Financial review

Introduction

The review describes developments in various markets, mainly in the period November to January.

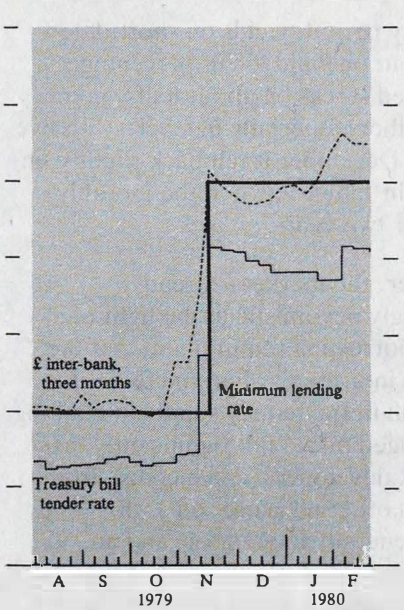
The Bank's minimum lending rate (MLR) was raised to 17% on 15th November and was then unchanged for the rest of the period. There was considerable tightness in the money market in mid-January, caused principally by very heavy official sales of gilt-edged stocks and by seasonal tax payments. The Bank helped to moderate these excessive liquidity pressures by releasing special deposits and (in mid-February) by offering temporary facilities for the purchase of gilt-edged stocks from the clearing banks, for resale in March.

On the foreign exchange markets (page 24), sterling recovered strongly from the fall which followed the lifting of exchange control restrictions in late October.

The review contains the usual sections on international banking and the euro-currency markets (page 28), oil money movements (page 31) and the commodity markets (page 31).

Money markets

Short-term interest rates in London



In early November there was general concern about the buoyancy of monetary growth, and this was reflected in higher interest rates. By mid-month, some increase in MLR—which had been raised to 14% in June—was already being discounted. In the event, the increase to 17%, announced on 15th November,[1] was larger than had generally been expected. After an initial adjustment to the new level, the market was encouraged by the volume of official sales of gilt-edged stocks and rates eased slightly. Hopes for an early cut in MLR intensified, and by the end of the month three-month rates had declined by about ½%.

For most of December, conditions in the market were reasonably comfortable. Three-month rates remained initially at the levels established at the end of November, but later rose because of fears about the effect of a strike in the steel industry. Shorter rates likewise remained easier until the final week of the month, when there was some tightening as various tax payments fell due.

In January the money market came under greater pressure. Although rates eased slightly in the first week, they later moved up sharply as payments of tax and settlements of purchases of gilt-edged stocks drained funds from the market. The increase in shorter rates was particularly marked, and by the middle of the month the negative differential between one-month and twelve-month rates had widened to about 2½%, compared with about 1¼% in mid-December. Rates reached a peak on 22nd January, with the seven-day inter-bank rate exceeding 20%.

[1] See the December 1979 *Bulletin*, page 372.

The authorities acted to moderate the pressure in the market by temporarily releasing special deposits. The rate of call from banks and deposit-taking finance houses was reduced from 2% of eligible liabilities to nil with effect from 16th January, to be restored to 1% on 8th February and to 2% on 7th March. (These recalls were later postponed to 8th April and 14th May respectively.) As part of the same operation, some £175 million of short-dated gilt-edged stocks were bought by the Bank from the clearing banks for later resale to them.[1]

The Bank also provided substantial assistance during the period as a whole by purchasing Treasury and local authority bills (some for subsequent resale) and, on a few occasions, commercial bills (all for resale), and by lending at MLR overnight or for short periods. On a few occasions, mainly in late November, early December and around the end of the year, the Bank sold Treasury bills to absorb surplus funds.

The pressure on the money markets continued throughout the first half of February, and the Bank announced on 13th February that it would, exceptionally, make available to the London and Scottish clearing banks temporary facilities for the purchase (on 15th February) and resale (on 13th March) of gilt-edged stocks at MLR. The facilities were for amounts of up to $1\frac{1}{2}$% of each bank's eligible liabilities and totalled some £500 million.

At the beginning of November, clearing bank base rates stood at 14%. On 13th November, one bank increased its base rate to $15\frac{1}{2}$%, but following the rise in MLR all the banks raised their base rates to 17%. Over the same period, their seven-day deposit rates were raised from $11\frac{1}{2}$%–12% to 15%.

Capital markets

The gilt-edged market

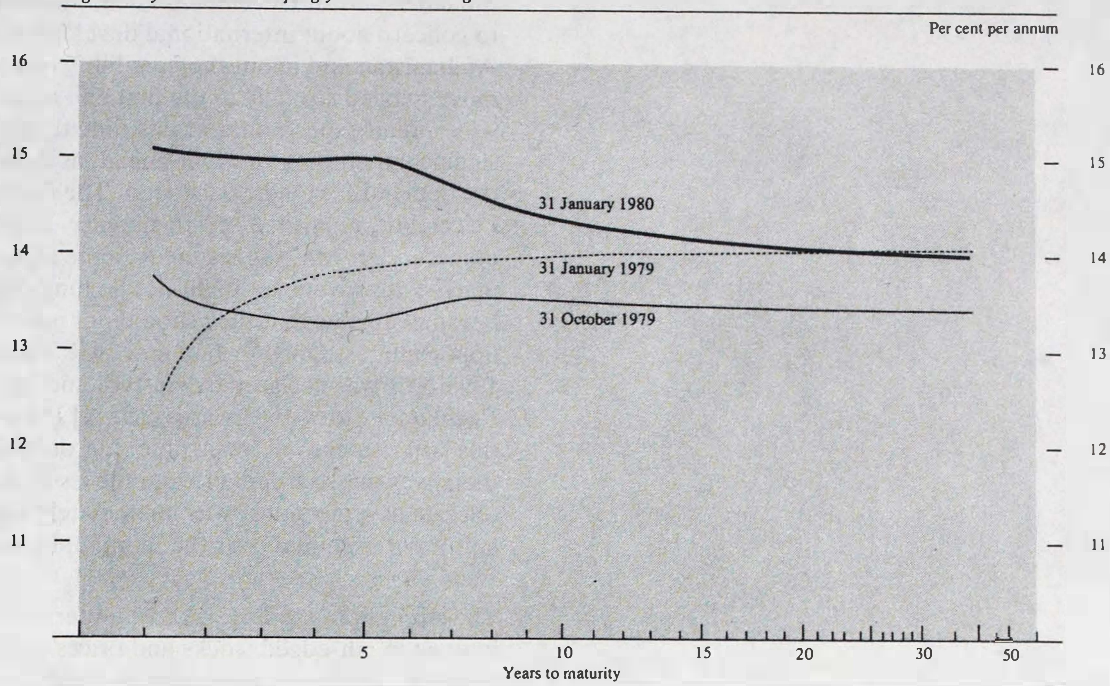
During the November/January period, yields on short-dated stocks rose on balance by about one and a half percentage points, and those on long-dated stocks by about half a point. Turnover increased in November, especially in stocks with five or more years to maturity; in December it fell back slightly on all maturities, but rose again in January, when the monthly figure was the highest for over two years.

