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Developments in the British Money Markets

by Michael J. Artis, London *

Perhaps the most striking recent change in the United Kingdom's monetary system has been the extraordinary growth in its money markets. In the standard text-book exposition of the monetary system, it has been customary to define as the money market the establishments which make up the London Discount Market. These discount houses, with their uniquely privileged access to the Bank of England for "last resort" loans, alone performed the essential tasks of money market institutions: they provided the outlet for temporarily surplus banking funds, and provided a mechanism for clearing temporary inter-bank imbalances. In addition to this, they made a market in bills and, latterly, in short-dated government bonds.

Structure of the Markets

The discount houses are still making the market in bills and bonds; and they still retain their unique relation with the Bank of England. But they are no longer the only, nor predominant outlet for surplus banking funds. There is quite a large number of reasons for the growth of these new "parallel" money markets. The credit restrictions by the monetary authorities have been one factor, the cartel of practices of the clearing banks another; government policy with respect to the finance of local authorities and the treasury bill debt is yet a third; and a fourth factor, of very considerable importance, has been the growth of the Euro-dollar market in London, with all that this has implied by way of the influx of foreign (particularly American) banks, and the growth of those banks most closely associated with Euro-dollar dealings.

The Discount Market

Table 1 gives some figures pertaining to the London Discount Market. They make very clear the increased dependence of the market on receipt of funds from the clearing banks; the share supplied by other banks and non-bank sources has fallen quite heavily over the period shown in the table. Indeed, the absolute amounts of funds supplied by non-clearing bank sources to the dis-

count market have been virtually static; and the discount market has been dependent for its growth on the relatively slow growing volume of lending from the clearing banks. Three factors which have particularly inhibited the discount market's growth have been the authorities' restrictions on lending by way of commercial bills (despite which the share of assets held in this form has continued to grow), the restriction of treasury bill finance (although the discount market share of outstanding treasury bills has tended to rise), and the inability of the discount houses to offer rates for short-term money which are sufficiently competitive. This partly arises from a wish not to compete too strongly with the clearing banks' deposit-gathering activities; and as the clearing banks for their part continue to value the discount market mechanism, and have carried on lending to the market whilst restricting their activity in the new money markets, the discount houses have struck a bargain which has sustained their existence, even if it has not offered them a rapid growth.

All the money markets are closely related; the proportion of assets invested by the discount market outside the traditional media of treasury, commercial bills and government bonds has grown. This fast-growing residual category of discount house lending includes lending to local authorities and to the inter-bank market.

Table 1
The London Discount Market:
borrowed funds by source

End-year	Borrowed funds			
	Total (£ mn)	Percentage ^{a)} supplied by:		
		London Clearing Banks	Other banks	Other sources
1961	1,016	55	29	13
1963	1,232	56	31	13
1965	1,381	62	28	8
1967	1,662	56	21	7
1968	1,573	72	20	8

Source: CSO, Financial Statistics.

a) Figures are rounded and exclude borrowing from the Bank of England.

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The Local Authority Market

The growth of local authority paper as a money market medium owes its origins to administrative decisions by the central government to limit the access of local authorities (the municipalities and county governments) to the Public Works Loans Board (PWLB) for finance. In response to these decisions, local authorities as far back as 1956 began to cultivate the market in short-term funds as an alternative. The market is now very highly developed: outstanding temporary debt of local authorities amounts to around two thirds of the outstanding value of market treasury bills today; the nature and terms of the debt are very finely varied to suit the requirements of lenders; and broking firms operate freely to match local authority borrowing requirements with those of lenders.

Table 2

Local authority temporary debt and finance houses' deposits: proportion held by banks and other financial institutions

End-year	Local authority temporary debt			Finance houses' deposits		
	Total a) (£ mn)	Percentage held by:		Total (£ mn)	Percentage held by:	
		Banks b)	Other financial institutions		Banks	Other financial institutions
1961	1,079	n.a.	n.a.	337	n.a.	n.a.
1963	1,349	21	10	390	18	8
1965	1,740	22	20	654	16	9
1967	1,888	21	22	597	14	12
1968	1,870	23	22	614	18	15

Source: CSO, Financial Statistics.

a) Excluding inter-authority debt.

b) Excluding overdrafts.

Table 2 shows that approximately two fifths to one half of the local authorities' temporary debt¹ is held by banks and other financial institutions in roughly equal amounts. The maturity structure of this debt has been gradually shortening, with over three quarters of the debt being at up to only seven days' notice by the end of 1968.

The restraint exercised over the growth of treasury bill finance has to a large extent been associated with the large increase in short local authority paper; and the market indeed regards the credit standing of the authorities issuing this paper as almost as good as that of the central government. The displacement of treasury bill finance by short-term authority loans has, however, had the side effect of displacing the discount market's position in some degree; for the discount market is able to exercise a certain monopoly power with respect to treasury bill purchases which it does not have in the case of local authority loans. Although the switch in local authority financing

has been deliberately created by the authorities, the latter are not oblivious of the dangers of an over-extended position being created. The future expansion of the market is consequently likely to be less vigorous than it has been in the past.

