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MONEY MARKET OPERATIONS SINCE NOVEMBER 24

It is now timely to take stock of the developments since November in our money market operations, to see what conclusions can be drawn about the questions addressed in the note on money market management sent to the Monck group in December.

Use of the discount window

There has been no great difficulty in "placing less emphasis on discount window lending". On only one occasion since November 24 have we lent on the 2.30 basis. That was on Christmas Eve, when a market shortage of some 300 had to be dealt with in a very short working day with many staff absent. After 225 of paper had been mobilised early on, seasonal indulgence to allow any remaining needs to be borrowed over the holiday week-end at MLR seemed appropriate, and 45 was so lent.

Market lending on "2.45" terms has occurred on five occasions, for a total amount of 107. We have re-established the original practice that all such lending is for seven* days, and that our "best" rate is the higher of MLR and the seven-day interbank rate. We have at times, when into the second tranche, been as high as 1½% over MLR, but at most times the lending rate has not seemed particularly penal. It is evident that rates such as the recent 14¼% are, even if payable for seven days, no real disincentive to borrowers who are strongly

* This produces certain problems over the facilities for stock-jobbers and money-brokers, which are supposed to be on similar terms to our lending to the LDMA on the particular day. Seven-day money is ill-suited to their needs, particularly the jobbers.

expecting an imminent reduction in the 14% MLR and other interest rates, and wish to maintain the largest possible book meanwhile. Moral suasion has limited the use of the 2.45 facility for that purpose, but we need to consider whether, at least in these circumstances, we should not now give ourselves greater discretion to select higher rates.

Open-market operations

The reduced emphasis on discount window lending has however accompanied an approach to open-market operations which has not aimed to limit our purchases of paper at all precisely to the market shortage according to our figures. This is partly - but only modestly - because we still have one institutional obstacle to such limitation. It is an understanding that, when we deny access to 2.30 borrowing, and so indicate that 2.45 borrowing is all that remains, then we stand ready to buy more of the paper in which we have been operating that day, so that houses can avoid having to borrow. This arrangement is quite separate from the traditional "last resort" facility of offering paper for discount - when we are involved in essentially bilateral transactions in which we can set rates at our discretion without directly influencing rates in the market. For the present, the principal problem posed by this feature of the 2.45 arrangements is the complication it introduces into the process of rate determination (see later); but once we were aiming at precise limitation of our market operations, we would have to suppress it.

The main reason why we have not so far aimed at more or less precise limitation is that we still have far too little confidence in the accuracy of our figures. Two weeks ago there were two consecutive days when our 2 o'clock estimate was proved wrong by 150 (in different directions, as it happened); and the same thing occurred again last Monday, when the Exchequer swing was responsible for 125 of this error. A great deal of effort is being devoted to improving our information (and we are trying to stir the banks into finding ways of improving theirs, and of reflecting it more accurately in their calling from the market). I have thought it right to await

the fruits of these labours, and the ending of the revenue season, which should itself reduce the amplitude of variation, before attempting a more precise management of bankers' cash. Throughout the recent period the market's position has of course been one of persistent deficit, so that over-buying on any one day simply reduced the following day's shortage, rather than bringing about an actual surplus.

The fact that paper has been offered in sufficient quantity to enable us to buy out, and occasionally over-buy, the shortages does demonstrate that the market mechanisms are, even at this stage, well developed. In the week of the January make-up day, for example, we bought over 1500, 1000 of it (of which 750 in the form of bank bills) in just two days. At the end of that week, we had reduced the total stock of bills in the market by about 2600 since the end of the year, at which time the total of *accessible bills was about 5800. The prospect is that we need to take out 1000 more at the tightest point on March 2.

Influences on yields and interest rates

From the foregoing, it will be evident (i) that we have in no way been operating a system in which interest rate and yields are determined by a market clearing process, and (ii) that the weight of our bill purchases was almost bound to lead to a decline in bill yields relative to those on other money market assets such as ineligible bills, CDs and inter-bank deposits.

