Operation of monetary policy

This review discusses monetary conditions, as measured by the main monetary aggregates, and events (including official operations) in the main domestic financial markets.

- *The Civil Service dispute obscured underlying monetary conditions and made a difficult background for the conduct of monetary policy operations.*
- *Sentiment in both the money and gilt-edged markets was adversely affected for much of the period by the high level of interest rates in the United States and by the related periodic downward pressure on sterling. Nevertheless, there was a smooth transition to the new arrangements for controlling the money markets.*
- *There was upward pressure on interest rates over the period but the authorities accommodated only a modest increase in the very short rates which they influence.*
- *Sales of government debt, although smaller than the exceptionally high sales made earlier in the year, were well maintained in often difficult conditions. The authorities issued a second index-linked gilt-edged stock and abolished age restrictions on index-linked savings certificates.*
- *New issues of equity accelerated to the highest level since 1975 and there were further innovations in other domestic capital markets.*

The three banking months of June to August,(1) with which this review is principally concerned, were a difficult period for financial markets. At home, the Civil Service dispute severely disrupted the flow of receipts to the Exchequer. This caused greater uncertainty than usual about the day-to-day cash position in the money markets and obscured underlying monetary developments, which became increasingly difficult for both the markets and the authorities to assess. Abroad, the policies of the US authorities resulted in a lengthy period of extremely high dollar interest rates in both the money and capital markets. This affected sentiment in UK markets directly and also led to expectations that the authorities would allow interest rates to rise to protect sterling. These developments provided a disturbed background to the Bank's operations.

(1) Mid-May to mid-August. Unless otherwise stated, all subsequent references are to calendar months.

Monetary aggregates

The principal aim of monetary policy during this period was to influence the rate of monetary expansion, primarily the growth of sterling M_3, in line with the current target of 6%–10% (at an annual rate) between mid-February 1981 and mid-April 1982. But, as soon as the Civil Service dispute began in March, the central government borrowing requirement (CGBR) began to be inflated by large amounts, which became increasingly difficult to estimate the longer the dispute progressed. From the outset, it was also uncertain what proportion of the corresponding improvement in the private sector's finances was being reflected in higher deposits with banks, thus raising the broad monetary aggregates (and also M_1 if funds were left on current account), and how much was being used in ways that would offset the direct expansionary effect of the dispute on money, for example by the repayment of bank loans. It therefore became increasingly difficult to establish the strike-adjusted trend of the money supply after March. During the period under review, the authorities concluded, on the basis of judgments offered by banks and others on the financial effects of the dispute, that the underlying rate of growth of sterling M_3 was likely to have been within the target range.

On a recorded basis, sterling M_3 is provisionally estimated to have risen at an annual rate of 17% in the first six months of the current target period (see Table A). The August figures were inflated, to an unknown extent, by round-tripping; while over the whole six months the Treasury estimate that the dispute may have inflated the CGBR on balance by over £4,500 million. If this estimate is correct (and making an allowance for round-tripping) then, unless under 35% or so of this amount fed through onto bank deposits, the underlying rate of growth of sterling M_3 was below the top of the current target range.

Table A
Growth of the monetary aggregates[a]

Percentage increases (annual rates); *seasonally adjusted*

Banking months	Mar. 80– Feb. 81	Mar. 81– Aug. 81(b)
Wider monetary base	5.8	2.0
M_1	8.7	11.0
Sterling M_3	18.6	16.9
M_3	20.5	25.1
PSL_1	15.3	16.5
PSL_2	13.5	15.0

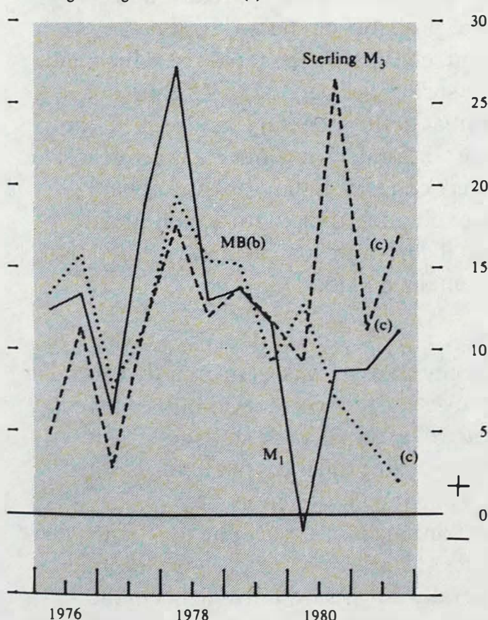
(a) The wider monetary base is defined here as notes and coin in circulation with the public and with banks, plus bankers' balances at the Bank of England (see coloumn 6 of Table 1.2 in the statistical annex). For definitions of the other aggregates, see the notes to Tables 11.1–11.3 in the statistical annex.

(b) Provisional and partly estimated.

