Operation of monetary policy

- *Short-term interest rates fell in the three months to mid-February (the period with which this review is principally concerned) despite a sharp rise in comparable US interest rates.*

- *Monetary developments suggested a cautiously encouraging picture and the exchange rate remained firm. The rate of growth of the broad aggregates slowed, aided by further recovery of tax delayed by the Civil Service dispute; but bank lending to businesses and persons continued to rise rapidly.*

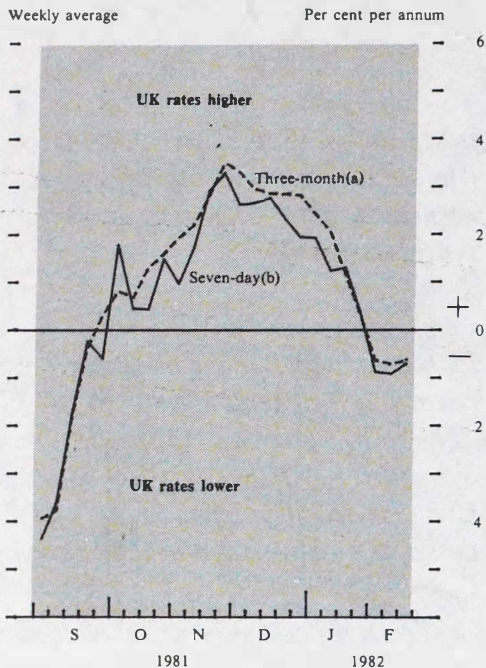
- *Massive cash flows from the banking system to the Government were caused by the main tax revenue season, the collection of delayed tax, and continuing official sales of central government debt. The Bank's open-market operations injected £3½ billion (net) of cash into the money market, taking its holdings of eligible bank bills to record levels.*

- *The UK non-bank private sector continued to buy large amounts of central government debt, with more emphasis than previously on national savings and certificates of tax deposit.*

- *The flow of new equity issues slackened towards the end of 1981 but the total of new equity capital issued over the year was still the highest in real terms since 1976. In February, Barclays Bank announced the largest ever conventional fixed-interest sterling stock issue by a commercial borrower.*

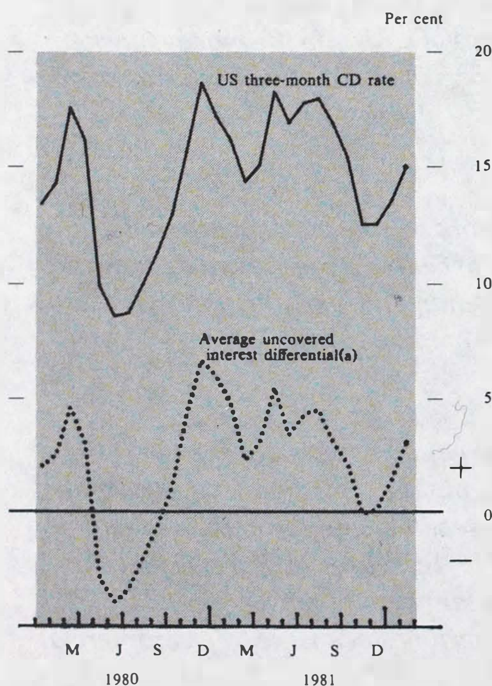
- *In the Budget, the Chancellor set a range of 8%–12% for the growth in 1982/83 of the broad monetary aggregates, sterling M_3 together with PSL_2, and the narrow measure, M_1. He also abolished all restrictions on the holding of index-linked gilt-edged stocks.*

Differential between UK and US short-term interest rates



(a) Three-month London inter-bank rate *minus* three-month New York CD rate.
(b) Seven-day London inter-bank rate *minus* overnight Federal funds rate.

International interest rate differentials



(a) The US three-month CD rate *less* a GNP-weighted average of short-term interest rates in Canada, France, Italy, Japan, Switzerland, West Germany and the United Kingdom. Monthly averages: February 1982 data partly estimated.

Review

In the three months to mid-February,[1] there was a further modest decline in short-term interest rates in the United Kingdom, despite a sharp rise in comparable US rates. Sterling slipped against the US dollar but was generally strong against the main European currencies, and its effective rate moved up over the period.

The United States continued to be the most important *external* influence. Short-term interest rates there had fallen very sharply during the autumn and the decline continued until the end of November. By then, interest rates in the United States had moved significantly below comparable UK rates, with a gap of over 3% between the respective three-month money rates.

