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AFL. Many thanks - a valuable record of a most interesting episode. 3.7.80

① I should be most grateful if you would complete the story in the light of subsequent statistical information, e.g. of what had actually happened to the level of E.L.s and individual RARs.

MR COLLEBY

The continuing lessons are that we should always aim to be near balance on money on made-up days (as in my experience we have succeeded in doing on mid-month make up days); & that we should aim also to avoid any 'incompatibility' between the rev-creating and the money-creating activities of the discount houses. Partly that is a question of our ensuring an adequate supply of revs on made-up days, which we have been striving energetically to achieve: partly it is a question of the banks correctly anticipating the flows of the day in time to call what they need from the houses in order to maintain balance in the inter-bank market. Ought they not to be able to do that without requiring direct access to ourselves? Please study in collaboration with P&L/MTRS & offer thoughts for discussion.

- Copies to Mr Fforde
- Mr George
- Mr Goodhart
- Mr Gill
- Mr Ecklin
- Mr Foot
- Mr D W Green
- Mr Longmuir/Mr Smith

② THE MONEY MARKET ON MONDAY 30 JUNE 1980
A.C. 22/7

The consensus in the market is that Monday was indeed a most exceptional day. The bare facts support this view: overnight inter-bank rates peaked at around 200%; there was a large shortage of money, though not extremely so (some £260 mn), but the discount houses took only about £140 mn of help, so that bankers' balances closed about £110 mn below target; more striking was that three of the big four clearers failed to achieve the 12½% reserve ratio, while the fourth only just scraped home. Other important ingredients to the story, such as the overall levels of eligible liabilities and reserve assets for the banking system, are not yet known.

I have been asked to provide an account of the day's developments and to indicate what lessons might be learnt. What follows draws upon conversations with people in the market, where the general thread of the story did not seem to be in dispute, but differences of emphasis were to be found.

The date was distinctive as being an end-quarter reporting day and the first reporting day after the termination of the corset.

There is always a tendency, whether or not the corset is operating, for eligible liabilities to rise, seasonally, at end-quarters - especially June and December - on account of interest-crediting and the like. This has never in the past appeared to lead to problems in meeting the reserve asset requirement; indeed, the

Thanks - A.C.
Mr Coleby. Sorry that this has been set on for so long. ① has, I imagine, already been satisfied by, eg, my note reviewing reserve ratios at 30/6. As to ②, I consulted P&L + MTRS, who believe that the clearers can find it very difficult to predict their money flows, especially on make-up days. We can no doubt help by, as you say, aiming for balance or giving strong guidance if there is just-balance expected. Between us we should be able to nip such a crisis in the bud & hence avoid the need for direct help to the clearers.
ALC 4/7/84
ARC 23/7

ratio has, even in non-corset periods, generally been more comfortable on quarter days than at mid-months. The combination of higher ELs and a higher RAR on quarter days than at neighbouring mid-months was also a particular characteristic of the corset period, because banks, at any time other than mid-month make-up days, were not under pressure to pare their RAs in order to minimise ELs.

Typically, therefore, banks have tended to hold RAs above trend on quarter days; there has been no tendency for this practice in particular to expose any shortages of RAs. The fact that there are generally a larger number of banks failing to meet the 12½% requirement at end-quarters than at mid-months is not so much a reflection of reserve asset scarcity as of the probability that a number (some would claim a large number) of banks do not adhere to the requirement on a daily basis and get caught napping, in particular, on quarter days.

In addition to any of the above end-quarter influences on ELs, observers assert, with varying degrees of confidence, that there has been significant re-intermediation since mid-June. Some "funny" lines of bills that were rather obviously designed for corset avoidance, have apparently not been renewed. At the same time, expectations of a cut in MLR led borrowers to prefer to draw directly from banks rather than borrow at term through bills.

In sum, therefore, ELs may have risen unusually rapidly between mid and end-June. If this is so, then there will have been a correspondingly higher RA requirement.

The purpose of the foregoing paragraphs is to establish that call money was probably required quite acutely for RAs on the day in question and was not therefore called sufficiently to relieve the money shortage. Why the pressures of 30 June did not arise on some short day earlier is open to speculation. The most charitable explanation would be that the surge in ELs was not really

intense until 30 June, on account, for example, of interest-crediting. A less charitable view is that banks do not adhere to the RAR on non-reporting days. If ELs had been rising steadily, one might have expected banks to have been acquiring forms of reserve asset other than call money; even so, many banks, particularly the smaller ones (FSD have sampled a few BS forms to confirm this) hold only call money for their RAR, and many do not have the inclination or expertise to diversify into other forms. If there was a jump in ELs only on the day in question, or if banks only then awoke to the 12½% requirement, it would anyway have been difficult to acquire some other forms of RA - for instance, gilts would not easily be found for same day settlement.