Among the other aggregates, PSL_1 and PSL_2 both grew slightly slower than sterling M_3 but total M_3 increased considerably faster.[1] The Civil Service dispute distorted these aggregates as well, though not necessarily to the same extent as sterling M_3. M_1 rose at an annual rate of around 11% but, as it may have been particularly heavily affected by the dispute (it rose by 5% in the first full month of the Civil Servants' action and fell in the month that the dispute was settled), this information gave little additional guidance to the authorities. In contrast, the monetary base, widely defined, grew at an annual rate of only 2%. This was probably the only aggregate not greatly affected by the Civil Service dispute but, as the chart shows, movements in the base over a six-month period have not borne a stable relationship in the last two years or so to concurrent movements in broader aggregates.[2] The slow rate of growth of the base this year, therefore, does not provide a reliable indicator of how broader aggregates would have moved in the absence of the dispute.

Short-term changes in the main monetary aggregates

Percentage change at annual rate(a)



(a) Annualised percentage change over six months to mid-February and mid-August.

(b) Wider monetary base [see footnote (a) to Table A].

(c) Provisional and partly estimated.

The counterparts to sterling M_3

The dominant feature of the counterparts to sterling M_3 in recent months (see Table B) has been the CGBR, swollen by the Civil Service dispute. Indeed, in the first six months of the current target period, the dispute may have roughly doubled the CGBR. The rest of the public sector contributed, by comparison, only a very modest amount directly to the growth of sterling M_3.

(1) The significance of the divergence of total M_3 from the other aggregates is discussed on page 324.

(2) More formal econometric studies in the Bank have confirmed the absence of such a relationship.

Table B
Sterling M_3 and its counterparts

£ millions (rounded); *seasonally adjusted*

Banking months	Mar. 80–Feb. 81 (quarterly average)	Mar. 81–May 81	June 81–Aug. 81(a)
Central government borrowing requirement	+2,600	+4,800	+4,200
of which, effect of Civil Service dispute(b)	—	*+2,600*	*+2,000*
Purchases(–) of central government debt by UK private sector (other than banks)	–2,300	–4,100	–2,600
of which:			
Gilt-edged stocks	*–1,800*	*–2,700*	*–1,900*
National savings	*– 400*	*–1,500*	*– 700*
Other public sector(c)	+ 200	+ 800	– 100
Sterling lending to UK private sector	+2,400	+1,500	+1,900
External and foreign currency factors(d)	—	+ 100	– 300
Non-deposit liabilities (increase–)	– 300	– 100	– 600
Sterling M_3	**+2,600**	**+3,000**	**+2,500**

(a) Provisional and partly estimated.
(b) Based on Treasury estimates.
(c) Direct borrowing by public corporations and local authorities from sources other than the non-bank private sector, less their purchases of central government debt.
(d) Includes bank lending in sterling to overseas.

As Table B also shows, purchases of central government debt by the non-bank private sector in the three months to mid-August were less than the exceptionally high rate in the preceding three months. Even so, the rate of funding in these three months (some £2½ billion) was above the average in the previous target period. Significant receipts came from both gilt-edged stocks and from national savings (see the section below on the funding programme). The authorities at no time thought it appropriate to seek to increase the rate of funding to offset the temporary effect of the dispute on the CGBR. Such a policy would have been possible—if at all—only at sharply higher nominal interest rates on the debt sold and would have meant seeking to fund a short-term temporary increase in the CGBR by sales of long-term debt, leaving the prospect of serious liquidity shortages in the banking system when the effects of the strike were unwound. As it was, debt sales to the non-bank private sector in the first six months of the current target period exceeded the estimated strike-adjusted public sector borrowing requirement (PSBR) by perhaps £1½ billion.[1]

Sterling lending to the private sector was also seemingly heavily affected by the dispute, with the impact naturally concentrated on businesses, whose need to borrow was greatly reduced. At this stage it is impossible to quantify even roughly the possible effect, because lending to the private sector is one of the most difficult counterparts to sterling M_3 to forecast or to interpret. One notable uncertainty in the period under review is the extent to which lending to companies may also have been reduced by the spate of capital issues that began in June. As discussed further below, some £650 million of equity capital was raised by UK public companies in the three months to end-July, by far the highest figure in any three-month period since 1975. In the first instance at least, a significant part of these funds could have been used to reduce bank loans. A second uncertainty is the extent to which the figures for August were inflated by round-tripping in response to the pattern of relative interest rates which developed (see below).

Lending to persons, however, both for house purchase and for other purposes—which was probably unaffected by the dispute—remained buoyant, continuing the rapid rise which had become evident during the spring (see page 323). This did not represent an immediate threat to the monetary target, given the authorities' judgment about the underlying monetary position. The authorities nevertheless were concerned that the total of bank lending to the private sector could be difficult to accommodate within the monetary target if corporate loan demand were to rise while lending to persons remained high.

External and foreign currency transactions were broadly neutral in their effect on sterling M_3 over the first six months of the current target period. In the absence of external trade statistics, it is not possible to distinguish the separate influences of all the various components of the balance of payments on monetary developments. In all three banking months of June to August, there were some official purchases of sterling in the foreign exchange market to smooth the generally downward movements in the exchange rate; but some of the contractionary effects on sterling M_3

(1) The ways in which the 'strike-induced' increase in the PSBR was financed are described in the section on money markets and interest rates below.

were offset, perhaps partly by oil companies' purchases of sterling, some of which will have been from non-residents, in anticipation of tax payments due on 1 September.