Thereafter, hopes of a further fall in US rates faded. Rates actually rose in mid- December, and in the second half of January—after some weeks of very rapid growth in M_1 in the United States— there was a further marked rise in short-term rates, although long-term bond rates were more stable.

In other major centres, short-term interest rates fell over the period. In particular, rates declined in a number of continental countries within a period of several days in the second half of January. While domestic considerations (some of long-standing) could be adduced to explain the fall in rates in each of the main continental countries involved, the fact that the changes came so close together temporarily encouraged a decline in UK rates as well.

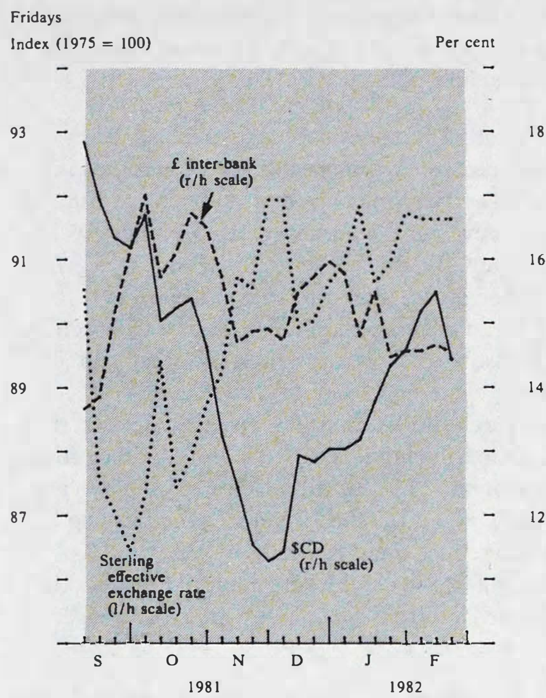
The combination of lower European rates and sharply higher US rates re-opened the positive differential between rates in the United States and elsewhere that had existed since mid-1980. Nevertheless, the gap of 3% shown in the chart at mid-February was still significantly below the peak reached at the end of 1980 (when US rates were on average some 7% above rates elsewhere).

A wide range of *domestic* factors affected UK monetary policy. Some were adverse, including a probably temporary rise in the annual rate of growth of retail prices. More encouragingly for the markets, statistics continued to show major gains in labour productivity in manufacturing and there were numerous modest wage settlements in the private sector. In mid-January, the threat of a miners' strike was lifted; while later that month the Government's determination to maintain the counter-inflationary thrust of policy was re-iterated in a number of Ministerial speeches.

Monetary developments and the relative strength of sterling in the face of rising US interest rates suggested a cautiously encouraging picture. The broader aggregates all grew less rapidly over the three months to mid-February than earlier in the target period, aided by the recovery of £1¾ billion of tax revenue delayed by the Civil Service dispute; sterling M_3 grew at an annual rate (a.r.) of 8%, and the broader PSL_2 by 9% (a.r.). M_3—which comprises sterling M_3 and UK residents' foreign currency deposits held with UK banks—grew by only 3% (a.r.).[2] The narrower aggregates moved erratically: total M_1 rose only modestly, with the non-interest-bearing component falling slightly, while the wide monetary base grew by 10% (a.r.) after a long period of slow growth. Bank lending to the private sector continued to rise fast.

(1) All subsequent references are to calendar months, unless otherwise specified.
(2) The recent behaviour of the private sector's foreign currency deposits and borrowing is discussed further on page 24.

The exchange rate and three-month interest rates



Sterling rose slightly in effective terms over the period and, although some unease was evident in the first half of December and again in mid-January, the underlying tone then became firm. Despite the sharp rise in US short-term interest rates relative to those in the United Kingdom, sterling fell by only 4% against the US dollar, and rose against the other major currencies.

In reaching a judgment on monetary conditions, the authorities had regard to the movement of a number of aggregates over time, as well as of other factors, notably the exchange rate. In his Budget, the Chancellor noted that this remained the basis of policy and that to make more explicit the way in which this was done, the growth range announced for 1982/83—of 8%–12%—would apply both to the broad aggregates—sterling M_3 together with PSL_2—and the narrow measure of money, M_1.

Over the year to mid-February, sterling M_3—which grew by $14\frac{1}{2}$%—was distorted significantly upwards by the effects of the Civil Service dispute and by the banks' move into the mortgage market. PSL_2, which was proportionately less influenced by the dispute and probably unaffected by the shifts in housing finance, grew by 12% and, over this period, provided a valuable alternative guide to the trend of the broad aggregates.

