File

I am not putting in Banks paper.

AT
10/1

10 DOWNING STREET

JR

Bank's paper on gilts

Your doubts on the Bank's paper may be valid, but I wondered whether it is right to use the Prime Ministers name to raise them. These are not issues on which she has, or can be expected to have, clearly worked out views.

Can you feed in your comments directly?

AT
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AT

I am happy to raise them myself. My paper would be a useful antidote if you are putting in the Banks paper

JR

9 January 1985

MR TURNBULL

The Bank's paper on gilt dealing reveals some problems.

1. The Bank intends to monitor solvency. Markets will be fast-moving and gilt traders will take positions many times larger than their capital. Will this monitoring be more successful than banking supervision (eg JMB)? Does it imply Government underpinning if grave errors are made?

2. How will market-makers feel having to report their daily positions only to the Bank, which in another capacity is the principal seller of stock to the market? The Bank not only retains but strengthens its position as privileged insider.

3. Liquidity in a market "will be supported by the primary obligation that market-makers will be required to accept, ie 'to make, on demand and in any trading conditions, continuous and effective two-way prices'".

   Market liquidity comes from the aggregate capital ventured in the market, coupled with the opportunity for profit which will determine how much a business is prepared to put at risk over and above its capital base. Liquidity itself can never come from an obligation. How is it to be enforced? How wide a spread on prices are people allowed? If it was effective, wouldn't it conflict with the need for prudence and profit?

Maybe we should raise doubts about these issues now. In practice, market liquidity will increase as more entrants bring more capital to bear - and the provisions for more price information and time-stamping of contracts are excellent. The only guarantee against bankruptcy of a market-maker is good management. Monitoring overnight positions may be too late or too difficult to interpret.

John Redwood

JOHN REDWOOD