The Finance Houses

The hire purchase finance houses are another set of institutions which offer liabilities short—and sound—enough to qualify for use as money market media. Quite a large number of these companies—which are heavily engaged in industrial and consumer hire purchase—are associated with clearing banks, either as wholly or partly owned subsidiaries. This association serves to underwrite the reputation of the paper they issue, since there is a tendency to believe that no clearing bank could afford to allow an important subsidiary or associate to founder. At the same time the clearing bank connection can often be a material factor in guiding funds to the affiliated finance houses. The clearing banks continue to operate a cartel agreement on the type of deposit obligation they are prepared to offer, and the rate of interest they will give; but they guide large customers to the doors of their finance house (or other) subsidiaries which operate outside the cartel agreement. The main deposit-holders with finance houses are in fact industrial and commercial companies; but as Table 2 shows, banks and other financial institutions together hold up to 30 p.c. of the deposit obligations. The growth of the market has been hobbled by the restrictions placed by the monetary authorities on the finance houses' expansion of assets, in the form of the credit ceiling and statutory regulation of hire purchase terms; when these are removed or relaxed, the market will no doubt resume a faster rate of expansion.

The Inter-bank Market

The markets already discussed act as money markets in an indirect sense. The institutions concerned—the discount houses, local authorities, and finance houses—offer liquid liabilities of which a large proportion is held by banks and financial institutions. As the distribution of excess supplies of funds changes, the liquid liabilities change hands, a process facilitated by the activities of firms of brokers, or other institutions acting as brokers. The inter-bank market functions in a direct manner; in this market, banks lend and borrow directly from each other; temporary surpluses lead the banks holding them to offer short loans to other banks experiencing temporary shortages. This contrasts with the indirect mechanism traditionally offered by the discount market and now by the local authority and finance house deposit markets. As tradition has dictated, the

¹ That is, debt of up to 12 months' maturity.

clearing banks remain aloof from the inter-bank market, at least so far as borrowing from it is concerned. There may well be doubts about the potential durability of this convention; but what action the clearing banks will take will obviously depend upon their evaluation of the worth to them of the discount market mechanism.

Accurate numbers concerning the size of the inter-bank market are hard to come by. The official statistics for the non-clearing and non-Scottish banks include a record of "balances held with other UK banks" in sterling (as well as in foreign currency) which might be thought to provide some measure of the growth of the market. (The figures do, however, also include normal working balances held at, for example, the clearing banks). By the end of 1968, (sterling) balances held with other UK banks by the accepting houses, overseas and other banks (i.e. excluding the Clearing Scottish and Northern Ireland banks) totalled £1,123 mn, against \$421 mn at the end of 1965. Independent "market source" estimates of the size of the inter-bank market have been put much higher than this²; and it is in any case difficult to disentangle this market from that in Euro-dollars. Balances with other UK banks denominated in foreign currencies are larger than sterling-denominated balances (Table 3), the total reaching nearly £3,000 mn at the end of 1968. The range of possible figures is large; but the suggestion is that at a minimum the new direct inter-bank market—either by 1965, or at least by the end of 1968—was challenging the discount market in size, and on the upper estimates may well have exceeded it substantially by the later date.

Table 3
Accepting houses, overseas and other^{a)} banks:
balances with other UK banks

End-year	Balances with other UK banks			
	Total (£ mn)		As percentage of gross deposits	
	Sterling	Foreign currency	Sterling	Foreign currency
1962 ^{b)}	458		15	
1963	640		17	
1965	431	629	8	11
1967 ^{c)}	760	1,475	8	15
1968 ^{c)}	1,123	1,848	8	14

Source: CSO, Financial Statistics.

a) Excluding London Clearing, Scottish and Northern Ireland banks; b) Figures for end-1961 comparable with those given in other tables are not available; c) Figures for 1967 and 1968 affected by devaluation and the inclusion of new contributors.

The Euro-dollar Market

The activities of the Euro-dollar market can hardly be separated from a discussion of money markets. For one thing, it is the Euro-dollar market which

has stimulated the growth of the non-clearing banks and it is these banks, in turn, which have so largely promoted the growth in the new money markets already described. Secondly, through the foreign exchange market, Euro-dollars can be converted to sterling for investment in the local authority, inter-bank and finance house markets. Thirdly, there is a substantial volume of inter-bank on-lending of Euro-dollars and these balances are a source of liquidity for limited purposes to the lending banks. Foreign currency balances can be readily exchanged into sterling, although the exchange control regulations inhibit the reverse operation.

