VICED ADDITIONALLY ON COMMENTS.

SB already. Lo...d - file (GA comments)

CONFIDENTIAL

11. 6.81

MR COLEBY
THE DEPUTY GOVERNOR'S PRIVATE SECRETARY

Copies to Mr Ffordes
Mr George
Mr Gill
Mr Byatt
Mr Latter
Mr Foot
Mrs Drummond
GPS

11/6.

Mr. Sijmik DS

Regarding yr last para: does this mean that the bills won't be renewed on maturity or that the 'line' won't be repeated when it expires?
And do acceptors generally know our views about foreign inland finance paper?

MONEY MARKETS IN WEEK ENDED 10 JUNE

General Features

Quite a turn-round from this time last week with the sharp fall in the £ against the $ feeding through in no uncertain way to the sterling money markets. With the Bank declining to offer the discount market any assurance about the level of interest rates here, they responded to the situation by marking bill rates higher, and tendering for Treasury Bills at 1% above the previous week's rate. Expectations of an upward move in MLR were inevitably raised and although most felt that the movements in the exchange rate and £ interest rates were overdone, the discount houses were, of course, forced to consider all possible situations/scenarios.

The subsequent recovery yesterday stemmed primarily from the relative stability of the £ this week, assisted by the announcement of better-than-expected money supply figures on Tuesday. Although it would be wrong to record overall market reaction as other than neutral, the figures undoubtedly contributed to a steadying of sentiment and helped to pave the way for an easier tone yesterday. Nevertheless, having seen rates move up a point or so and then come back by 1/2 point, the market remains nervous about the implications of the lower exchange rate against the $ for the future course of interest rates here. In the present climate no one is looking for a further downward movement in MLR and there are worries that the Government's efforts to reduce inflation have been seriously blown off-course.

Daily Money Conditions

These have continued to be comfortable because of the surplus liquidity in the system, and in the last week we have sold £500 mn. in short

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(10 and 12 day) Treasury Bills to mop-up surpluses. Some £200 mn. of that figure have gone to banks.

The overnight and week inter-bank rates have reflected these surpluses conditions and houses have been able to pick up a lot of overnight money at rates below 10%. With longer rates hit by the drop in £, there was, early this week, a steeply rising yield curve with a gap of 1 1/2% between the 1-week and 1-month inter-bank rate. While this gap has narrowed in the last day, it will be interesting to see how the very short rates respond to the shortage of £350 mn today, £85 mn. of which was 'created' by excess mopping-up yesterday.

Treasury Bill Tender

With the lack of assurance on interest rates here and a falling pound last Friday morning, the discount houses submitted a joint-agreed bid some 24 1/2p lower than the previous week's pro rata price. As only one outside bank tendered (for £7.5 mn.) and was accepted, the houses obtained 93% of the bills, their price producing a rise of 1% in the average rate of discount (tenders for local authority bills last Friday and Monday this week produced a rate 1/4% higher than the Treasury Bill rate - an unusually large differential).

It is difficult to forecast the outcome this week - much will depend on what happens to sterling in the next 24 hours and on the underlying sentiment.

Houses' Reactions

The discount houses have reacted in varying ways to the events of the last week. It has been a new experience for them as we follow a policy of allowing market forces to determine rates. A natural reaction to sell their longer assets has been frustrated by the easy money conditions and while at least 2 houses have reduced their gilt holdings, others have decided to stick it out while taking every opportunity to shorten their books. Generally speaking, however, books are currently pretty full.

Other Points

Three months' bank bill rates rose by 1% (in line with the outcome of the tender) between last Wednesday and Tuesday this week, but yesterday's recovery reduced the rise over the week to 3/8%, while one-month bank bills have actually eased by 1/8% over the same period.

A £100 mn. acceptance credit line drawn by Credit Foncier of France was sold into the market on Tuesday (at the top of the market!) - we have told the acceptor concerned that we would not expect these bills (covering 'foreign inland finance') to be a permanent feature, but have agreed to temporary financing by this means.

MTRS

Money Markets Division (HO-G)
11 June 1981

M T R Smith (4710)