At the beginning of November, the market—already depressed—became increasingly pessimistic in the light of a high projected public sector borrowing requirement and the publication of statistics which indicated a sharp increase in bank lending and rapid growth in the money supply in banking October. Accordingly, gilt-edged prices fell significantly, as expectations of a rise in MLR developed. The increase from 14% to 17%, announced with other measures on 15th November, was larger than generally looked for, and an immediate demand for stock emerged. By the end of that day, the second tranche of 12% Exchequer Stock 1999/2002 had been withdrawn as a tap stock and remaining supplies of $11\frac{1}{2}$% Treasury Stock 1989 had been exhausted. In order to meet the strong demand for stock, a second tranche of $13\frac{3}{4}$% Treasury Stock 2000/2003 was created; this was, unusually, placed with the Issue Department of the Bank so that it could be made

[1] Operations of this kind are now customary when, in consequence of the release of a proportion of special deposits to the clearing banks in August 1978 (see the additional notes to Table 4 in the statistical annex), the full benefit of a reduction in the rate of call for special deposits is not otherwise available to these banks.

Time/yield curves of British government stocks[a]

A generally downward-sloping yield curve emerged.



[a] The lines measure the nominal rate of interest which a stock at each maturity should bear if issued at par. The curve runs from the shortest-dated stock with a life of more than one year to the longest-dated stock. A revision to the construction of these curves was described in the June 1976 *Bulletin* (page 212). The relevant program is available from the Bank at the address given on the reverse of the contents page.

available in the market on the 16th. The full amount of £1,000 million was sold on that day and an issue of 15% Treasury Stock 1985 was announced.[1] With the Government's funding programme reactivated, prices rebounded sharply. The market's optimism was, however, tempered by fresh fears about the level of wage settlements. By the time of issue on 22nd November, the price of the new stock was out of line with the market, and initial applications were small.

On 23rd November, a long-dated stock issue, £1,000 million of 14% Treasury Stock 1998/2001,[2] was announced. Following this, prices became firm enough to allow the medium-dated tap stock, 15% Treasury Stock 1985, to be sold. But by the time 14% Treasury Stock was issued (on 28th November) prices had declined sufficiently to make the stock expensive, and applications were again small. The market continued to drift down as investors became more apprehensive that the November banking figures would be unfavourable, while the continuing unrest in Iran was also a disturbing influence.

On 11th December, the eligible liabilities figures and the balance sheets of the London clearing banks for mid-November were published. Although these statistics suggested a disappointingly sharp increase in bank lending, the market appeared to be more impressed by the indication that the rate of monetary growth had slackened. (This view was confirmed on 20th December when the money supply figures for banking November were published.) Gilt-edged prices immediately became more buoyant, and, on the 11th, supplies of 15% Treasury Stock 1985 were exhausted. Confidence was maintained both by the strengthening of sterling and by the Prime Minister's statement, on 14th December, that public expenditure plans for 1980/81 would be revised; as a result the Government Broker was able to sell some of the long-dated tap stock above the issue price.

[1] £800 million of this stock was issued (with a further £200 million reserved for the National Debt Commissioners) at the minimum tender price of £98.50 per cent, payable in full on tender.

[2] On issue on 28th November, allotments were made at the minimum tender price of £95.50 per cent, with £20 per cent payable on tender, £40 on 14th December and £35.50 on 9th January.

The market remained reasonably firm, in quiet trading, during the latter part of December. Then, after a brief setback owing to concern about international developments in Iran and Afghanistan and about the possibility of a steel strike, prices moved ahead strongly in the first half of January. There were widespread expectations at this time that yields would decline significantly during the year ahead, as economic activity and the demand for credit slackened. The banking figures for December, published on 8th January, indicated slower monetary growth, suggesting to some investors that this market improvement might not be long delayed; others then became anxious that they should not miss any possible opportunities. On 10th January, 14% Treasury Stock 1998/2001 was declared exhausted, and on the same day 14% Exchequer Stock 1984 was issued.[1] Initial applications for this latter stock were negligible, but on the following morning there was massive demand and the issue, having begun to operate as a tap stock, was immediately exhausted at a half-point premium over the minimum tender price.

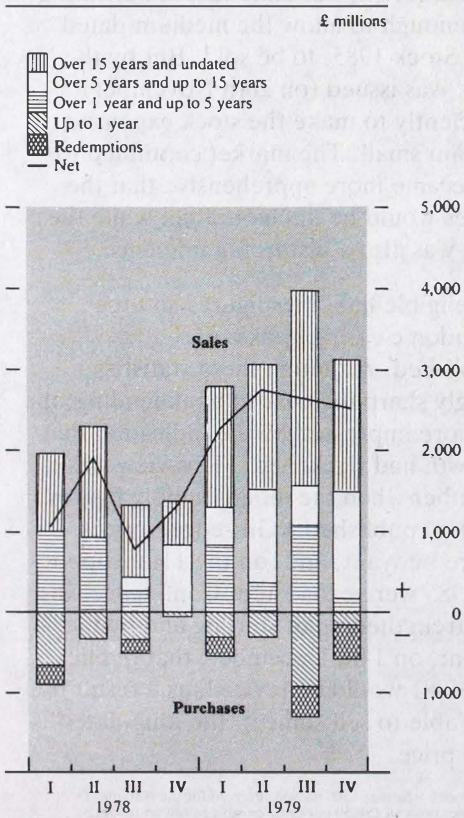
The strength of sterling attracted international and domestic interest in gilt-edged stocks and prices generally continued to improve. There was particular overseas demand for $3\frac{1}{2}$% War Loan. Another feature at this time was the steady demand for low-coupon stocks, which enabled the Government Broker to sell significant amounts of 3% Exchequer Stock 1984 at prices up to £70 per cent. On 18th January, two new partly-paid stocks were announced, £800 million of $13\frac{1}{2}$% Exchequer Stock 1983 and a second tranche of £1,000 million of $12\frac{1}{2}$% Treasury Stock 2003/2005.[2]

