing with them at official level at the appropriate time, within the strategy set out above.

10. I apologise for the fact that, because of the late arrival of the Bank's paper, I have to ask for a decision at least about tomorrow's announcement by first thing tomorrow morning.

cwk

C W KELLY

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THE TREASURY BILL TENDER

1 The Treasury Bill tender, which had been £100 million a week for several years, was raised to £250 million for tender on 22 May and since the 29 May tender has been £400 million.

2 The tender was increased in response to the sharp fall in our commercial bill holdings from the January peak bought about by -

(a) the CGBR, which was high partly for seasonal reasons and partly because of heavy lending by the PWLB to local authorities (which does not contribute to the PSBR, being an intra-public sector transaction);

(b) the bunching of gilt-edged maturities; and

(c) our heavy purchases of foreign exchange.

Given the possible need for further heavy purchases of foreign exchange it was important to have some assurance that the money market's cash position would not be so easy that market short-term interest rates could fall away from the levels we were trying to maintain. The increased Treasury bill tender was designed to help secure that objective.

3 Our total assistance to the money market fell to a low point of £2.5 billion on 28 May; since then, however, it has begun to increase once more, so that on 26 June, our holdings of commercial bills were up to £4.8 billion. Against that, market holdings of Treasury bills were £2.5 billion on 26 June, so that the net official position in bills was £2.3 billion in credit.

4 The Treasury Accountant's day-by-day forecast of Exchequer revenues and disbursements over the coming seven weeks, together with information on gilt calls, gilt redemptions, projected changes in the note circulation, etc, enables us to put together a

forecast of the influences on the cash position of the money market. The object of our money market operations is to offset these influences; where the forecast influences are such as to withdraw cash from the money market, the offsetting can take place either through a rise in our holdings of commercial bills or through a reduction in market holdings of Treasury bills: in either case the net official creditor position in bills (equals official holdings of commercial bills minus market holdings of Treasury bills) will increase. Other things being equal, a larger rather than a smaller Treasury bill issue makes no difference to the net creditor position in bills, because the additional Treasury bills lead to larger day-to-day cash shortages in the money market, which we relieve by additional purchases of commercial bills.

5 The forecast changes in the net official creditor position in bills over the next seven weeks are shown in table 1 below. The figures assume no additional gilt sales and foreign exchange transactions beyond those already contracted: this means that they incorporate some £500 million of gilt receipts for July secured through earlier sales of partly-paid stock, but no gilt receipts for August. They also allow for the receipt of the proceeds of the BAA sale (timed for 28 July), but do not incorporate the large temporary inflow of refund money likely to be associated with it. No allowance is made for the post-strike catch-up of either VAT collections or VAT refunds, but the two amounts, though uncertain in timing, are likely to be broadly offsetting in amount.

Forecast changes in the net official creditor position in bills

Changes from 26 June to	£ billions, cumulative changes
3 July	+ 0.4
10 July	+ 0.6
17 July	+ 0.2
24 July	+ 0.3
31 July	- 0.1
7 August	- 0.3
14 August	- 1.4

6 The figures point to little change in the net official creditor position in bills during July, followed by some fall during August. But allowance for the further gilt sales for which we are aiming beyond those incorporated in the figures would make a significant difference to the figures: if they are allowed for the net official creditor position in bills is projected to increase during July; with the decline during the first half of August perhaps being insufficient to offset fully the rise in July.

7 On this near-term view, then, our commercial bill holdings would be likely to rise even if there were no further increase in the Treasury bill issue. This would be an argument for reducing the weekly Treasury bill tender forthwith, from the present £400 million a week to the £100 million a week needed to cover the maturities of Treasury bills issued three months ago.

8 Looking further ahead, however, we think there is a strong case for a gradual reduction in the tender over the next four months, rather than an immediate reduction.

9 The peak level of assistance in January this year was some £16 1/2 billion. Over the financial year as a whole, if the present funding rule is retained and the PSBR is fully funded through sales of public sector debt to the non-bank private sector and through external and foreign currency finance of the public sector, the main influences on the cash position of the money market will be:

(i) The rise in the note issue, which raises the need for assistance, perhaps by some £3/4 billion.