Money markets and interest rates

The Civil Service dispute complicated management of the money markets, making it more than usually difficult to forecast the day-by-day cash flows between the market and the Exchequer. The overall effect of the dispute (until it was settled at the end of July) was to add massively to net cash flows to the banking system, thereby contributing to a persistent tendency for overnight and very short-term rates to ease. The initial recovery of delayed government revenue, which began in August (and which was equally difficult to predict day by day), reversed these conditions so that short-term interest rates tended to harden.

With underlying sterling M_3 thought likely to have been within the target range, the Bank sought, through its operations, to maintain reasonable stability in rates at the very short end of the market. In early July, however, the need for some increase in rates was accepted, in the face of a sharp weakening in sterling. Thereafter, technical pressures—mostly for higher rates—were again resisted.

Longer-term money market rates were strongly influenced over the period by the high level of American interest rates and by the resulting expectations that rates in the United Kingdom would have to rise to protect sterling. Early in August, domestic rates fell back again, as sterling stabilised and hopes of a fall in American rates were renewed. However, this proved temporary and, largely because of the prospect of a prolonged period of money market shortages as the effects of the Civil Service dispute unwound, rates rose again towards the end of banking August.

Cash and liquidity

By mid-May, the net effect of the Civil Service dispute had been to delay the payment of perhaps £2,600 million from the banking system to the Government. As a result, the acute cash shortages experienced by the banking system in the first half of March had disappeared and the Bank had drawn some £1,800 million out of the system by running down its portfolio of bills from the record levels reached in March, as can be seen from Table C.

In the three months to mid-August, the dispute may have added a further £2,000 million or so temporarily to the CGBR, despite a significant reflux of revenue after the dispute had ended. The Bank continued to seek to prevent this temporary flow of cash to the market from depressing very short-term interest rates by absorbing cash in various ways. While the dispute continued, the Bank ran down further its holdings of eligible bank bills and of other bills, thereby absorbing cash from the market. For two weeks from mid-July, an additional £100 million a week of cash was drawn out of the market by raising the weekly Treasury bill tender from £100 million to £200 million. Finally, on 24 and 31 July and on 18 August, a total of £1,000 million additional Treasury bills were issued, to mature on 1 September, when over £2,000 million of oil-related taxes were expected.

These measures were chosen in preference to calls for special deposits for two main reasons. First, they seemed more consistent with the objectives announced last November of allowing market

Table C
Influences on the cash position of the banking system

£ millions (rounded); *not seasonally adjusted*
Increase in banks' cash +

Banking months	Jan. 81– Mar. 81	Apr. 81– May 81	June 81– Aug. 81
Money market influences			
CGBR (recorded)	+ 300	+4,900	+4,900
CGBR net of strike effect(a)	*+ 100*	*+2,500*	*+2,900*
All other(b)	−4,100	−3,300	−3,100
Total	−3,800	+1,600	+1,800
Official operations affecting cash			
Sales (−) of eligible bank bills(c)	+2,500	−1,800	− 100
Increased issue (−) of Treasury bills(d)	+1,200	+ 100	−1,400
All other(e)	+ 200	—	− 200
Increase in banks' balances at the Bank	+ 100	− 100	+ 100

(a) Based on Treasury estimates.
(b) Change in note circulation, sales of Government debt, change in the official reserves, etc.
(c) By the Issue and Banking Departments of the Bank.
(d) Including sales of Treasury bills maturing on 1 September and of 'mop-up' bills (see text).
(e) Changes in official holdings of local authority bills, market advances, etc.

forces a greater role, through the bill markets, in the determination of the structure of interest rates. Second, they gave greater flexibility in day-to-day operations both when the cash was withdrawn from the markets and, prospectively, when it was restored. This was because they could be initiated and reversed very quickly—an important consideration given the uncertainty during the Civil Service dispute over the daily cash position of the Government.

By end-July, when the dispute ended, the net effect of the Bank's measures had been to leave the discount market and banks with large holdings of bills which the Bank could buy back as delayed government revenues flowed in.[1] For all this, the underlying shortage of liquidity (which, with the authorities providing liquidity on a large scale, had been readily apparent in March) remained. In part this was a consequence of the funding achieved by the authorities in the previous and the current monetary target periods in seeking to restrain the growth of sterling M_3. In the year to mid-August 1981 net sales of central government debt to UK residents exceeded the strike-adjusted CGBR by about £3 billion (Table D). But for the Civil Service dispute, liquidity would have been drained from the banking system on a large scale. Over the same period, bank lending to the private and overseas sectors grew very rapidly, and the banks' balance sheets expanded correspondingly, implying the need for a significant increase in liquidity.

Table D
The underlying liquidity problem

£ millions; *not seasonally adjusted*

Banking months	Mar. 80– Aug. 80	Sept. 80– Feb. 81	Mar. 81– Aug. 81(a)
CGBR (+) excluding strike effect	+6,675	+5,175	+5,300
Net sales (−) of central government debt to UK residents(b)	−4,825	−6,550	−6,900
Net effect of above operations	**+1,850**	**−1,375**	**−1,600**
Sterling lending to UK private sector and to overseas(c)	**+7,100**	**+3,500**	**+6,400**

(a) Provisional and partly estimated.
(b) Includes sales to the UK banking sytem, as such sales reduce banks' cash as directly as sales to non-banks. Excludes Treasury bills and transactions under special purchase and resale arrangements.
(c) Excludes transactions by the Issue Department of the Bank.