An important reason for paying regard to a wide range of aggregates is the rapid evolution (as in the United States in recent years) of the financial system. Thus, there is considerable likelihood that one or more aggregates may be affected by permanent structural change, as well as by such temporary distortions as the Civil Service dispute. In recent years, total M_3 has been significantly affected by the abolition of exchange controls; sterling M_3 has been increased by the banks' recent major extension of their lending for house purchase; while the wide monetary base (which mainly consists of notes and coin) and the non-interest-bearing element of M_1 may have been influenced by changes in payments habits. A number of developments currently taking place or in prospect could significantly affect the aggregates: these include the possible introduction by the clearing banks of interest-bearing current accounts, expansion of the payments facilities offered by building societies, and increasing provision of withdrawal facilities for building society term shares.

The sequence of main events

Largely under the influence of a rapid fall in US interest rates, strong downward pressure on interest rates had developed by mid-November. By the second half of the month, all money market rates except those at the very short end were consistent with a cut in banks' base rates. Very short rates, however, remained high, partly because of continuing large cash shortages. Over the next two weeks the Bank sought to remove any purely technical factors which were keeping these rates up. By early December, the clearing banks felt able to reduce base rates by $\frac{1}{2}$%, to $14\frac{1}{2}$%. Sterling remained strong while rates were coming down. But in the first full week of December sentiment weakened in all domestic markets, in response to a prospective strike ballot by miners, disappointing sterling M_3 figures for banking November, and a rise in short-term US rates. Over this week, sterling's effective rate fell by 2%, longer money market rates rose by $\frac{1}{2}$% and gilt-edged prices fell back sharply. This mood of unease persisted until the New Year, although sterling did recover modestly. The Bank provided funds fully and promptly each day, to reassure the markets and to consolidate the position.

Sentiment improved markedly in the New Year. A prospective major strike at Ford was averted by a pay offer averaging $7\frac{1}{2}\%$; the sterling M_3 figures for banking December showed little growth and were better than had been generally expected. Sterling recovered to an effective rate approaching 92.

For some time, the weekly US money supply figures had been growing faster than expected; the prospect of another upturn in US interest rates increased and sterling once more slipped against the US dollar. The US money figures announced on 15 January were particularly discouraging. But neither this nor the start of regular strikes on British Rail seriously undermined confidence, as it became apparent that the miners were likely to reject strike action. Strong downward pressure on short-term rates then reappeared and was encouraged by a cut, on 21 January, in official West German, Swiss and Dutch short-term rates. As in November, the Bank sought to reflect market influences by an orderly reduction in its own dealing rates for bills. The fact that US rates were moving up had little immediate impact and on 22 January the clearing banks again felt able to reduce their base rates by $\frac{1}{2}\%$, to 14%. Large official sales of gilt-edged stocks were made in this period and the Bank announced a third issue of index-linked gilt-edged stock.

A further unexpected rise in the weekly US figures for M_1 announced on 22 January brought renewed nervousness in UK markets, but confidence soon returned as US markets remained calm, and sterling quickly recovered. At the tender for the index-linked stock, the authorities set a minimum price equivalent to a yield in real terms of 3%[1] and sold a significant amount on these terms at the tender and on the following day.

For the rest of the banking month, markets remained generally cautious as the weekly US money figures continued to disappoint. But sterling continued strong in effective terms, with losses against the US dollar offset by gains against other currencies (notably those in the European Monetary System). Expectations of further imminent falls in short-term interest rates faded from the end of January but there was no significant upward pressure; even when US prime rates rose to 17% at mid-month, the underlying tone in all markets remained good.

Table A
Growth of the monetary aggregates[a]

Percentage increases (annual rates); *seasonally adjusted*

Banking months	Mar. 80– Feb. 81	Mar. 81– Feb. 82	Sept. 81– Nov. 81	Dec. 81– Feb. 82
Wide monetary base (M_0)	5.9	3.6	0.7	9.7
Non-interest-bearing M_1	5.5	3.9	− 4.1	− 0.4
M_1	8.8	8.7	8.2	6.3
Sterling M_3	18.6	14.4	17.0	8.2
M_3	20.5	17.1	18.6	3.4
PSL_1	15.1	13.7	13.4	9.0
PSL_2	13.5	12.1	9.7	9.3

(a) For definitions, see tables and notes in the statistical annex, as follows: wide monetary base, Table 2; M_1, sterling M_3 and M_3, Tables 11.1–11.3; PSL_1 and PSL_2, Table 12. Columns 1 and 3 relate to the old banking sector, columns 2 (as far as possible) and 4 to the enlarged monetary sector introduced in mid-November.

