(Markets file)
(Philip)

MTKS. "Done" [illegible]

Many thanks – top copy passed on by hand.

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26. 2.81

MR COLEBY
THE DEPUTY GOVERNOR'S
PRIVATE SECRETARY

We ought, I think, to send this to the Press Office

No copy

A.C.

Copies to

Mr Fforde
Mr George
Mr Gill o/r
Mr Byatt
Mr Latter o/r
Mr Foot
Mrs Drummond
GPS

MONEY MARKETS DURING WEEK ENDED 25 FEBRUARY

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MONEY MARKETS DURING WEEK ENDED 25 FEBRUARY

General

The most significant feature of the past week has been the renewed downward movement in rates. This started on Monday morning in the wake of the Observer article on the possibility of a 3% cut in MLR in the Budget, reinforced by similar comment in Monday's FT. Apart from the exchange rate which dropped sharply, the downward movement has been most noticeable in the period rates from one month upwards. Thus the one-month rate has shown a fall of 5/8% since last Wednesday and the three-month rate a fall of nearly 7/8%. Only yesterday did the market show signs of reaction, with some rates slightly firmer in the afternoon, probably in anticipation of the shortages at the beginning of next week. The three-month eligible rate has in the same period fallen by about 5/8% to 11 3/4% (i.e. a yield of 12.1%). Thus the market has already discounted a drop of nearly 2% in MLR which is why there is some concern, certainly in the discount houses, that there might be some adverse reaction to a drop of less than 3%.

Day-to-day conditions in the last week have generally been quite comfortable with only Friday producing a sizeable shortage (we bought £320 mn. bank bills of varying maturities). However, discount houses' cost of money has continued to remain high in relation to the return on their 'liquid' assets and it is taking an act of faith on the part of some houses to maintain the size of their books. From figures just available, total Discount Market sterling assets showed a rise of £360 mn. in banking February, much of that rise being in eligible bills in order to build up their liquidity. With the average cost of funding these assets

MTRS 26/2 ALC 26/2 DG 26/2

in the range of 13.60-13.80%, houses are understandably concerned about the negative return.

Immediate reaction to Tuesday's announcement on the temporary reduction to 8% in the RAR from 2-10 March was mixed. While the discount houses have been told that facilities can be utilised next Monday, there is some anxiety about the size and extent of calling of money by the banks. The banks themselves may not have positioned themselves for the very heavy drain on liqudity partly because of considerable doubt on the scale of the problem (current figures for next week show a market shortage of £1.2 bn. on Monday, with some £1.3 bn. due in PRT - roughly equating to the amount of reserve assets released by the 2% cut).

Eligible bank bills

With expectations of a cut in MLR increasing as the Budget date draws nearer, there has been evidence of a drying-up in the issue of bills, and houses report a scarcity of paper. This, of course, has helped to push rates down and the only surprise has been that earlier this week banks were still buying three-month bills from the market - further evidence of an apparent lack of positioning for next Monday, since any such interest stopped on the announcement of the 2% cut in the RAR.

Open-market operations

The market was given notice at the end of last week of a further development (not yet put into operation) in our open-market operations. This is a variation of the sale and repurchase transaction in commercial bills utilised during the life of the corset, and is intended to mobilise paper with a maturity of over one month without having to 'set' a rate for such longer dated paper. Instead, the houses will bid a money rate for the period covered by the 'repo' and this will be applied to the consideration created by the discounted value of the bills which they sell to us. The houses have been considering the implications of this technique and, apart from some accounting difficulties, have, on the whole, reacted favourably to it.

Treasury Bills

A rise of 5p in the pro rata price last Friday was more than vindicated in the successful bidders' view by the term of events this week and by the demand which has resulted for them. Successful tenderers were limited to three - two discount houses, one of whom obtained 60 of the bills, and one outsider (Citibank). At current trading levels, a further rise of 10p in the pro rata price would be warranted at Friday's tender.

Other points

As a result of the lower rate expectations, there have been considerable inflows of sterling from Europe and the Far East in the early part of this week, a broker contact tells me. It has been mainly 6, 9 and 12-month money, and there has been no shortage of takers.

Union Discount feel that Professor Alan Walters' visit to them on Tuesday was a very worthwhile exercise. Barclays told me yesterday that first indications of their lending in banking February reveal a drop of around £50 mn. which on the revised seasonal adjustment figure, might indicate a less-than-satisfactory outcome as far as the lending component in M3 is concerned.

Gillett Brothers' results for their year ended 31 January were announced yesterday and have been well received.

[initials]

Money Markets Division (HO-G)
26 February 1981

M T R Smith (4710)