On 30 June, the banks as a whole did not withdraw enough from the discount market in the morning to force the houses to obtain sufficient assistance to cover the overall money shortage. The clearers individually believed themselves to be roughly square by the end of the morning; other banks still had to find funds to cover their lending - especially, no doubt, the reserve assets they were holding. A steady and sizeable drain on the clearers ensued. At the end of the day, balances had to be below target by the amount of the remaining money shortage, simply as a matter of arithmetic, but, with individual banks scrambling for funds, and, in particular, individual clearers fighting to hold on to their target balances for reserve asset purposes, inter-bank rates were bid to astronomic levels.

The eventual shortfall in the clearers' balances here was equivalent to about 0.3% of their ELs, which was itself probably sufficient to push their RAR below 12½%. It is arguable that the clearers should retain a more comfortable margin of reserve assets to cope with such pressures. Against this, it may be thought unfair that they have to bear the burden of adjustment at the end of the day. Although the clearers knew from our morning forecast the likely scale of the day's money shortage, individually they will not necessarily have seen any direct advantage for themselves in calling from the houses in order to maintain their balances here

closer to target, although, when the secondary effects of not acting to draw out sufficient official assistance are considered, the wisdom of not calling more may be queried. For the system as a whole, it may be possible marginally to add to the volume of reserve assets by calling and subsequently placing the funds back at call, since at the end of the day balances will be nearer target. But this process of RA generation is limited by the degree to which the houses' resources allow them to take assistance while maintaining the level of their call money; and the procedure is not attractive to the banks, who face the possibility of call money rates being bid very low.

Once the drain began, the irony is that, by individually seeking to safeguard their RAR, the clearers probably contributed to their own failures. The upward shift in inter-bank rates opened up arbitrage opportunities, and instances have been cited of customers drawing on overdraft facilities and placing the proceeds in the inter-bank market. This would have put further downward pressure on reserve ratios as ELs were inflated. It was perhaps this process as much as the enforced reduction in balances at the Bank that brought the clearers' reserve ratios down to $12\frac{1}{2}\%$ and below. The extent that the ratios of other banks may also have suffered from round-tripping is not yet known.

While the banks were weathering the hectic afternoon, the discount houses were, in the main, amused bystanders. Their books had been squared satisfactorily and most (in terms of importance) were up against one or other of their multiplier ceilings, having benefited in particular from the demand for reserve assets. There were tales of banks anxious to place call money during the afternoon, but the houses were, on balance, either unable to take funds because of resource constraints, or reluctant to do so at any but very low interest rates because of their inability at that stage of the day to put the funds out profitably. The lowest rate at which call money was actually placed appears to have been 4%.

In sum, the events of 30 June highlighted the conflict that can arise from reliance upon the discount market fulfilling the twin, but not necessarily ^acompetible roles of principal provider of reserve assets and conveyor of last-resort lending.

In theory, these events could repeat themselves on any day when money is short, particular if, as seems probable for the time being, ELs are expanding at a faster pace than is the discount houses' capacity to accept call money, and especially if ELs surge suddenly. Now that the corset has lapsed there should be no special features on a reporting day, but, regrettable though it may be, one senses that in practice the problem is most likely to re-surface on a reporting day because of non-compliance with the RAR at other times.

Therefore, we ought perhaps to take such steps as may be practicable to avoid money market shortages on make-up days. There are grounds for some sympathy for the clearers in that they in particular encounter unpredictable swings in ELs, while having to comply with the RAR simultaneously, rather than on a lagged accounting basis. Alternatively, one might adopt a more dispassionate stance, leaving the banking system to cope with its own problem. This sentiment would be shared by those who feel that the clearing banks bring much of the trouble upon their own heads by persisting with customer arrangements that allow round-tripping. However, it is the distortion which such arbitrage may bring to the monetary statistics that is probably our principle concern, and in this context we would doubtless prefer not to witness soaring inter-bank rates on make-up days.

Beyond the immediate future, the abolition of the RAR would insure against a repetition of Monday's situation, but there are some sceptics who believe that the proposed liquidity norm could give rise to exactly the same experiences, with reporting day window-dressing etc.

In the nearer future the solution to problems of this type could only come either from leaning on the banks to help themselves, or from our channelling assistance direct to the banks. The

former option would involve somehow impressing on the clearers their need, collectively, to call sufficient from the discount houses. One clearer was in fact doing just that on Tuesday - deliberately calling more than he required in order, in his words, to help cool down the inter-bank market. Persuasion in this direction may not, however, always be very effective, depending on the costs that the course of action may appear to involve; even though the cost of not so acting may at the end of the day be greater. The main problem with this approach is that the problem may only become apparent too late for any action to be taken. The alternative course - the provision by us of some assistance direct to the banks - raises various questions of propriety and coverage, but is probably the more attractive, so long as the facility could be available beyond the time at which the discount houses take their help from the Bank. This conclusion should perhaps be taken into account in the review of possible assistance over the coming weeks, which is currently in progress.

The above considerations are aimed principally at coping with the money shortage and averting high overnight rates. They do not necessarily ensure that RAs will be plentiful enough, but persistent experience of RA pressure should encourage banks to look for more of their RAR to be satisfied from sources other than call money.

Money Markets Division
4 July 1980

A R Letter (4303)

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