When the reserve asset ratio requirement was in operation, the banking system could first meet any shortage of cash by selling surplus reserve assets to the Bank. When the surplus was exhausted, the Bank had to choose—in the short run at least—between:

- a reduction in the minimum reserve asset ratio requirement (as was made in January, and again temporarily in March and April);
- encouraging the creation of additional private sector reserve assets—notably eligible bank bills—by buying bills and thus influencing relative interest rates (so far as this was possible);
- buying non-reserve assets, as with the temporary purchase and resale in 1980 of gilt-edged stocks held by banks.

The abolition of the reserve asset ratio will provide the banking system with somewhat more flexibility to draw on liquidity (subject to the needs of prudent banking) to meet temporary drains. But in the longer term an improvement in the liquidity of the banking system would be consistent with the achievement of the monetary target only if the growth of the banking system's lending to the private and overseas sectors is restrained.

Interest rates and official operations

From 20 May to 2 June, conditions in the money markets were generally quiet, with the Bank providing cash on a significant scale on only two days, 26 May and 2 June (see Table E for a summary of some of the operations discussed in this section). Interest rates moved little.

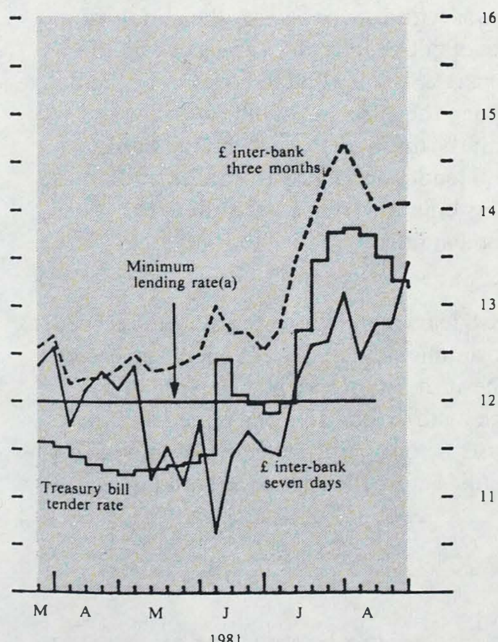
(1) In this context the extension of eligibility to over forty additional banks, effective from 20 August, was also helpful (see page 348).

Table E
Official operations in the money markets on selected days[a]

Date	Form of operation	Main assets involved(b)	Maturity band of asset(c)	Amount (£ millions)	Interest rate(d) (per cent)
26 May	Outright purchase, and resale agreements (unwinding on 2 and 9 June)	Eligible bank bills	Up to 14 days	220	11$\frac{3}{8}$–11$\frac{3}{4}$
3 June	Official sale	Treasury bills	Up to 14 days	220	10$\frac{3}{4}$–11$\frac{3}{8}$
16 June	Outright purchase	Treasury bills and eligible bank bills	Up to 14 days	120	11$\frac{1}{4}$–11$\frac{3}{16}$
		Eligible bank bills	1 to 3 months	60	12 –12$\frac{1}{8}$
1 July	Official sale	Treasury bills	Up to 14 days	70	11 –11$\frac{1}{4}$
6 July	Secured loan to discount market for seven days			100	12$\frac{1}{4}$
10 July	Outright purchase, and resale agreement (unwinding on 14 July)	Local authority and eligible bank bills	Up to 14 days	300	12 –12$\frac{1}{2}$
22 July	Resale agreement (unwinding on 27 July)	Local authority and eligible bank bills		100	12 –12$\frac{1}{4}$

(a) Illustrating the Bank's operations on certain dates mentioned in the text.
(b) Resale agreements may be secured against any acceptable asset.
(c) Relevant only for outright transactions.
(d) Lowest and highest rates quoted, expressed as a rate of discount, except for resale agreements and the secured loan, where the yield is quoted.

Short-term interest rates in London



(a) Since 20 August, minimum lending rate has not been continuously posted.

On 3 June, under the pressure of impending cuts in dollar North Sea oil prices, and with a large and prospectively widening gap between short-term interest rates in the United Kingdom and the United States, sterling began to weaken, going below $2 in New York that evening. On the following day, there was a sharp adjustment of market interest rates, on fears that these might be increased to protect sterling. Three-month inter-bank rates rose by around three quarters of a percentage point between 3 and 8 June, and twelve-month rates by around one point. Very short-term rates remained low, generally below 11% for overnight money, reflecting easy money market conditions at that time and a desire by lenders to offer funds overnight while uncertain about future rates. The Bank took no action other than to mop up prospective cash surpluses on 3 and 5 June by selling short-term Treasury bills, thereby preventing very short-term rates from falling further.

The following week saw a reappraisal in the market and a reversal on 9–10 June of roughly half the previous week's increase in longer-term rates. Sentiment was helped by moderately encouraging money supply figures and by the absence of any further downward pressure on sterling. On 10 June, the Bank again sold short-term Treasury bills to absorb a large cash surplus.