Monetary aggregates[2]

Three months to mid-February

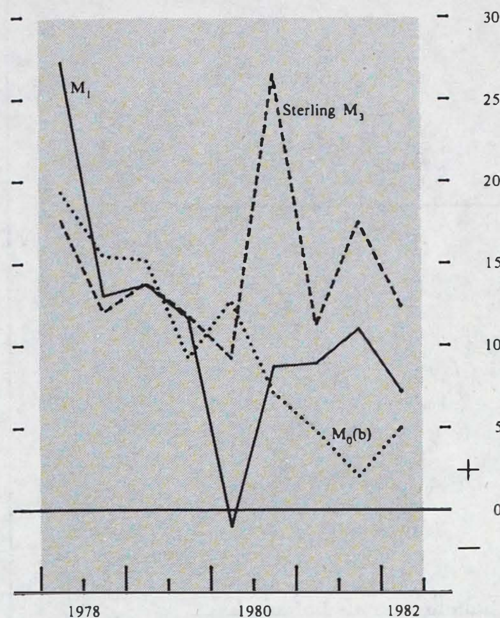
The broader monetary aggregates all grew at annual rates below 10% (Table A). The behaviour of M_3, which rose very slowly after a long period of very rapid growth, was particularly striking; indeed M_3 rose less fast than sterling M_3—an unusual occurrence over the period since UK residents were again allowed to hold foreign currency freely (in October 1979). A possible explanation is that for much of the period sterling interest rates were generally higher than their dollar equivalents, encouraging the UK private sector to run down its holdings of dollars (and thus of M_3) and to

(1) The semi-annual interest payments and ultimate capital repayment on indexed gilt-edged stocks do not reflect price changes immediately, but with a delay of eight months. Depending on how this delay is treated, it is possible to calculate different approximations for the real yield on these stocks. The calculations on which the yields shown in the text are based amount to assuming that the rate of inflation used to calculate a particular dividend in fact relates to the six months immediately preceding this dividend.

(2) From mid-November the Bank has published monetary statistics on the basis of the new enlarged monetary sector, as explained on pages 531–8 in the December 1981 *Bulletin*. The percentage changes for particular aggregates allow, so far as is possible, for the break in the series which occurred in November. It is not, however, possible to make such an allowance in compiling the counterparts to sterling M_3 (Table B and related text); here, the figures up to and including November 1981 are on the old definition, but the difference is not likely to be significant.

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) Wide monetary base (see notes to Table 2 in the statistical annex).

Table B
Sterling M_3 and its counterparts

£ millions (rounded); *seasonally adjusted*

Banking months	Mar. 80– Feb. 81	Mar. 81– Aug. 81	Sept. 81– Nov. 81	Dec. 81– Feb. 82
	(Quarterly averages)			
Central government borrowing requirement	+2,600	+4,500	+1,100	– 600
of which, Civil Service dispute(a)	—	*+2,200*	—	*–1,800*
Purchases(–) of central government debt by UK non-banks	–2,300	–3,200	–2,800	–2,400
of which:				
Gilt-edged stocks	*–1,800*	*–2,300*	*–2,300*	*– 800*
National savings	*– 400*	*–1,100*	*– 600*	*–1,100*
Other public sector(b)	+ 300	+ 400	+ 500	+ 100
Sterling lending to UK private sector	+2,400	+1,700	+4,500	+4,800
External and foreign currency factors(c)	– 100	– 100	– 400	—
Non-deposit liabilities (increase–)	– 300	– 400	+ 100	– 200
Sterling M_3	**+2,600**	**+2,800**	**+3,000**	**+1,700**

(a) Based on Treasury estimates; excludes additional debt interest paid because of the delay to receipts.

(b) The contribution to the public sector borrowing requirement of public corporations and local authorities, *less* their borrowing from the non-bank private sector.

(c) Includes bank lending in sterling to overseas.

borrow in dollars rather than use sterling to make payments. Indeed, the UK private sector ran down its foreign currency deposits with UK banks by over £1 billion while borrowing nearly £½ billion[1] additional foreign currency. The foreign currency banking transactions of the UK private sector are discussed at greater length on page 24.

The narrow aggregates moved erratically, as they often do over a period as short as three months. The wide monetary base rose quite rapidly, following a long period of slow growth, while the non-interest-bearing element of M_1 fell, for the second successive three-month period. The interest-bearing element of M_1 continued to rise sharply, as it had done throughout the second half of 1981.