In the event, over the period since New Year the movement of rates and yields has been downwards on all money market assets, though it has been greatest on those bills in which we have been dealing. This is shown in the attached Chart, which records a marked widening of the differential between three month bank bills and CDs at the time of heaviest activity in January, subsequently distinctly narrowed again. But the extent of the general decline in the

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* The figures exclude all bill holdings of non-residents, and the non-bank private sector's holdings of eligible bank bills and local authority bills.

relative yields on bills has been, I think, encouragingly small and transient. Our depredations have been very large in relation to the available stock, which may be expected to be distinctly larger once new eligibility criteria have been arrived at. Experience so far suggest that our longer-term needs to inject cash into the market could continue to be met by operations in bills only, without undue disturbance to rate patterns - provided the market makers can continue in substantially their present way of business, and provided that the recent sectoral imbalance in the economy is not too prolonged.

It is, however, the performance of the actual level of yields that needs closest examination. There can be no denying that, paradoxically at a time of large market shortage, our operations have contributed to the decline in yields of the past six weeks. This has not been entirely accidental. Though I have been careful not to lead rates down, I have been prepared to validate reductions arrived at in the market, by accepting progressively (but gradually) lower rates on paper offered to the Bank whenever that has been necessary in order to buy out the shortage; sometimes, as indicated above, we have overbought, but have never accepted a lower rate in order to do so. We could have resisted the declining rates more forcefully, eg by avoiding overbuying, or by rejecting paper at lower rates than we had previously accepted - whether to induce the re-offer at a higher rate or to leave a shortage against which we would lend penally. By not doing so, I have implicitly been concluding that the resulting rates were consistent with current policy objectives such as might be reflected in a target interest rate band.

It is not possible to relate experience over this period at all directly to the type of interest rate band suggested in our note to the Monck group, because the rate on seven-day Treasury Bills, our proposed indicator, has remained one that is set by our own posted dealing rates. Over the period since 24 November, our rate (of discount) on short bills has come down from 13 3/16 to 12 3/4. We can draw no clear conclusions about what might have happened to the market rate if we had not been posting dealing rates. /Once

we move out of the revenue season, and have less need to mobilise paper in vast quantities, I propose to abandon posted rates even for the shortest of paper.]

It may, however, be instructive to examine how representative the seven-day Treasury Bill rate has been, over the period, of other short-term rates such as the seven-day inter-bank. The attached chart shows that the interbank rate is distinctly variable, but has not over the period seriously parted company from the TB rate. Its recent firming, to stand rather higher against TB rate than at times over the period, probably reflects the upward pressure imparted to very short rates by growing expectations of an imminent decline in rates generally.

If it has not been possible over this period to observe how a more fully market-determined rate at the seven-day point would emerge from our operations, it has certainly been possible to identify some of the technical problems involved in setting up such a process. The greatest, already referred to, concerns the fragility of our information, even after lunch on the day of operation. But also important is the difficulty of producing anything akin to the Fed's "stop rate" for overnight Fed Funds, because of (i) the multiplicity of instruments in, and maturity terms at which we are dealing and (ii) the fragmenting of our dealings into a first, and main, operation before lunch, fairly often topped up after lunch, and with dealings sometimes continuing thereafter up to 2.45 in accordance with the conventions of the 2.45 facility. This means that, at successive points in the day, we are having to make rate/quantity decisions which, once made, feed back into the market's response to subsequent invitations to offer paper, so that by the end of the day we are in effect once more in the position of making rates rather than taking them. We have tried to protect ourselves against this problem by occasionally declining to deal after lunch except at higher rates than those arrived at in the morning, but cat-and-mouse games of that sort are not really a satisfactory way of doing business.

One clear conclusion is that we must now vary the conventions of the 2.45 facility, so that our dealing operations will have better defined cut-off points. That will still, however, leave us with difficulties if the amount of paper offered by the cut-off time is,

on our figures, inadequate or barely adequate to take out the shortage, and we could find ourselves, reluctantly, accepting paper at rates which seem unjustifiably low. A second question for consideration is whether we might reduce the maturity terms at which we engage in outright operations by substituting repurchase deals.

That question, and others bearing on our Monck group memorandum which arise out of this note or from the record of my visit to the US, are to be dealt with in a separate note.

A.L.C.

12 February 1981

ALC