Rates remained more stable for around three weeks, with attention concentrated on likely interest rate movements in the United States but with no decisive developments there or at home. When the Bank needed to provide cash to the system, as on 16 June, it was usually in the form of modest outright purchases of bills. Overnight rates occasionally fell away sharply towards the end of the day, as unexpected cash flows associated with the Civil Service dispute left more cash in the market than had been forecast; but otherwise rates moved little.

At the end of June, sterling came under further downward pressure, falling below $1.90 in New York on 1 July. Between 1 and 3 July, the Bank intervened each day to mop up prospective surpluses of cash and to prevent very short-term interest rates weakening unduly.

But on 6 July, in the face of an expected cash shortage on that day, the Bank offered a three-day purchase and resale agreement to the discount houses and rejected the rates bid as too low. The Bank then signalled its desire for somewhat higher rates by lending for one week at $12\frac{1}{4}\%$.[1]

Reaction in the market to the Bank's action was to mark all interest rates higher; seven-day and one-month inter-bank rates rose by one half to three quarters of a point in the week to 9 July, three-month inter-bank rates by five eighths of a point and one-year rates by half a point.

Over the following week, inter-bank rates for periods longer than one week stabilised. Rates for seven days or less were volatile, although the Bank continued to provide cash to the system when needed (as on 10 and 13 July) at rates between 12% and $12\frac{1}{2}\%$. At times, the seven-day inter-bank rate rose above $12\frac{1}{2}\%$, leading to comment that banks would shortly raise their base rates to protect themselves against round-tripping.[2]

In the following week, to 24 July, rates for periods of one month and longer rose again, partly because of further pressure on sterling (which reached a three-year low against the dollar on 21 July) but also in response to the announcement on 17 July of a tender a week later for £800 million special Treasury bills to mature on 1 September. In the event, these bills sold on a yield basis of around $14\frac{1}{4}\%$, with three-month Treasury bills on the same day also yielding nearly 14%. On most days during this period the Bank offset cash shortages by resale agreement, or occasionally by buying outright, providing very short-term cash at rates of 12%–$12\frac{1}{4}\%$ and longer-term funds at an appropriate market rate.

The markets remained short of cash until the end of banking August. Once the Civil Service dispute had been settled, some delayed revenue was quickly collected and, in addition, substantial earlier resale agreements and Bank purchases of eligible bills matured. Further cash was withdrawn towards the middle of August by renewed sales of gilt-edged stocks and a call on the second index-linked stock. Assistance had to be given by the Bank almost every day, involving the purchase of bills outright and on a resale basis. To limit the drain on the system, the Bank reduced the Treasury bill tender on 31 July from £200 million to £100 million for 91-day bills and from £250 million to £100 million for 1 September bills.

In the first half of August, fears of a rise in interest rates receded, as sterling showed greater stability and as market operators became more confident about the authorities' own stance. Seven-day inter-bank rates fell back by three quarters of a point from their peak, and one-month rates by one point; longer rates moved down by around half a point. Just before the end of the banking

(1) As explained in the June *Bulletin*, page 173, the discount houses are invited to bid for such facilities but the Bank retains complete discretion over its response. The precise rate at which the Bank lent was made public after inaccurate rumours of a much higher rate began to circulate in the market. Subsequently, information on the Bank's dealings was made available on a daily basis (see below).

(2) In principle, with base rates at 12% and one to three-month rates between $13\frac{1}{2}\%$ and $14\frac{1}{4}\%$, the banks were also vulnerable to round-tripping for periods of much longer than a week. But in practice there can have been few bank customers confident enough that base rates would not rise in the near future to risk round-tripping for long periods.

month the continuing cash shortages (and expectations that they would persist as the effects of the Civil Service dispute unwound) raised rates again.

Developments in techniques

In the three months to mid-August, the Bank's techniques, as developed over the previous nine months, were employed in a wide range of market conditions. In general they worked smoothly as market operators adjusted to the changes, but in conditions of often widespread uncertainty there was inevitably occasional misinterpretation of particular actions by the Bank.

Essentially, as foreshadowed in November 1980, the Bank has been trying to smooth out day-to-day shortages or surpluses of cash by means of open-market operations, rather than by direct lending to the discount market. In dealing with shortages, the Bank has usually either bought bills outright or, if the shortage was to be followed before long by a day of prospective surplus, it has bought bills for resale on that day. When the market has been in surplus, the Bank has sought to sell Treasury bills set to mature on a day of prospective shortage. Where large transactions could be estimated in advance—notably oil tax payments or calls on part-paid gilt-edged stocks already sold—operations have been framed accordingly (as with the issue in July and August of Treasury bills to mature on 1 September). All these operations were conducted within the context of a general objective for very short-term interest rates. Where the Bank dealt in longer-term bills, it did so to change the market's cash position on the day of the transaction and hence to influence very short-term interest rates. The Bank did not aim to affect rates on longer-term bills themselves but, rather, operated at appropriate market rates to avoid giving a signal which could otherwise have had undue influence on the market.