By the time these stocks were issued on 23rd January, the market was nervous, influenced by the volatility in the price of gold, and neither stock was fully subscribed. But renewed hope of a fall in interest rates then resulted in strong demand, especially at the longer end of the market; on the following morning the balance of $12\frac{1}{2}$% Treasury Stock 2003/2005 was sold at a one-point premium, as well as sizable amounts of $13\frac{1}{2}$% Exchequer Stock 1983, which then operated as a tap stock. Thereafter, the market reacted as these large stock purchases were digested against a background of acute shortages in the money markets. Nevertheless, at the end of January, yields throughout the maturity range were about one half to three quarters of a percentage point lower than at their peak at the beginning of the New Year.[3]

In the final quarter of 1979, net official sales of stocks amounted to £2,510 million.[4] Sales of long-dated stocks amounted to £1,645 million, of medium-dated to £1,320 million, and of stocks with one to five years to maturity to £160 million. Purchases of stocks within one year of maturity

Official transactions in gilt-edged stocks by maturity[a]

In the December quarter, net sales of stocks by the authorities amounted to £2,510 million.



[a] Components are on occasion too small to be shown separately.

[1] £1,000 million of this stock was issued (with a further £100 million reserved for the National Debt Commissioners), at the minimum tender price of £96.50 per cent, payable in full on application. This stock was issued to contribute to the refinancing of forthcoming maturities, including the next maturity, £1,000 million of 9% Treasury Convertible Stock 1980. The latter stock matured on 3rd March, although it could be converted on that date, at the option of holders, into 9% Conversion Stock 2000 (in accordance with the terms of its prospectus). The Bank ensured that publicity was given to recommendations that holders who were considering the exercise of this option should consult their professional advisers.

[2] For the 1983 stock, allotments were made at the minimum tender price of £96.75 per cent, with £60 per cent payable on tender and £36.75 on 29th February. For the 2003/05 stock, allotments were made at the minimum tender price of £91.50 per cent, with £25 per cent payable on tender, £45 on 15th February and the balance of £21.50 on 14th March.

[3] On 22nd February, the issue was announced of £800 million 14% Treasury Stock 1996. The minimum tender price was £95.50 per cent; £20 per cent was payable on tender, £30 on 18th March and the balance on 11th April.

[4] The figures relate to cash raised, and thus in the case of partly-paid stocks only instalments actually paid are included in the totals.

totalled £180 million. Two stocks matured in the period, 10½% Treasury Stock 1979 and British Electricity 3½% Guaranteed Stock 1976/79, with about £205 million and £180 million respectively in market hands; a further £50 million was paid out for outstanding amounts of stocks which matured in the previous quarter.[1]

National savings

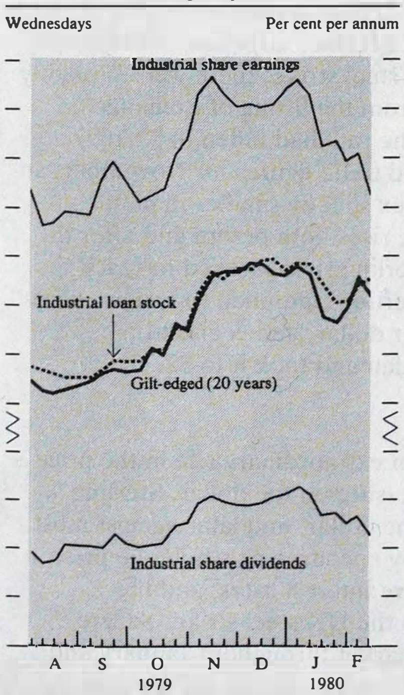
Net receipts from national savings rose from £153 million in the third quarter of 1979 to £207 million in the fourth, but for the year as a whole were substantially lower than in 1978. The recovery reflected substantial sales of index-linked retirement certificates, following the raising (from 3rd December) of the maximum limit on individual holdings from £700 to £1,200. Retirement certificates continued to sell well in the early part of this year, and net receipts were given a further boost by the introduction of the relatively attractive nineteenth issue of national savings certificates on 4th February. The new issue yields a return of 10.33% per annum free of tax, if held for five years, compared with 8.45% for the eighteenth issue. The interest rate on National Savings Bank investment accounts was raised from 12½% to 15% on 1st January.

Other markets

There was only moderate activity in the local authority market during the November to January period. There were no new issues of stock, and over the period as a whole issues of negotiable bonds were again exceeded by redemptions. In January, however, some local authorities increased their issues of bonds ahead of the end of the financial year.

Security yields

Yields on long-dated gilt-edged and on debentures rose on balance during the period.



Turnover in the company debenture market continued to fall. Yields rose by one and a half percentage points during November, remained stable in light trading in December, but fell back by three quarters of a point in January. New issues of loan capital and preference shares exceeded redemptions by £3 million. There were no new debenture issues but gross issues of preference shares totalled £42 million, of which £25 million was by one company.

Prices in the equity market, which had risen slowly from August to mid-October, fell sharply thereafter, and continued to fall in early November. The FT-Actuaries industrial (500) share price index, which stood at 260 at end-October, fell to a nine-month low of 241 on 15th November. In late November and early December the market slowly recovered, taking the index to 254 on 14th December. Thereafter investment uncertainty was fostered by fears about developments in the Middle East and the prospect of a national steel strike, and the index fell back to 241 on 3rd January. There was then a sharp recovery: influenced by strong demand for gilt-edged stocks, turnover increased and prices rose, and at end-January the index stood at 268. The sharp rise in the price of gold had its effect on gold shares. The FT gold mines index, which stood at 202 at end-October, rose to 360 on 18th January and ended the month at 330, a rise of 63% in the three months.

New money raised by issues of equity capital during the period amounted to £105 million, £62 million of which was by one company, Pilkington Brothers Limited.