(ii) The amount of central government lending to the rest of the public sector other than that which is used to repay debt to, or place deposits with, the monetary sector. This reduces the need for assistance. In March, April and May, central government lending amounted to £4.0 billion, but debt repayments by the rest of the public sector to the non-bank private sector were £1.4 billion.

(iii) Net purchases of public sector debt by banks and discount houses, which could be either positive or negative.

10 In other words there is some prospect that the assistance peak in January 1988 may be lower than in 1987, but it could nevertheless easily be of the order of £15 billion. This means that our holdings of commercial bills may have to increase by around £10 billion over the next seven months - an average increase of £1 1/2 billion a month.

11 We think it would be helpful to try to phase the run-down of the Treasury bill tender so as to try to smooth out the rise in our holdings of commercial bills (so that more of the rise occurs in the next few months and the increase in December 1987 and January 1988 is less sharp), with the aim of reducing the market disturbance arising from the large net increase in our holdings. In fact there can be no assurance that we can achieve this smoothing by manipulating the Treasury bill tender, because if the market is nervous about a rise in interest rates it may quickly sell back to us in our market operations all the additional Treasury bills we have created. Nevertheless given that the technique is likely to cost nothing to use (because the market yield on Treasury bills is sometimes a little below, but rarely, if ever, above, the yield on eligible commercial bills) and that in most circumstances it should achieve some degree of smoothing, it seems worth employing.

12 Table 2 (attached) gives a month-by-month forecast of influences on the net official creditor position in bills over this financial year. The figures are very fragile - indeed some are no more than guesswork - but the main conclusion, that there are likely to be substantial increases in the net official creditor position in October and December 1986 and (especially) January 1987, is likely to be quite robust.

13 Against this background we propose that our general aim should be a reduction in the weekly Treasury bill tender from £400 million to £100 million in steps of £100 million, phased as follows:

(a) The first reduction, to £300 million a week, to take place around the end of July. This would mean that Treasury bills issued in weekly tenders of £400 million during July would mature in October, exceeding the amount of new Treasury bills to be issued during October. If the July-issued bills remained in the market until maturity, this would help smooth the rise in assistance needed in October.

(b) The second two reductions, successively to £200 million and £100 million a week, to take place later in the year, so that Treasury bills issued to mature in December and January would exceed new Treasury bills issued in those two months. The last reduction, to £100 million a week, would need to take place no later than October, so that the amount of Treasury bills outstanding at the assistance peak was no greater than that implied by 13 weeks of £100 million tenders.

14 Plainly individual weeks' tenders, and the timing of changes, would need to be considered not only in the light of this general aim but also against the background of the particular situation. For example at present we would not in any event want to reduce the tender from £400 million a week until the Civil Service strike is ended. But we think it would be helpful to have agreement on the general aim outlined above as a framework for considering the tender week by week.

Bank of England

1 July 1987

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Table 2

Influences on the net official creditor position in bills 1987-88

£ billions

	CGBR	Reserves (-)	National Savings (+)	CTDs (+)	Gilt sales* (+)	Gilt maturities (-)	Notes (+)	Total**
1987								
April	-2.4	-1.8	+0.2	+0.2	+1.4	-1.1	+0.4	-3.5
May	-1.6	-2.9	+0.2	+0.2	+1.5	-0.8	+0.5	-3.0
June	+0.1	=	+0.1	+0.2	+1.1	-0.6	-0.4	+0.5
July	-0.3	=	+0.2	+0.2	+1.1	-1.0	+0.6	+0.8
August	-1.2	=	+0.2	+0.2	+1.1	=	=	+0.3
Sept	-0.7	=	+0.1	+0.1	+1.1	-0.6	-0.5	-0.5
Oct	+1.0	=	+0.2	-0.4	+1.1	=	-0.3	+1.6
Nov	-1.5	=	+0.2	+0.1	+1.1	-0.8	-0.3	-1.2
Dec	-0.7	=	+0.1	+0.1	+1.1	-0.1	+0.8	+1.3
1988								
Jan	+5.2	=	+0.2	-0.7	+1.1	-0.4	-0.7	+4.7
Feb	-0.5	=	+0.2	-0.3	+1.1	-0.1	+0.1	+0.5
March	-4.4	=	+0.1	+0.1	+1.1	-0.8	+0.5	-3.4