There was only one major innovation implemented during the period—the introduction, via the main press agencies, of up-to-date information about the Bank's dealings in the money markets. Originally this change had been intended, in a fuller form, for 20 August,[1] when the new monetary control arrangements came into effect, but part of it was brought forward when inaccurate information began to circulate on 6 July. The Bank's objective, with this development, is to provide all market operators with access as rapidly as possible to relevant information about the Bank's activities and daily forecasts.

On 5 August it was announced that from 20 August the new monetary control arrangements would begin to take effect. From that date also, MLR would no longer be posted continuously, but the Bank might in some circumstances announce in advance the minimum rate which, for a short period ahead, it would apply in any lending to the market. These developments had been foreshadowed in November and March and are described more fully on page 347.

From 20 August, the Bank has been conducting its money market operations by reference to a band for very short-term interest rates set by a process analogous to that which has hitherto determined

(1) The extended service was introduced on that date.

MLR. Details of the band will not be disclosed, to leave as large a role as possible for the influence of market forces in determining the structure of interest rates and to allow the authorities flexibility in their market operations. So far as the money markets are concerned, two elements of the new monetary control provisions are likely to be especially relevant to the authorities' own operations. First, the London clearing banks' operational balances—the fulcrum for the authorities in the money markets[1] —are likely to be smaller and more actively managed by the clearers themselves than hitherto. This will make it even more important than previously for all participants in the money markets to have accurate information about their actual and prospective cash position each day and may mean that, particularly towards the end of the day, very short-term interest rates become more volatile. Second, the minimum reserve asset ratio requirement on all banks, which up to now has effectively assured the bill and gilt-edged market makers of a large volume of call money every day, has now lapsed; instead, eligible banks have given certain undertakings which will ensure that funds are made available to these market makers but which will leave a greater role for market forces in determining the size and cost of such funds.

The funding programme

Despite difficult conditions, the funding programme was well maintained during the three months to mid-August, with net purchases of central government debt by UK non-bank residents (the aggregate most directly relevant to the control of sterling M_3) of around £2½ billion. Although this was considerably lower than the exceptional rate achieved in the previous three months (see Table B), it was more than sufficient to fund fully the estimated CGBR after allowance for the effects of the Civil Service dispute. Gilt-edged stocks were, as usual, the main contributor, although national savings also raised a significant amount.

The gilt-edged market

Sentiment in the gilt-edged market was adversely affected for much of the period by the same uncertainties as faced the money markets. Prices fell fairly steadily—apart from occasional modest rallies—and towards the end of July yields on long-dated stocks had risen to their highest for over four years. By then, short-dated stocks were yielding around 14½% or more, against 13½% at mid-May, and longs up to 15½%, against 14½%.

In these conditions and with redemptions and buying-in of next maturities amounting to almost £1,000 million (see Table F), net official sales were well below the exceptional rate of the previous three months. Funding outside the banking system, however, was assisted by net sales by banks and overseas residents.

Table F
Transactions in gilt-edged stocks[a]

£ millions
Sales + / purchases − (except last row)

Banking months	Sept. 80– Nov. 80	Dec. 80– Feb. 81	Mar. 81– May 81	June 81– Aug. 81(b)
Gross official sales	+3,470	+3,170	+4,110	+2,380
Redemptions and purchases of next maturities	− 480	−1,050	−1,330	− 960
Banking system	− 550	− 550	—	+ 400
Overseas	− 20	+ 150	− 100	+ 70
Net purchases (+) by UK non-banks	**+2,420**	**+1,720**	**+2,680**	**+1,890**

(a) Excluding the sale and repurchase agreements between the banks and the authorities in 1980.
(b) Provisional and partly estimated.

Against this uncertain background, the Bank modified its selling techniques, relying less upon conventional tap stocks—none were issued during the period (see Table G)—and instead replenishing the Issue Department's portfolio when necessary with small tranches of existing stocks, which could be sold when market rallies occurred. In addition, a second £1,000 million index-linked issue was made.

(1) See *Monetary Control* (HM Stationery Office, Cmnd. 7858).

Table G
Issues of gilt-edged stock (21 May to 19 August)

Stock	Amount issued (£ millions)		Date announced	Date issued	Date exhausted	Minimum price per £100 stock (£)	Payable per £100 stock:			Redemption yield (per cent)
	Total	*of which to NDC*(a)					On tender (£)	Second instalment (£)	Third instalment (£)	
12¼% Exchequer Stock 1992(b)	250	—	29/5	29/5	—	—	—	—	—	—
12% Treasury Stock 1995(b)	250	—	29/5	29/5	—	—	—	—	—	—
12% Exchequer Stock 1999–2002(b)	250	—	29/5	29/5	—	—	—	—	—	—
2% Index-Linked Treasury Stock 2006	1,000	—	3/7	8/7	9/7	(b)	30	30 on 14/8	balance on 11/9	(b)
3% Exchequer Stock 1984	250	—	24/7	24/7	—	—	—	—	—	—
3% Treasury Stock 1985	250	—	24/7	24/7	—	—	—	—	—	—
12½% Exchequer Stock 1994	250	—	31/7	31/7	—	—	—	—	—	—
12½% Treasury Stock 2003–05	250	—	31/7	31/7	—	—	—	—	—	—

(a) National Debt Commissioners.
(b) See text.