[1] See the December 1979 *Bulletin*, page 382.

Net sales of unit trust units totalled only £4 million, a decrease of £16 million from the previous three months. Gross sales were £7 million lower at £87 million, while repurchases rose by £9 million to £83 million.

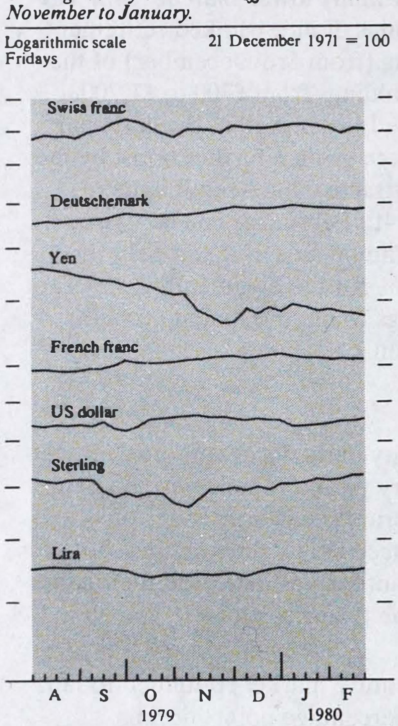
Foreign exchange and gold markets

Summary

Between November and January, events in Iran and Afghanistan were often the dominant influences in the markets, and there was a dramatic increase in the price of gold. The US dollar, though under occasional pressure and losing some ground, showed considerable resilience. Sterling, helped by high interest rates and the increases in oil prices, recovered from the fall which followed the lifting of exchange control restrictions in late October, and rose by over 7% in effective terms. There was a realignment of the currencies in the European Monetary System (EMS) on 30th November, with the Danish krone devalued by some 5% against the other participating currencies. Interest rates continued to rise, except in the United States where they fell on balance from their early-November peak.[1]

Indices of effective exchange rates

Sterling rose by over 7% in effective terms during November to January.



Sterling

After the announcement on 23rd October of the lifting of exchange controls, sterling was under some pressure; on 5th November the rate fell to $2.0645, with the effective rate index (ERI) at 66.1, the lowest since end-April. Thereafter sterling rose fairly steadily, helped by the rise in MLR on 15th November. There was then some adverse reaction both to domestic industrial troubles and to pessimistic official economic forecasts, but a subsequent drop in US interest rates in the last few days of the month and developments in the Middle East led to a recovery, with sterling ending the month at $2.1980 (ERI 69.9).

In early December, however, sterling weakened with sentiment affected by fears of a further large rise in the money supply and the possibility of a steel strike; there were probably also some outflows resulting from the lifting of exchange controls. By 10th December the rate had fallen to $2.1697 (ERI 68.8). But with improved trade figures for November, an increase in the retail price index slightly smaller than in previous months, and oil price rises both before and after the OPEC meeting in Caracas, sterling strengthened to reach $2.2080 on Christmas Eve. Sterling continued to rise as events in Afghanistan led to a weaker dollar, and year-end commercial and professional demand took it to $2.22½ (ERI 70.2) on the 31st.

The New Year opened with an extraordinary rise in the price of gold and a brief spell of pressure on the dollar. Sterling strengthened at first against the dollar, and later against most other currencies, influenced by encouraging wholesale price figures, continuing high relative interest rates, and the expectation of a settlement to the UK steel strike. Severe shortages in the UK money market throughout January and overseas interest in gilt-edged stocks maintained the demand for sterling, which touched $2.29½ in mid-month. Thereafter fears of higher inflation and the prolongation of the steel strike brought the rate back to close the period at $2.2672 (ERI 71.8) against a firmer dollar.

[1] The Federal Reserve discount rate was raised by one percentage point to a record 13% on 15th February.

During the three months, the UK reserves rose by $1.2 billion to $23.7 billion after accruals of public sector borrowing under the exchange cover scheme of $665 million and repayments of $1,075 million. There was a series of transactions with the International Monetary Fund (IMF) in January. The United Kingdom repaid $85 million under the oil facility and $260 million under the 1977 standby, but the latter repayment had no net effect on the UK reserves because it led to a corresponding increase in the UK reserve position in the Fund (which is already included in the UK reserves). The IMF also allocated SDR 305 million ($390 million) to the United Kingdom as part of the three-year disbursement programme. In addition, some 599,000 ounces of gold were restituted by the IMF to the United Kingdom;[1] this produced a valuation gain of some $80 million because since March 1979 gold has been valued in the UK reserves at a price higher than that at which the restitution was made. A valuation gain of $340 million also accrued to the reserves as a result of the renewal in January of the swap with the European Monetary Co-operation Fund of 20% each of the United Kingdom's reserve holdings of gold and US dollars in exchange for European currency units. The gain arose because, following the increase in the price of gold since the previous renewal, the gold component of the new swap was given a higher value than that of the maturing swap.

US dollar

The US dollar, which had strengthened following the monetary measures of 6th October, showed considerable resilience in the face of the various political developments of the three-month period, and although it fell on balance by some 2% in effective terms it needed only occasional support. In November, after the seizure of hostages in Iran, the dollar fell by some 4½% against the deutschemark but rose by a similar amount against the yen, in spite of massive sales of dollars by the Japanese authorities to support their currency. In December, these movements were partly reversed, although oil price increases ahead of the OPEC meeting, a rise in the gold price after a period of relative stability, and some diversification of holdings of US dollars (though probably confined to accruing, rather than existing, dollar reserves) led to some pressure around the middle of December. Events in Afghanistan and the very sharp increase in the price of gold at the start of the New Year also gave rise to a brief period of pressure when the dollar reached 84.0 in effective terms and a record low point against the deutschemark of DM 1.6996. Thereafter the dollar staged a recovery, despite further movements in the gold price and further official sales of dollars in support of individual currencies (particularly by the Scandinavian countries). In addition, it became evident that US economic activity was not slowing down as much or as soon as had been expected. These factors were, however, offset by the improvement in the 1979 US trade balance, and the deterioration in those of Western Germany, Switzerland and Japan, and fears for world peace, which pointed to the United States as a desirable haven for funds. The success of the issue in January of a further tranche of 'Carter' bonds

[1] Prior to 1973, member countries paid about 25% of their quota, or quota increase, in gold. With the aim of reducing the rôle of gold in the international monetary system, it was agreed in 1976 to sell one third (50 million ounces) of the Fund's gold. Of this, half was to be sold ('restituted') directly at the old official price of SDR35 per fine ounce to all members of the Fund as at 31st August 1975 in proportion to their quotas, and the other half was to be sold at public auction for the benefit of developing countries. The final restitution took place in January 1980 and the auctions are scheduled to end in May 1980.

announced in October 1979[1] was also in the dollar's favour and served as a reminder of the determination of the US and West German authorities to maintain orderly markets. The dollar closed the period at 85.1 in effective terms.