*To all sectors

**Including in the case of outturns other influences not identified in the table.

3757/015

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RB

FROM: P D P BARNES
DATE: 3 July 1987

MR KELLY

cc PS/Chancellor 2
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Peretz
Mr Culpin
Mr Grice
Mr Watts
Mr Richardson

TREASURY BILL TENDER

The Economic Secretary was grateful for your submission of 2 July.

2. The Economic Secretary agrees that the Bank may announce a £400 million tender today for issue next week.

3. However, he would like to discuss longer term strategy with officials. This office will be in touch to arrange a meeting.

PB

P D P BARNES
Private Secretary

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PO Papers
PSe

FROM: P D P BARNES
DATE: 7 July 1987

NOTE OF A MEETING HELD IN ROOM 51/2 TREASURY CHAMBERS PARLIAMENT STREET AT 3.00 PM ON MONDAY 6 JULY

Those Present
Economic Secretary
Mr Peretz
Mr C Kelly
Mr Richardson
Mr W Allen - Bank of England

TREASURY BILL TENDER

Mr Allen explained that the Bank exerted its main influence over short-term interest rates through its operations in the money markets. One of the ways in which it did this was to buy short-term commercial bills (creating a 'bill mountain') or allow these to expire in its possession. In January the bills mountain had totalled £16½ billion. Since then three co-incidental factors - the high seasonal CGBR, the bunching of gilts maturities, and the large dollar intervention - had reduced the bill mountain to around £2½ billion by mid-May. It now stood at around £6 billion. Mr Allen thought that the three factors which had brought about the bill mountain's rapid decline were temporary. He thought the bill mountain would increase to around £15 billion by the following January. A smooth transition to this large figure would cause fewer problems of market management and the Bank proposed varying the size of the weekly sales of Treasury Bills to achieve this.

2. The Economic Secretary agreed that the Bank should undertake the phased reduction in the Treasury Bill tender as proposed in paragraph 13 of the Bank's paper after consultation with Treasury officials. The Economic Secretary would not need to be consulted about the precise timing of the change in the size of each tender. Progress could be reviewed at monthly funding meetings.

3. The Economic Secretary also said that he would like to see background paper setting out how the Bank's handling of Treasury Bills and the money markets fitted into monetary policy as a whole. Mr Allen promised to see what was available.

PB

P D P BARNES
Private Secretary

cc PS/Chancellor 2
Mr Cassell
Those Present

3887B/037

CONFIDENTIAL

FROM: C W KELLY

DATE: 13 October 1987

ECONOMIC SECRETARY

cc: Chancellor
Sir P Middleton
Mr Cassell
Mrs Lomax
Mr Peretz
Mr R I G Allen
Mr Grice
Mr Watts
Mr Richardson o/r

TREASURY BILL TENDER

We consulted you earlier about the phasing out of an increase in the Treasury bill tender started in the summer and intended to help smooth out a swing in the stock of money market assistance. The size of the tender finally reverted to the standard £100 million on 2 October.

2. The Bank have now proposed a new operation, of a similar but rather more substantial kind. Specifically, they would like to supplement the normal weekly tender of 13 week Treasury bills for a short period in late October and early November with an additional tender of 9 week bills, of an amount possibly up to as much as £800 million on each occasion.

3. The background is a forecast of the total stock of money market assistance outstanding which shows it rising from its current level of £5.3 billion to between £7½ and £8 billion on 23 October, falling away again in late October and November and then rising very sharply in late December/January during the tax collecting season. It is possible that the increase in January could be as much as £4½ billion. All the figures are, however, subject to wide margins of error.

