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MONEY MARKETS DURING WEEK ENDED 7 OCTOBER

General Features

Quite an eventful week, with base rates rising in nervous conditions by another 2% last Thursday and then a marked turn-round in sentiment and trading in the last 3 days. The view in the market has been that the authorities were content to see base rates at 16% and that the Bank's subsequent market operations have lent weight to this. The hope that the rate structure will stabilise at this level, plus the steadier behaviour of sterling in the foreign exchange markets, has helped domestic rates and there has been a much heavier level of trading (in periods up to 2 years) over the last 3 days. The 2% rise in £M3 appeared to have little effect on market sentiment, perhaps because the increase in Clearing Bank lending was down on last month's increase, but, in any event, had been, to some extent, discounted. Nevertheless, there are inevitably those in the market who are still hesitant and do not expect interest rates to show much change before the end of the year; moreover, they see little hope of the Government getting back into its target range of money supply growth as a result of recent increases.

The downward movement in rates over the last week has been quite marked (especially in the last 24 hours) with the 1-month rate down by 3/8%, the 3-month rate down by nearly 3/4% and the 1-year rate down by 1/2%. There are incipient signs of a reverse yield curve developing again.

Daily Money Conditions

In general, these have been quite comfortable with VAT rebates continuing. On two days open-market operations were unnecessary but renewed sales of gilts on Monday contributed to a shortage of just

over £300 mn on Tuesday. Our operations that day consisted of buying bills in both Band 1 and Band 2, thereby 'influencing' market rates up to 1 month, and of buying bills for resale to the market today. On Monday, purchases totalling £123 mn were all in Band 1 (maturing in 14 days or less).

The daily forecasts continue to be difficult with the flow of VAT rebates and the resultant problems of planning ahead. Nevertheless, this week has been less unpredictable than last week so far.

#### Treasury Bill Tenders

The Friday tender produced an outturn of a discount rate of 16% (a yield of 16 5/8%), the discount houses obtaining 88% of the £100 mn bills on offer. The reluctance to buy 3-month paper, following the upheaval in interest rates over the week, was the main reason for the rise in the rate, but with the relatively sudden turn-round in sentiment, houses are now finding 3-month paper attractive - and a market for these bills. As a result, I expect Friday's tender to result in a fall in the rate of discount - on present market indications to 15 5/8% (a pro rata price of around £96.10).

Another issue of special (in this case 3 1/2 week) Treasury Bills took place this week with only £100 mn of the original £300 mn on offer being allotted (because of developments in the gilt market which was taking money out of the market yesterday). The discount houses again showed little appetite for the bills, partly, it was said, because they were now looking for longer paper and partly because they regarded these bills as less liquid. As a result their bids ranged from 16% up to 16 1/2% although as a result of the cutting of the tender, the pro rata rate was 16 1/8%.

#### Other Points

It is likely that as a result of the difficult market conditions over the last 3 months and also as a result of some sizeable gilt holdings, the resources of the discount houses will have fallen by some 8 or 9% since end-June. Three houses will account for the major part of the fall.

*WRS*  
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(Ho-G)