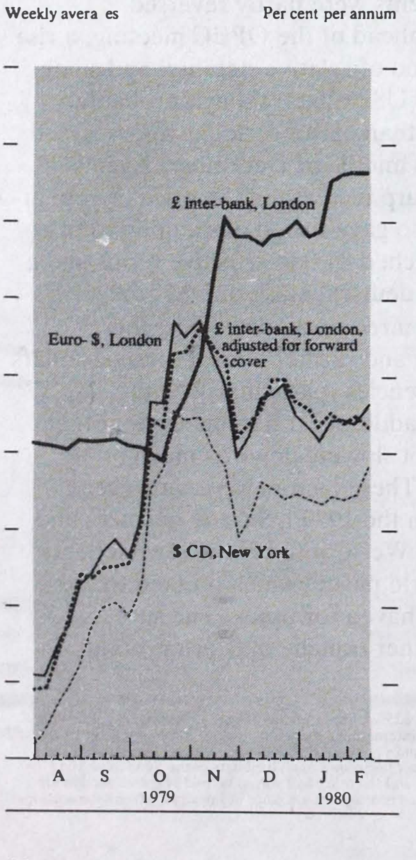
Other currencies

There was a second realignment of currencies in the EMS. In the face of chronic external payments and debt problems, the Danish Government presented stringent measures, including a prices and wages freeze, to parliament, and on 30th November devalued the krone by some 5% against participating currencies. At first, the krone replaced the French franc as the strongest currency; but towards the end of December it fell abruptly to fourth, and later fifth, place, when the austerity package met domestic opposition. The EMS was fully stretched between the Belgian franc (the weakest currency throughout) and the Danish krone at the beginning of December, and between the Belgian and French francs at the end. The Belgian franc was the most divergent of the three, generally over $\frac{3}{4}$% from the next weakest currency (the Irish pound) and sometimes beyond the threshold of divergence. Accordingly, the Belgian authorities raised their bank rate, and the Lombard rate for secured borrowing, to $10\frac{1}{2}$% and $12\frac{1}{2}$% respectively on 13th December, and sold dollars and French francs. The deutschemark, guilder and lira occupied the middle of the $2\frac{1}{4}$% band for most of the period; in each case official discount rates were raised. Sterling's strength contributed to pressure on the Irish pound, and the Irish authorities sold sterling, mainly in order to keep their currency within the $2\frac{1}{4}$% band. The divergence between the two currencies widened to nearly $6\frac{1}{2}$% from just over 1% at the beginning of the period.

Outside the EMS, the Swiss authorities took measures, including the suspension of negative interest commission on non-resident Swiss franc deposits, to prevent too great a movement of the cross rate against the deutschemark, which at one point approached Sw.Fr. $94\frac{1}{2}$ = DM 100. The Swedish krona required substantial support as the current account deficit widened, and the discount rate was raised in two stages to 10%. The Japanese yen was adversely affected by concern over the effect of developments in the Middle East on oil prices and supplies. By the end of November the rate had fallen nearly 6% in effective terms, despite a one percentage point increase in the discount rate (to $6\frac{1}{4}$%) early in that month. It exceeded Y250 against the US dollar on the 26th, and substantial central bank intervention was followed the next day by some relaxation of controls on inflows and the cessation of cheap yen finance for imports. Although these measures led to a strengthening of the yen, the market remained nervous, and the rate oscillated after the middle of December between Y230 and Y240, though without much official support.

UK and US three-month interest rates

UK interest rates rose well above euro-dollar rates, which fell back in the period.



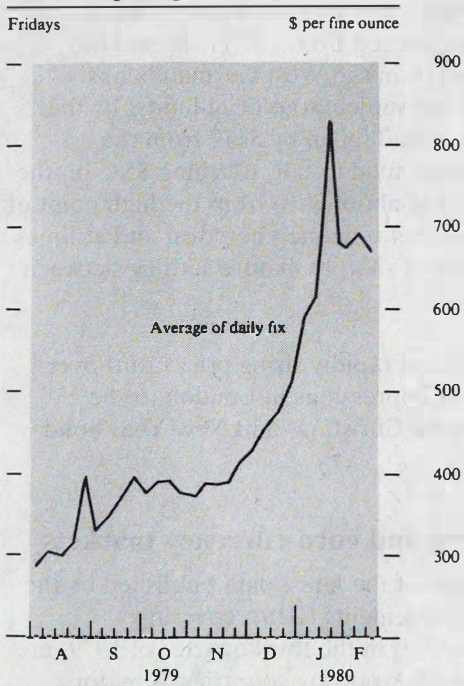
Interest rates and differentials

The three-month euro-dollar interest rate approached 16% in early November but had fallen to 14% by early December; it touched 15% at Christmas but later fell back to around $14\frac{1}{2}$%. A few large US banks raised their prime rates to $15\frac{3}{4}$% in November but in late November and early December reduced them to $15\frac{1}{2}$%–$15\frac{1}{4}$%. By the end of the period, most large

[1] DM 9.5 billion of these bonds (see the March 1979 *Bulletin*, page 25) have so far been issued—DM 3 billion in December 1978; DM 2.5 billion in March 1979; DM 2 billion in November 1979; and DM 2 billion in January 1980.

banks were quoting $15\frac{1}{4}\%$, although some had quoted 15% for a time in January. The three-month sterling inter-bank rate rose to just over 17% after the increase in MLR on 15th November; it then traded mostly between $16\frac{3}{4}\%$–17% until the latter part of January, when tight domestic conditions took it to $17\frac{1}{2}\%$–$17\frac{3}{4}\%$. The discount on three-month forward dollars which had opened up in mid-October disappeared shortly before the MLR increase, and a premium of up to $2\frac{7}{8}\%$ arose at the end of November and the beginning of December. This fell back to $1\frac{3}{4}\%$ before rising in January first to $2\frac{1}{2}\%$, and later to over 3%, as UK domestic rates became firmer. The covered differential remained close to interest-rate parity.