At the beginning of banking June, the authorities were already assured of over £300 million gross receipts in that month from the balance due on the first index-linked stock. They had two tap stocks available for sale: 11½% Treasury 1985 and the low coupon 3% Treasury 1986. Conditions early in the month were not propitious for further official sales: the major American banks had raised their prime rates to 20% on 18 May and there was talk of a rise in UK short-term rates. But demand did pick up in the last week of May, on hopes of a settlement to the Civil Service dispute and with the payment of the last call on the index-linked stock (which meant that there were no outstanding calls pre-empting the liquidity of potential buyers). By 29 May the tone of the market—particularly at the longer end—was sufficiently good for the Bank to issue tranches, of £250 million each, of two medium-dated stocks and one long-dated stock (see Table G) so that it could meet demand in these areas of the market.

This move was initially successful, and on the next working day, 1 June, moderate amounts of these tranches were sold. In addition there was modest demand for the 1985 tap stock, which had recovered to the price established early in May. On the following day, however, the market suffered a new set-back as fears of a further rise in US interest rates revived, and on 3 June sterling fell below $2 in New York. The market weakened sharply on 4 June, in response to worries that the authorities might have to raise short-term interest rates to protect sterling and on concern over the inflationary implications of the fall in sterling; prices fell by £1 in short-dated stocks and by £2 or more in longs.

In parallel with the reappraisal in the money markets, the gilt-edged market recovered between 8 and 10 June and further modest official (non-tap) sales were possible. A cut of one percentage point in its prime rate by one major American bank spurred renewed demand on 15 June and the Bank took the opportunity towards the end of the banking month to sell a significant amount of stock, mainly from the recently issued tranches, and gross official sales for banking June exceeded £900 million.

On 18 June (the first day of the new banking month) the very large rights issue by British Petroleum focused attention on the prospective demands of new equity issues on investment funds, and there was a temporary set-back to gilt-edged prices. In the following week, and again in the first two days of July, there were

renewed doubts about the course of American interest rates, with sterling again weak, and demand for conventional stocks dried up. In such circumstances, the most appropriate way to maintain the momentum of the funding programme appeared to be to issue a second index-linked stock; this was announced on Friday 3 July, for tender on 8 July. In this choice of timing, the authorities had regard to the fact that the price of the first index-linked stock had improved (albeit in a narrow secondary market) in June, moving contrary to the price of conventional stocks for the first time when sterling came under pressure.

In the period to the tender, market sentiment again weakened sharply, influenced by civil disturbances and the rise in very short-term interest rates. At the tender, the stock was not allotted in full and the price at which it was allotted—£86 per cent—was well below that expected by the market. The prices of conventional stocks fell when the result of the tender was made public, with losses on the day ranging to £1⅝ in long-dated stocks.

On the following morning, heavy demand emerged for the balance of the new stock, which was sold (in £30 per cent paid form) at £⅜ above the tender price. This helped sentiment in the market as a whole. The conventional market appeared to have found a firmer basis for trading, and—after refusing lower bids—the Bank established a new price (of £91, giving a redemption yield of 14½%) for the 1985 tap stock. Larger sales of this tap stock were made on 10 July, while small sales of the low coupon 1986 stock were also possible then and on 15 July. Nevertheless, by the end of banking July, gross official sales had amounted to only £600 million.

At the beginning of banking August the market became easier, on disappointment over the details of the money stock figures for banking June when these became available on 16 July, and weakened further the next day after the Warrington by-election. By 20 July, the FT index for gilt-edged prices was at its lowest for four and a half years and yields on long-dated stocks were around 15¾%. Some demand appeared at these levels; between 22 and 27 July medium and long-dated stocks recovered over £2 and shorts one quarter of that amount. On 24 July, the Bank announced new tranches of two existing low coupon stocks, because insufficient quantities of the 3% Treasury 1986 stock remained for it to operate as a tap, and there was the prospect of significant reinvestment demand for low coupon stocks as holders of 3% Exchequer 1981, maturing on 21 August, were repaid. To complete the range of stocks in its portfolio, the Bank announced tranches, on 31 July, of one medium and one long-dated stock.

Early in August, sterling again came under pressure against the dollar, and on 4 August worse-than-expected provisional figures for sterling M_3 in banking July were published. But these factors caused only a temporary set-back to prices and, after sterling had fallen below $1.80 on 10 August, potential buyers appeared more encouraged by renewed hopes of a fall in American interest rates and by good wholesale price statistics for July than concerned about the prevailing weakness in the exchange rate. Against a background of a general, if modest, rise in prices, the Bank sold stock—mostly from the latest longer-dated tranches—on both 11 and 12 August. A strengthening of demand on 17 August, apparently encouraged in part by a recovery in sterling, brought the price of the 1985 tap stock back above the level at which official

sales had last been made (on 10 July), and a slightly higher price was established, at which a moderate amount of stock was supplied.