An analysis of the counterparts to sterling M_3 (Table B) shows how the unwinding of the Civil Service dispute contributed to a modest central government surplus—the first seasonally adjusted surplus over any three banking months since 1972. Around £1¾ billion of delayed tax revenue came in, leaving perhaps £2½ billion outstanding. The underlying public sector borrowing requirement (PSBR)—that is, after adjustment for seasonal factors and for the effects of the dispute—was of the order of £1¼ billion in the quarter.[2]

The funding programme maintained considerable impetus, with net sales of central government debt to the UK non-bank private sector of about £2½ billion.

Lending in sterling by the banking system to the private sector also continued to increase rapidly; over the three months it rose by £4¾ billion, an annual rate of growth of 30%. Businesses may have borrowed three quarters of the total.[3] A significant part of the finance was no doubt used to pay the delayed taxes mentioned above. In addition, there is evidence that the rate of destocking fell sharply in the second half of 1981, and this—together with production and distribution delays caused by the unusually bad weather—may have added to firms' needs to borrow. Nevertheless, the implied underlying rate of growth of business demand for bank credit remains disquieting.

Bank lending to persons over the three months may have increased by around £1¼ billion (not seasonally adjusted), roughly the same as in the previous three months. The London clearing banks lent nearly £900 million, of which two thirds was for house purchase. On 20 January the Bank sent a notice[4] to all recognised banks and licensed deposit-takers, seeking their co-operation in ensuring that lending for house purchase is not significantly inflated by borrowers realising house equity for consumer purposes unrelated to the purchase or improvement of residential

(1) These figures reflect transactions—ie they exclude estimated valuation changes resulting from movements in sterling.

(2) It is not possible to calculate the PSBR precisely on a banking month basis.

(3) A reasonably accurate breakdown for this period by type of borrower was not available until after this *Bulletin* had gone to press.

(4) The text read: 'The Bank is concerned to ensure that lending on mortgage for house purchase should in fact be applied to the purchase or improvement of residential property and not to the realisation of capital profits on their houses by the borrowers. To this end recognised banks and licensed deposit-taking institutions are asked to ensure, when making mortgage finance available on exchange of residential property, that, where the borrower is increasing the size of his mortgage and whether the previous mortgage had been provided by themselves or another lender, the bulk of the unencumbered proceeds of the sale are applied to the new acquisition or improvement of the new purchase. Recognised banks and licensed deposit-taking institutions are also asked to ensure that, where a mortgage is transferred to themselves from another lender but there is no exchange of properties, the size of the mortgage is not normally increased unless the property is to be improved.'

The Bank has written to the main associations of insurance companies asking that their members should have regard to this request in so far as it affects their own mortgage lending. The Treasury has made a similar request to the Building Societies Association.

Foreign currency banking transactions by the UK private sector

Since the abolition of exchange controls in October 1979, UK residents have been able to borrow and lend freely in foreign currencies. The private sector has used this freedom quite extensively, and a significant proportion of its transactions with the UK banking system has been in foreign currencies, mainly US dollars. The importance of foreign currency operations is demonstrated by the table, which shows the currency composition of the non-bank private sector's deposit and loan transactions with UK banks in the year to mid-February 1982.

Between mid-February and mid-October 1981, the private sector was generally very liquid, largely as a result of the Civil Service dispute, which delayed tax collections. During this period, the private sector's total bank deposits in sterling and foreign currency increased by some £1.7 billion more than its borrowings. Of this, £1.0 billion was reflected in a lengthening of the sector's foreign currency position—in other words, the private sector's foreign currency deposits rose by £1.0 billion more than its foreign currency borrowings—and only £0.7 billion in a lengthening of the sterling position (here, as elsewhere in this box, the sterling equivalent of foreign currency transaction flows excludes estimated valuation effects arising from exchange rate changes).

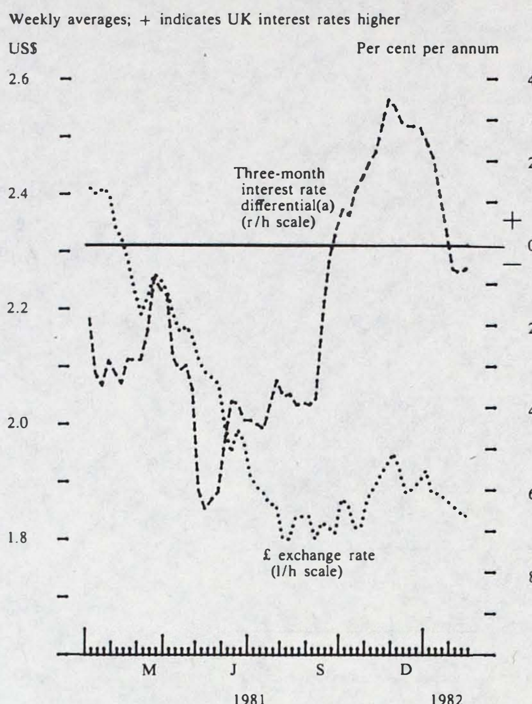
Among the influences on the private sector may have been the fact that sterling interest rates were generally lower than the corresponding US dollar rates in this period, and that, perhaps partly as a result of the interest differential, sterling's exchange value against the dollar was generally falling, as the chart shows.