London gold price



Gold

At one time in the period under review the price of gold had more than doubled; most of the increase took place after Christmas, but there was a sharp fall towards the end of January.

The US Treasury's decision in October to vary the amount and timing of future gold auctions (of its 'coin bar' quality gold) was supported on 1st November by an auction of $1\frac{1}{4}$ million ounces, announced at short notice and of nearly twice the previous amount. The price of gold fell in response, being fixed at $372.80 per fine ounce in London on the 2nd, the lowest of the period. It remained depressed for most of November, trading between $380 and $395, little affected by the developing crisis in the Middle East. There was heavy demand, however, at the IMF auction on 5th December when an average price of $426.37 was set. The prospect of higher oil prices following the OPEC meeting in mid-month led to further buying, and gold was fixed in London at a record $494 on the morning of the 19th. Rumours of a US auction to be held in early January led to sales of gold for delivery at the year-end. The enforced closing of these short positions, after a spate of buying following the intervention in Afghanistan had driven gold to around $525 at end-December, took place in a market in which it was reported that all the gold on offer at the IMF monthly auction on 2nd January had been purchased by a small number of European banks (at an average price of $562.85). Accordingly, on the next day the price leapt, first in Hong Kong, and then in London, where it was fixed at $634 in the afternoon, a rise of some 30% in just over a week.

The deterioration in international relations, and the publicity to which the previous price movements had given rise, were evident factors in the subsequent increase. But underlying these were influences relating to the future supply of gold to the market. These included the decision by central bank Governors at the regular monthly meeting in Basle not to intervene in the market by selling gold; the statement by Mr Miller, the US Treasury Secretary, that further US Treasury auctions would be inappropriate for the present; the lack of any announcement by the IMF concerning its regular auctions, due to finish in May;[1] the realisation that South Africa's production, being fairly inflexible, was unlikely to increase, and could even decrease if the higher prices led to any significant move to extract lower grade ores; and reports that Russian sales in the second half of 1979 had been modest. Furthermore, under such conditions existing holders would be reluctant to disinvest. Sources of demand are less easy to

[1] See the footnote on page 25.

discern. Nevertheless, it became clear that only a small shift in the portfolio preference for gold by the major oil-exporting countries (a possible result of the instability in the Middle East) could generate large demand. In such circumstances, the price inevitably became extremely volatile.

On 16th January, the day after Mr Miller's announcement, gold passed the $700 mark to reach $765 at the London morning fix, a rise of $81 from the previous afternoon; and on the 18th, with rumours of Soviet naval movements, it exceeded $800. It was fixed at $850 in the afternoon of the 21st (a new record) but fell back after news that trading in silver futures had been restricted by the New York Commodity Exchange to the liquidation of existing contracts, and that margins against gold and silver contracts had been raised. The fall gathered pace the next day with the announcement of similar measures by the Chicago Board of Trade and the inclusion of precious metals in the West German banks' dealing positions which are subject to official limits; by the afternoon fix in London it had fallen by $112 from the previous afternoon. It continued to fall, touching $585 on the 23rd at one point, a drop of about 30% from the high point of $862 on the 21st. The market remained nervous, and at times the price continued to move sharply, before settling between $650 and $700.

During the recent months of rapidly rising prices, turnover appeared, on the basis of impressions in London, to be substantial, except over the Christmas and New Year holiday period.

International banking and euro-currency markets

The most striking features of the latest data published by the Bank for International Settlements (BIS), covering international bank lending[1] in the third quarter of 1979, are the re-emergence of the oil-exporting countries as major suppliers of funds to the market and the continued high level of borrowing by the non-oil developing countries.

The oil price increases and shorter credit terms announced earlier in 1979 were the major factors behind the increase of nearly $20 billion in deposits by the oil-exporting countries, by far the largest rise in recent quarters. The borrowing by non-oil developing countries ($11 billion in the third quarter) reflected in part their increasing balance of payments difficulties; but their deposits rose by $4 billion, which suggests that these countries were continuing to take advantage of the attractive terms in the market to borrow in excess of their immediate needs.

Latin American countries were again the heaviest borrowers. However, Eastern European countries also appear to have taken advantage of market conditions: as a group, they borrowed just over $3 billion and redeposited almost as much, but transactions by individual countries varied greatly—the USSR was by far the largest depositor of new funds, whereas Poland was the major new borrower. Japan and the United States were major borrowers and also major depositors. In the case of Japan, the growth was particularly marked and led to

[1] See Table 14 in the statistical annex. The figures cover the external business in domestic and foreign currency of banks in the Group of Ten countries, Austria, Denmark, the Republic of Ireland and Switzerland, and of branches of US banks in certain off-shore centres.

net borrowing of $3 billion; the United States supplied $16 billion to the market as high interest rates at home and abroad increased the reserve cost of domestic deposits and enhanced the attractiveness of external deposits, but at the same time a similar volume of reserve-free funds flowed back to the United States from abroad.

Overall, the gross claims of banks in the reporting area increased by $95 billion to $1,042 billion. If inter-bank activity within the area is excluded, the net size of the market is estimated to have grown by $50 billion to $635 billion. Provisional figures for the fourth quarter indicate that the rate of expansion has slowed; some countries may have drawn down deposits instead of borrowing, as the US Government's freeze of official Iranian assets gave rise to some uncertainty in the market.

This decline in the rate of growth was apparent in the London euro-currency market during the fourth quarter. Despite end-year window-dressing, banks' gross foreign currency liabilities rose by only $26 billion, compared with $40 billion in the previous quarter. The figures suggest that there was very little underlying growth, since a large proportion of the increase was accounted for by inter-bank activity, some of which was seasonal. The oil-exporting countries deposited an additional $3 billion, much less than in the previous three months, and all deposited in the first six weeks of the quarter. US non-bank residents increased their deposits in London by $1 billion whereas US banks reduced their holdings by $2 billion; both can probably be explained by interest-rate differentials between the US and other markets.

The largest growth in claims (apart from the increase in inter-bank activity) was in respect of non-oil developing countries, whose indebtedness increased by $2 billion.