Other forms of funding

National savings remained an important form of funding in the three months to mid-August, with receipts averaging around £250 million a month. (This was only half the rate of the previous three months but conditions then had been exceptionally favourable, largely because interest rates on several types of national savings only slowly came to reflect the cut in MLR made in the Budget.) The relative importance of index-linked certificates increased, with sales continuing to benefit from the reduction (to fifty) in the minimum age of holders that had been introduced in April. By the end of July, however, receipts from national savings looked likely to ease in the coming months, with some competing rates higher than in the spring and with the main adjustment to the age reduction largely complete. To maintain this element of the funding programme, the Government therefore announced at the end of July that, from 7 September, all age restrictions on index-linked certificates would be lifted.

Transactions in other forms of central government debt were of little net importance during the period under review. Some certificates of tax deposit were sold in banking July, when funding in other forms was somewhat modest, but there were net surrenders in payment of tax in the other two months.

Table H
Other capital markets

£ millions; *not seasonally adjusted*
Net cash raised +

Calendar months	Aug. 80– Oct. 80	Nov. 80– Jan. 81	Feb. 81– Apr. 81	May 81– July 81(a)
Local authorities				
Stocks	– 90	– 84	– 8	+ 3
Negotiable bonds	+ 4	+ 16	– 39	– 18
Private sector				
Loan capital and preference shares(b)	+ 57	– 75	– 25	+ 34
Equity capital(b)	+289	+439	+215	+636
Unit trusts	+ 42	+ 80	+175	+144

(a) Provisional.
(b) Net issues by listed UK public companies.

Table J
Stock issues[a] by overseas borrowers in the domestic sterling market (1 July 1980 to 1 August 1981)

Date announced	Borrower	Amount (£ millions)	Maturity (years)	Method of sale(b)	Gross redemption yield at issue (per cent)
1980					
29 July	Denmark	75	25	P	13.28
1981					
14 Jan.	Iceland	15	35	P	15.12
16 Mar.	Sweden	50	5	O	13.56
9 Apr.	Pemex	50	25	P	15.00
27 Apr.	IBRD	100	5	O	13.65
5 May	Finland	50	5	O	14.55
19 May	Hydro Quebec	40	30	P	15.51
29 June	Inco Ltd	25	25	P	16.00

(a) Excluding convertible issues.
(b) P placing, O offer for sale.

Other capital markets

There was a significant increase in the flow of new equity issues during the summer, with more than £630 million raised in the three months to end-July (see Table H). This was the highest for any three-month period since 1975 and, although the BP rights issue announced on 18 June accounted for at least £285 million of this,[1] there was a fairly regular flow of announcements, even when equity prices fell during July. The possible implications for bank lending, and thus for sterling M_3, of a sustained surge in equity issues were noted briefly on page 322.

In the fixed-interest markets, conditions were generally more difficult, with a rise in long-term yields discouraging other prospective domestic borrowers.

Overseas borrowers in the domestic (so-called 'bulldog') market were also generally deterred by the yields necessary to sell fixed-interest stock, but in the three months to end-July three straight issues of stock were made (see Table J), together with three convertible issues by Japanese companies. These six issues raised a total of £190 million.

Of the three straight issues, that by Inco (a major Canadian nickel producer) was particularly interesting: it was the first issue by a private borrower in this market since it was effectively re-opened after the abolition of exchange controls and the first to offer the option of redemption at maturity in either sterling or dollars at a fixed rate (of $1.98).

(1) This issue will raise £624 million in total and was made on a partly-paid basis (the second call is in December). Shareholders had the option, however, of paying the full subscription price immediately and thereby qualifying for the interim dividend.

Table K
Outstanding droplock arrangements

Trigger level(a)	Amount committed as at mid-August (£ millions)
$12\frac{1}{2}$% up to 13%	75
11% up to $11\frac{1}{2}$%	8
$10\frac{1}{2}$% up to 11%	31
10% up to $10\frac{1}{2}$%	30
$9\frac{1}{2}$% up to 10%	68
9% up to $9\frac{1}{2}$%	5
$8\frac{1}{2}$% up to 9%	20
No specified level	26

(a) Usually set with reference to the yield on high coupon, long-dated gilt-edged stocks.

Among other capital market developments, there were two of possible long-term significance. In the local authority market, Birmingham City Council issued a £75 million droplock stock in August, the first major stock issue in this form in the domestic sterling markets[1] and a development which gave further impetus to consideration of the droplock technique as a means of corporate financing. The interest rate on the stock will initially vary every six months and will be set at $\frac{3}{4}$% over the London inter-bank offered rate. Maturity will be in 1986, unless the par yield on gilt-edged stocks with seven years to maturity has by then fallen to $12\frac{3}{4}$% or less. In that event, the droplock will operate and the stock will be converted into a fixed-rate issue with a seven-year maturity, carrying interest at $13\frac{1}{2}$%.

Second, the Nationwide Building Society began offering one-year bonds which, unlike earlier issues by the Alliance Building Society, are listed and are open to a wider range of holders. The sums involved were small—£10 million by mid-August in the case of Nationwide—relative to building society net flows; but this development increases the possibility that, in time, the capital markets may come to provide the larger societies with an avenue for diversifying their borrowing.

(1) For a description of droplock issues, see the June *Bulletin*, page 178. Table K updates the figures on droplock issues given in June.