UK and US interest rates crossed over in October 1981, and for the following three months UK rates were the higher, with sterling tending to appreciate against the dollar. Moreover, substantial tax revenues delayed by the Civil Service strike began to be recovered and the normal tax-paying season got under way. Over the three months between mid-October and mid-January, the private sector's total bank borrowings went up by £5.2 billion more than its deposits. Of this, as much as £1.9 billion, or 37%, was reflected in a shortening of the foreign currency position.

In banking February, US interest rates were once more higher than UK rates, and the pound was again weak against the dollar, although steady in terms of the effective exchange rate index. However, the private sector continued to face an outflow of cash, and the increase in borrowings

Sterling and US/UK interest rate differentials

Weekly averages; + indicates UK interest rates higher



(a) Three-month London inter-bank rate minus three-month New York CD rate.

exceeded the increase in deposits by some £1.8 billion. Of this, some £1.4 billion was reflected in a shortening of the sterling position and £0.4 billion in a shortening of the foreign currency position.

Statistics of banking transactions of UK residents with certain banks abroad are also available, based on data compiled by the Bank for International Settlements. In the first three quarters of 1981, UK non-bank residents increased their foreign currency deposits with such banks by £0.6 billion, while their new foreign currency borrowing from such banks went up by less than £0.1 billion.

It is clear that the UK private sector has used foreign currencies as a temporary store of value and a medium of borrowing on a large scale over the last year. Moreover, it appears that its decisions have been influenced by the evolution of international interest rate differentials and by exchange rate movements.

UK private sector transactions with the UK banking system

£ millions; *not seasonally adjusted*

	Amounts outstanding at mid-Feb. 1981	Transactions: Mid-Feb. 1981–mid-Oct. 1981		Mid-Oct. 1981–mid-Jan. 1982		Mid-Jan. 1982–mid-Feb. 1982		Mid-Feb. 1981–mid-Feb. 1982	
	Net borrowing –	*Increase in deposits/reduction in borrowing +*							
Balance of transactions with the UK banking system	**–1,305**	**+1,670**		**–5,220**		**–1,840**		**– 5,390**	
of which:									
Deposits	*63,068*	*+9,520*		*+ 700*		*– 30*		*+10,190*	
Borrowing(a)	*64,373*	*–7,850*		*–5,920*		*–1,810*		*–15,580*	
Balance of sterling transactions	**+ 715**	**+ 670**		**–3,330**		**–1,450**		**– 4,110**	
of which:									
Deposits	*56,068*	*+7,070*		*+1,680*		*—*		*+ 8,750*	
Borrowing(a)	*55,353*	*–6,400*		*–5,010*		*–1,450*		*–12,860*	
Balance of foreign currency transactions(b)	**–2,020**	**+1,010**	**(+ 610)**	**–1,890**	**(–1,870)**	**– 390**	**(–510)**	**– 1,270**	**(–1,770)**
of which:									
Deposits(b)	*7,000*	*+2,460*	*(+4,440)*	*– 980*	*(–1,420)*	*– 20*	*(+200)*	*+ 1,460*	*(+3,220)*
Borrowing(b)	*9,020*	*–1,450*	*(–3,830)*	*– 910*	*(– 450)*	*– 370*	*(–710)*	*– 2,730*	*(–4,990)*

(a) Including Issue Department holdings of commercial bills.
(b) The figures shown in parentheses include estimated valuation effects arising from exchange rate changes.

property. The purpose of this notice is to help ensure that lending on mortgage for house purchase is in fact applied to that purpose. (See the Governor's speech to the Finance Houses Association, page 102.)