There was some repayment of foreign currency borrowing by UK residents from the London market in the third quarter, following the exchange control relaxations on the financing of outward direct investment. After the lifting of all exchange controls in October, there were some repayments of foreign currency borrowing taken to finance overseas portfolio investment, but overall in the fourth quarter foreign currency borrowing in London by UK residents was flat. On the other hand UK residents increased their foreign currency deposits with UK banks by $1 billion in the fourth quarter.

The maturity analysis of the foreign currency positions of UK banks at mid-November shows that when compared with mid-August there was a small reduction in net liabilities at less than eight days, while net liabilities at eight days to one month, and one to three months, increased. This last change was particularly marked and was mirrored by a fall in net liabilities in the three to six months band.

In view of the continuing expansion of the market, it may be more relevant to look at net liability positions as a proportion of total claims. On this basis, there has been no significant change in the banks' short-term positions over the last year. Even over a longer period, the proportionate mismatch in the shortest maturities has varied very little, although there was a clear increase between late-1977 and mid-1978 which has since been reversed.

UK banks' liabilities and assets by customer[a]

$ billions

	1978	1979			
	29 Dec.	30 Mar.	29 June	28 Sept.	31 Dec.
Foreign currency liabilities of UK banks to:					
Other UK banks	62.7	65.0	70.3	78.0	87.5
Other UK residents	9.5	9.5	11.1	10.4	11.5
Overseas central monetary institutions	41.9	48.7	52.3	58.4	61.4
Other banks overseas	139.6	131.6	142.8	162.2	170.0
Other non-residents	33.1	36.2	39.6	46.6	51.0
Other liabilities[b]	2.7	2.6	2.8	2.7	3.3
Total liabilities	**289.5**	**293.6**	**318.9**	**358.3**	**384.7**
Foreign currency assets of UK banks with:					
Other UK banks	62.8	63.4	68.0	76.3	85.1
Other UK residents	21.0	22.1	22.9	22.1	22.1
Banks overseas	149.2	149.4	164.0	190.1	204.3
Other non-residents	54.7	55.8	59.2	64.3	68.1
Other assets[b]	3.8	4.2	5.0	5.5	5.8
Total assets	**291.5**	**294.9**	**319.7**	**358.3**	**385.4**

[a] Figures differ from those in Table 6 in the statistical annex (see additional notes to Tables 12 and 13).

[b] Mainly capital and other internal funds denominated in foreign currencies.

UK banks' liabilities and claims by country or area[a]

$ billions outstanding

Net source of funds to London −/net use of London funds+

	1978	1979			
	29 Dec.	30 Mar.	29 June	28 Sept.	31 Dec.
BIS reporting area:					
European area	− 2.7	− 4.5	− 7.6	− 6.7	− 3.5
Canada	− 1.6	− 1.7	− 0.9	+ 0.4	+ 0.5
Japan	+ 9.6	+ 9.8	+10.9	+11.8	+12.9
United States	−13.8	−12.0	−14.7	−18.9	−15.9
Off-shore banking centres	+ 8.3	+ 9.0	+11.5	+15.9	+14.8
Other Western Europe	+ 0.2	+ 0.7	+ 0.3	− 0.1	+ 1.4
Australia, New Zealand and South Africa	+ 3.3	+ 2.7	+ 2.3	+ 2.5	+ 2.3
Eastern Europe	+ 8.4	+ 8.0	+ 9.0	+ 9.2	+ 8.6
Oil-exporting countries	−16.3	−17.8	−18.3	−24.9	−27.6
Non-oil developing countries	− 1.4	− 1.8	− 0.7	+ 0.6	+ 2.4
Other[b]	− 4.6	− 5.2	− 4.7	− 3.6	− 7.9
Total	**−10.6**	**−12.8**	**−12.9**	**−13.8**	**−12.0**

[a] The breakdown corresponds to that in Table 12 in the statistical annex.

[b] Includes international organisations and certain unallocated items.

Maturity structure of UK banks' net foreign currency position

$ billions; *percentages in italics*

Net liabilities −/net assets+

	1979			
	Mid-Aug.		Mid-Nov.	
Less than 8 days[a]	−17.5 [−13.4]	*31.5*	−17.0 [−12.3]	*28.6*
8 days to less than 3 months	−26.5	*47.8*	−32.0	*53.9*
3 months to less than 1 year	−11.5	*20.7*	−10.4	*17.5*
Net borrowing up to 1 year	−55.5		−59.4	
Net lending at 1 year and over	+52.7		+55.8	
	− 2.8		− 3.6	

[a] Figures in brackets include all holdings of London dollar certificates of deposit regardless of maturity since these may be regarded as immediately realisable assets for the holding bank.

The surplus of the oil-exporting countries in the first half of 1979 was the major influence on the half-yearly BIS maturity analysis for June 1979:[1] its main effect was a reduction in claims on Middle Eastern countries. Elsewhere, the volume of claims continued to increase, particularly on those countries which were already among the larger borrowers—claims on Argentina rose by 58% over the half-year, those on Venezuela by 19% and those on South Korea by 36%, against an average rise of 8%. Claims on China also rose sharply, from $1 billion to over $3 billion. There were no significant changes in the maturity structure of the borrowers' debt.

Medium-term euro-currency credit markets
Medium-term credits announced in the fourth quarter of 1979 totalled $16 billion,[2] some $2½ billion less than in the third quarter. The volume of new credits was buoyant in October (just under $6 billion) and November ($7½ billion), but fell very sharply in December to below $3 billion, reflecting the uncertain state of the markets following the freezing of Iranian assets by US banks. The low volume continued in January ($3 billion) and some major borrowers among the developing countries were largely absent from the market. There was a significant fall in the average size of loan, which was $68 million in December and $60 million in January, compared with $90 million in 1979 as a whole. There were also some indications that terms were starting to move back in favour of lenders: the weighted average term of new credits fell to 8.8 years in December and 8.6 in January compared with 9.5 in the third quarter of 1979, and the spreads[3] on some loans for borrowers from developing countries were higher than they had been on comparable borrowings earlier in 1979.