4. Rapid swings in the size of the stock of money market assistance are not helpful to market management. If the bill

market contracts in late autumn and/or then fails to expand rapidly enough over the turn of the year distortions could be caused as a result of the Bank finding themselves bidding for an inadequate supply of bills. The issue of additional Treasury bills in late October/November would help to smooth the process by adding to daily shortages/reducing surpluses during the period when money market assistance would otherwise be falling; and if they were 9 weeks bills they would mature during the tax revenue season when assistance will be rising again - provided, of course, that the market did not sell them back to the Bank before that happened.

5. There is no legal bar on 9 week bills. The only necessary **formality** would be to amend the weekly tender notice. The undertaking by the discount market to underwrite the tender would cover the additional bills as well as the normal 13 week bills.

6. Nor ought the operation involve any cost. It might even yield a profit since it involves selling Treasury bills in order to buy additional commercial bills which ought in normal circumstances to offer a better yield. If the market became nervous about a rise in interest rates, it is not impossible that the Treasury bill tender rate could go above the rate at which we were prepared to buy bills. But the Bank would then have the option of bidding for some of the bills themselves, thus withdrawing them from the tender.

7. The amounts involved will depend partly on the way the figures move. But at present the Bank envisage a total of between £2-£2½ billion spread over 3 or 4 weeks.

8. Presentation will clearly need careful handling. The Bank are confident they can pass it off as a technical operation - as they were successful in doing with the summer operation. But the last issue of 9 week bills was made in 1962, so there is clearly a risk of attracting some attention and, although the markets may understand what we are doing, the press may need it explained to them. We would not want the operation to be misinterpreted as an attempt to inject extra liquidity.

9. We should also perhaps pause for thought about the implications for where we are going in the longer term. Coming so soon after the previous operation, this proposal would clearly establish the Treasury bill tender as a technical instrument in a way it has not been for some time.

10. We regard this, however, as an entirely healthy development. We see some attraction in moving to a pattern where some of the strain of seasonal variations is taken by varying the Treasury bill tender rather than the size of the Bank's commercial bill portfolio. This ought to help to reduce distortions in the bill market and consequent variations in the relationship between the cost of borrowing by commercial bill and bank advances which, although we have never quite been able to put our finger on it, we strongly suspect tends to distort the monetary figures in an unhelpful way.

11. The Bank would like to begin with a tender on 23 October. This would imply an announcement at the time of the previous tender, ie this Friday, 16 October. In view of the novelty of the operation, we think it might be sensible to issue a press notice the previous day (15 October) briefly explaining what we are doing. A draft is attached. We would need to take a final view of the figure at the time of issue. We might also need to look again at the exact words used if the figures then showed that we would be planning to do more than offset prospective surpluses.

12. We would be grateful for your authority to proceed on this basis.

C W KELLY

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DRAFT PRESS NOTICE

THE TREASURY BILL TENDER

The Bank of England announces that, for a short period from 23 October, the normal tenders of 13-week Treasury bills will be supplemented by additional tenders of 9-week Treasury bills.

NOTE TO EDITORS

This addition to the Treasury bill tender is a technical operation intended to offset prospective surpluses of cash in the money market in late October and the first half of November arising from the seasonal pattern of central government borrowing. It is expected that the initial offering of 9-week bills will be for [£800] million and that the subsequent offerings will be of a comparable order of magnitude. The maturity of the 9-week bills, in late December and in the first half of January, will coincide with the seasonal shortages of cash arising from corporate tax payments during that period.

The last issue of 9-week Treasury bills was in 1962; but in July and August 1981 special tender Treasury bills were issued to mature on 1 September 1981, when large petroleum revenue tax payments were due.

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FROM: P D P BARNES
DATE: 13 October 1987

MR KELLY

cc PS/Chancellor
Sir P Middleton
Mr Cassell
Mrs Lomax
Mr Peretz
Mr R I G Allen
Mr Grice
Mr Watts
Mr Richardson

TREASURY BILL TENDER

The Economic Secretary was grateful for your submission of 13 October.

2. The Economic Secretary is content that the Bank should proceed as you suggest.

PB

P D P BARNES
Private Secretary

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