Year to mid-February

Sterling M_3 rose by 14½%, compared with the target set last March of 6%–10% (annual rate) for the fourteen months to mid-April 1982. As explained above and in previous *Bulletins*, sterling M_3 appears to have been an unreliable indicator in this period, notably because of the major moves by banks into the provision of housing finance and because of the effects of the Civil Service dispute. PSL_2, which is little, if at all, affected by the shift in housing finance (because it includes most building society deposits) and is relatively less distorted than sterling M_3 by the Civil Service dispute, grew by only 12% over the year. This may have been a better estimate of the underlying rate of growth of the broad sterling aggregates.

For the second successive year, the growth of the narrower aggregates was much more modest than that of the broad aggregates, with the wide monetary base and the non-interest-bearing element of M_1 both rising by around 4%. Total M_1 grew by nearly 9%, with a rise of one third in its interest-bearing component (most of which occurred in the second half of the year and perhaps represented an accumulation of large wholesale balances awaiting reinvestment[1]).

Among the counterparts to sterling M_3, the PSBR has remained under control; indeed, in this month's Budget, the Chancellor put the PSBR for 1981/82 at £10½ billion, the figure projected in the 1981 Budget. This would be some £2½ billion lower than in 1980/81.

The funding programme was well maintained so that, over the year to mid-February, net sales of public sector (mainly central government) debt exceeded the PSBR by around £¾ billion, or by £3¼ billion if the borrowing requirement is measured in strike-adjusted terms.

The rate of growth of bank lending in sterling to the private sector also rose sharply over the year. Lending to persons accelerated during the summer, to be followed by an increase in the rate of corporate lending.

Over the nine months to mid-November—the latest date for which complete figures are available—lending to persons rose at an annual rate of 45%, and corporate and other lending (restrained by delayed tax payments) by only 15%. In this period, the rise in lending for house purchase accounted for nearly two thirds of total lending to persons, and was running at a monthly rate (over £200 million) nearly four times that of the previous year.

Money markets and interest rates[2]

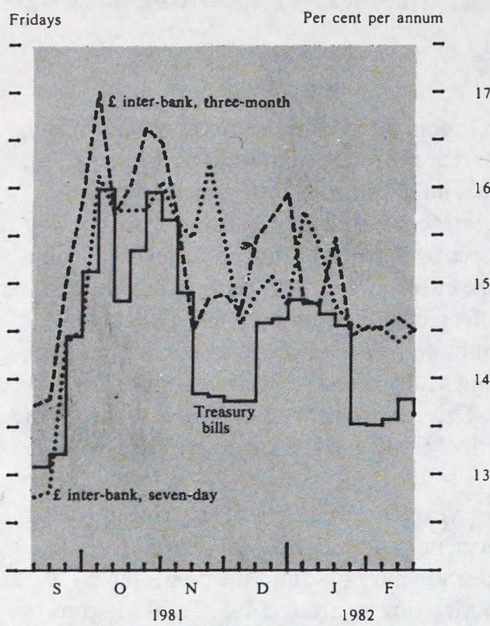
Banking December

Banking December began with optimism about interest rate prospects. US rates had been falling and there were expectations that clearing banks' base rates (which had been reduced to 15% on

(1) Support for this view is provided by figures showing that, in the fourth quarter of 1981, the only sector to increase its sight deposits substantially was that of the financial institutions (other than banks). Interest-bearing current accounts did not become significantly more important during the year.

(2) Details of the Bank's operations are given in Table 10 in the statistical annex.

Short-term interest rates in London



9 November) would soon be cut again. The yield curve of market rates sloped downwards quite sharply, with the three-month inter-bank rate as much as 1% below the seven-day rate. In part, this was because very short rates were reflecting expectations of a further decline in longer rates, and operators were willing to borrow for very short periods in the hope of raising longer-term money in due course at a lower rate.

Two early days of substantial cash shortage acted as an additional upward influence on very short rates. But this pressure eased from 23 November onwards, and longer rates firmed a little as hopes of a further fall in interest rates in the United States faded. Nevertheless the yield curve remained downward sloping. Having reduced marginally the rates at which it accepted bills offered to it on 25 November, the Bank began from the following day to seek to reduce the upward pressure on very short rates, by providing sufficient cash as early in the day as possible to offset fully the prospective market shortages.

Rates for three months and over started to firm again at the end of November, as market rates in the United States showed signs of rising. Very short rates, meanwhile, began to respond to the Bank's full provision of cash, and by 3 December the seven-day inter-bank rate had fallen below 15%, leaving the yield curve for periods up to one year relatively flat. Following the decline in very short-term rates, the clearing banks announced a cut of $\frac{1}{2}$% in their base rates to $14\frac{1}{2}$%, on 3 December. On the same day, the Bank further reduced the rates at which it accepted bills offered to it, bringing them into line with the newly established pattern of rates in the market. Money rates remained steady at the new levels until the last day of the banking month (9 December). Longer money rates then firmed, under the influence of discouraging bank lending figures for November implied by the provisional money figures released the previous day, and forecasts of a record US budget deficit in fiscal 1982.