The factors giving rise to the Euro-dollar market are familiar enough: the United States payments deficits have provided the dollars, and the US capital investment and interest rate restrictions have provided an ample incentive for their use. Most of the main banking groups are involved in the business; particularly active dealers are the American banks in London, whose representation has grown explosively in the last few years. By the end of 1968, the total foreign currency claims on UK banks had reached the staggering figure of over £7,000 mn with a virtually matching amount of foreign currency claims.

The structure of money market rates exemplifies differences in risk, in average term, and in competitive pressure; the call money rate of the discount market shows the effect of cartelistic arrangements between that market and the clearing banks and so tends to stand below the level of other money market rates. Local authority rates tend to be slightly below finance house and inter-bank rates, partly for reasons of risk; and in the same way they tend to stand somewhat above treasury bill rates. Inter-bank rates are on the whole the most prone to fluctuation as they reflect most closely the day-to-day shifts in the demand/supply situation whilst it is the Euro-dollar rates which exhibit the greatest sensitivity to overseas movements in interest rates.

The quickly-changing money market scene owes much to the fast growth of banks outside the

Table 4
Lending to the discount market^{a)}

	1961	1963	1964	1965	1966	1967	1968
Total (£ mn):							
Clearing banks	590	579	671	780	852	1,001	1,044
Other banks ^{b)}	242	264	246	248	198	210	182
As p.c. of gross deposits: ^{c)}							
Clearing banks	7	7	7	8	9	10	10
Other banks	8	7	5	4	3	2	1

Source: CSO, Financial Statistics.

a) Figures are as at end-year, on varying dates in December;

b) All other banks excluding Scottish and Northern Ireland banks;

c) Percentage figures rounded.

traditional clearing bank system. These banks have different traditions and more flexible patterns of behaviour, and it is these together with their fast rate of growth which have supported the expansion of the new money markets.

Table 4 shows the differences between the fast-growing banks and the clearing banks in the proportion of their funds lent to the discount market. It includes quite clearly the growing unpopularity of discount market lending in the portfolios of the non-clearing banks. Whereas the clearing banks have tended to step up the proportion of their gross deposits invested in discount market call money loans, the other banks have systematically and substantially reduced theirs. Had these fast-growing banks maintained their original portfolio preferences, their lending to the discount market would have been some eight times as great, by the end of 1968, as in fact it was. And it would then have been considerably more than the clearing banks' total lending to the market, despite the fact that the latter have increased the proportion of the assets they invest in this way.

Finally, Table 5 shows the proportion of the portfolio of the fast-growing banks devoted to other short-term investments, where these can be distinguished. The figures indicate that the fall in the proportion of funds lent to the discount market has been partially offset by a rise in the proportion of funds invested in alternative ways. Unfortunately the figures are not good enough to allow a precise breakdown. However, it can be seen that, proportionately, lending to local authorities has remained fairly constant over the period (absolutely, it has risen strongly from about £290 mn at the end of 1962 to about £1,100 mn at the end of 1968), lending to the discount market has fallen (pace Table 4, both proportionately and absolutely) whilst lending of a residual mixed category has increased strongly. The mixed category includes balances with other UK banks (both in sterling and in foreign currencies) and, as well, call money other than that lent to the discount

market. It thus incorporates the inter-bank market, and elements of the finance houses' market, as well as figures relating to working balances, on-lending of Euro-dollar deposits and miscellaneous loans to bullion dealers, money brokers and other establishments. The growth of this part of banks' portfolios is quite striking.

Table 5

Accepting houses, overseas, and other ^{a)} banks: selected "money markets" lending in proportion to gross deposits

End-year	"Money market" lending			
	Total (£ mn)	Type, by percentage of gross deposits		
		Discount market	Local authority debt	Call money ^{b)} and balances with other UK banks
1962	1,027	8	10	16
1963	1,258	7	9	18
1964	1,524	5	10	18
1965	1,897	4	10	19
1966	2,114	3	8	20
1967	3,215	2	8	24
1968	4,330	1	8	22

Source: CSO, Financial Statistics.

a) Other than London Clearing, Scottish and Northern Ireland banks; b) Other than to the discount market.

Because of the rather imprecise statistics, and the inherent nature of the money markets, intertwined as their operations are, it is not easy to give precise figures of their size. However, by the end of 1968, discount market borrowing from banks was just under £1,500 mn; bank-held finance house deposits topped £100 mn, and bank holdings of local authority debt had reached over £400 mn. Estimates of the inter-bank market vary; the pool was certainly more than £1,000 mn in size and may have been very considerably more. The Euro-dollar market, as a whole, was worth some £7,000 mn; and banks' holdings of balances with other banks in foreign currency denomination exceeded £1,800 mn. The chances are good that the growth of the new money markets will continue to exceed that of the traditional discount market.



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