Foreign and international bond markets
In January and early February prices in the international dollar sector of the market fell substantially—by three or four points in January and then by a further four to five points in the second week of February. This reflected the growing view in the markets that any US recession would only be mild, with a consequent deterioration in the outlook for inflation. Yields rose to record levels, with the average yield on a sample of bonds[4] reaching around 13.15% in mid-February compared with 11.38% at end-December (and 10.42% at the end of September). The increase in the six-month euro-dollar rate over the same period was less marked—from 14.63% at end-December to 15.13% in mid-February—and the inverse yield gap therefore narrowed from 3¼% to 2%. Holders of portfolios financed by short-term borrowing will thus have suffered considerable losses and in this uncertain climate there have been few new issues. Foreign issues in New York and international issues amounted to only $385 million in January, compared with a monthly average in 1979 of $1,060 million.

Yields also rose in the deutschemark sector, but less sharply; the average yield on a sample of bonds increased from 7.47% at end-December to 8.04% in mid-February. This rise reflected the impact of a large volume of new issues

[1] The UK contribution to the half-yearly analysis, which sets out by maturity the claims of banks in the Group of Ten countries, Austria, Denmark, the Republic of Ireland and Switzerland on countries outside this area, appeared as Table 14 in the annex to the December 1979 *Bulletin*.

[2] The Bank of England records medium-term euro-credits with maturities of three years or more on the date of announcement, but such credits are recorded in the BIS data only when they are taken up and only to the extent that they are not replacing maturing debt.

[3] The interest on medium-term euro-currency loans is usually based on the London inter-bank offered rate (LIBOR), which is variable throughout the life of the loan, plus a fixed margin or 'spread'.

[4] The average maturity of the selected bonds is 10.1 years.

announced during January (the dollar-equivalent value of these amounted to $1,340 million compared with a 1979 monthly average of $600 million) and rising yields in the domestic market.

Prices of foreign Swiss franc issues also fell substantially during January, but this had little impact on new issues activity: the dollar-equivalent value of these new issues was $540 million, about the same as the monthly average in 1979. There were clear indications that shorter maturity paper was relatively more popular.

Deployment of oil money[1]

The total deployed cash surplus of the oil-exporting countries for the third quarter of 1979 is estimated to have been $22.5 billion, compared with only $10.7 billion for the whole of the first half of the year (see table). The large mid-year oil price rises led to a marked increase in revenues, and the cash surplus for investment in 1979 as a whole was probably in the region of $50 to $60 billion.

During the third quarter, funds held in the United Kingdom rose by $8.9 billion—the largest quarterly increase since 1974. Most of this was attributable to increases in foreign currency deposits (mainly US dollars). Investment in the United States went up by over $2.0 billion, and there was a substantial, and widely spread, increase of $9.2 billion in bank deposits in other countries. Bilateral lending to less developed countries was little changed from the previous quarter.

The surplus in the fourth quarter reflects continued high oil and gas revenues, most of which have so far been retained in financial assets. Total placements in the United Kingdom were less than half those in the third quarter, mainly because of significantly lower foreign currency deposits.[2] New investment in the United States during the fourth quarter was strong, notwithstanding the American freeze on official Iranian assets, and this brought the total deployment in that country for the year to around $8 billion. It is likely that there were further sizable increases in bank deposits in other countries in the fourth quarter. There may also have been some increase in bilateral lending by oil exporters in the Middle East, including a pick-up in lending to individual nations to help finance their balance of payments deficits.

It is expected that the surplus for investment in 1980 will be at least twice as large as that identified for 1979, possibly in the region of $110 to $120 billion.

Estimated depioyment of oil exporters' surpluses[a]

$ billions

	1977	1978	1979			
	Year	Year	1st qtr	2nd qtr	3rd qtr	4th qtr[b]
United Kingdom						
British government stocks	—	−0.3	0.1	—	0.1	0.2
Treasury bills	−0.2	0.2	0.1	0.3	0.2	−0.6
Sterling deposits	0.3	0.2	0.2	0.1	0.4	0.7
Other sterling investments[c]	0.4	0.1	—	0.2	0.1	0.1
British government foreign currency bonds	0.2	—	—	—	—	—
Foreign currency deposits	3.4	−2.0	1.9	1.4	8.1	3.5
Other foreign currency borrowing	—	—	—	—	—	0.2
	4.1	−1.8	2.3	2.0	8.9	4.1
United States						
Treasury bonds and notes	4.3	−1.6	−1.2	−0.6	0.3	0.4
Treasury bills	−0.8	−0.9	—	0.4	1.0	1.9
Bank deposits	0.4	0.7	−0.7	1.1	0.7	3.0
Other[c]	5.3	3.1	0.3	0.1	0.2	0.8
	9.2	1.3	−1.6	1.0	2.2	6.1
Other countries						
Bank deposits	7.5	5.0	1.7	−0.6	9.2	..
Special bilateral facilities and other investments[c][d]	12.4	8.6	3.7	2.5	2.6	..
	19.9	13.6	5.4	1.9	11.8	..
International organisations	0.3	0.1	−0.2	−0.1	−0.4	0.2
Total	**33.5**	**13.2**	**5.9**	**4.8**	**22.5**	..

.. not available.

[a] This table excludes liabilities arising from net borrowing and inward direct investment and also, on the assets side, changes in credit given for oil exports.

[b] Provisional.

[c] Includes holdings of equities, property, etc.

[d] Includes loans to less developed countries.

Commodity markets

There was continued active trading in futures contracts in London during November to January. For 1979 as a whole, turnover was about 20% higher in volume than in 1978.

The dominant influence in the markets for industrial materials was once again the overspill of speculative pressure from the markets in precious metals. After rising by 90% in the previous three months, silver prices doubled between

[1] For an analysis of the financial flows of oil-exporting countries see page 6. These countries are defined for the purpose of these statistics as the thirteen members of OPEC, plus Bahrain, Brunei, Oman, and Trinidad and Tobago.

[2] See the previous section.

November and January, partly in line with events in the gold markets (see above). But with normal commercial demand for industrial materials (except for rubber) depressed, these pressures have done little more than provide a firmer tone in the markets than might otherwise have been expected and, with some speculators taking physical delivery of stocks, have not solely been confined to futures contracts. For rubber, traders expect consumption to exceed supply this year, and record prices have been paid.

In the terminal markets for foodstuffs, only the price of sugar, which rose by about a third during the November/January period, has shown any marked change; in this case what had earlier appeared to be a temporary market shortage became recognised as a more fundamental change in the world balance of supply and demand.