Banking January

On the first two days of banking January, sterling fell sharply as US interest rates rose and the miners agreed to vote on a strike in support of their pay claim. Over the weekend, martial law was declared in Poland, and on Monday 14 December some US prime rates rose slightly (the first increase since early July). These factors pushed longer money market rates up, with three-month inter-bank rates rising by $\frac{5}{8}$%, to $15\frac{5}{8}$%, in three days. The Bank responded by providing ample cash to meet the forecast shortages at a rate in the shortest maturity band unchanged from that ruling before sentiment had weakened—and at rates in bands 2 and 3[1] only modestly higher than before. On 15 December the Bank bought bills in band 4 for the first time since the new arrangements came into effect on 20 August. The Bank continued to provide ample cash, and rates fell back a little as sterling appeared to stabilise at an effective rate of around 90.

Operators remained highly nervous about US developments, however, and up to the New Year the Bank maintained stable dealing rates to consolidate the position. The market's cash position in the period was generally easier than for some weeks, and when surpluses appeared on several days the Bank was able to offset them on two occasions by selling very short-term Treasury bills. Interest rates remained volatile; at times, bill rates moved up on technical considerations as some discount houses ran up against

(1) Band 1 = up to 14 days maturity; band 2 = 15–33 days; band 3 = 34–63 days; band 4 = 64–91 days.

the prudential limits set on the size of their balance sheet and so were reluctant to buy bills. Sterling was quietly firm, however, with the effective rate moving up to 90.9 by the end of the year.

In the New Year sterling strengthened further. The release on 5 January of significantly better-than-expected provisional sterling M_3 figures for banking December and the prospects of an early settlement to a pay dispute at Ford outweighed the news, on 7 January, that a discount house had made heavy losses and required additional capital. With the onset of the tax revenue season sizable cash shortages reappeared, but these were offset by the Bank without undue difficulty, and on 11 January the Bank accepted the slightly lower yields on longer-term (band 4) bills offered by the market.

There continued to be considerable concern about US developments as the weekly money supply figures had been worse than expected for several weeks. But when exceptionally bad figures were announced on 15 January (and US interest rates seemed likely to rise sharply), the adverse effect on sentiment in the UK market was offset by suggestions that the miners' ballot then taking place had rejected strike action. On 18 January the Bank accepted lower dealing rates for very short bills, which was taken by the market as a signal that the authorities would not stand in the way of a modest fall in rates. Very short US rates rose that day but sterling strengthened and, on each of the next three days, the Bank accepted lower rates for very short bills and for some longer bills. On 21 January the West German and Dutch central banks announced interest rate cuts, which helped to offset news of a further rise in US rates and which caused press speculation about a European agreement to lower rates. By the morning of 22 January, UK inter-bank rates had fallen sufficiently for the clearing banks to feel able to reduce their base rates by $\frac{1}{2}$%, to 14%. The Bank again accepted lower dealing rates for very short bills.

Banking February

Another disappointing set of weekly US money figures precipitated a further rise in short-term US interest rates. Sterling slipped against the dollar and UK money markets opened nervously on 25 January. Sentiment quickly recovered, however, as the Bank maintained the lower dealing rates for very short bills that had been established before the weekend and, over the next two days, also accepted rates for longer bills that were significantly lower than those taken before the cut in base rates. The market was further reassured when, on 26 January, the Chairman of the Federal Reserve Board denied plans for an immediate increase in the US discount rate. Sterling recovered strongly, rising by nearly 1% in effective terms over the week.

On 29 January and 1 February the Bank again lowered its dealing rates (except for very short bills) in response to market pressure. But a rise of $\frac{1}{2}$%–$\frac{3}{4}$% (to 16$\frac{1}{4}$–$\frac{1}{2}$%) in US prime rates on 1 February caused a modest reaction, and over the rest of the week (to 5 February) market expectations of a further decline in UK rates faded. Sterling, however, remained strong in effective terms, even when it became known on 5 February that North Sea oil prices were being reduced.

For the rest of the banking month (to 17 February), sterling maintained its effective rate, falling against the US dollar in the face of continuing high US interest rates but rising against European currencies.

Table C
Influences on the cash position of the banking system

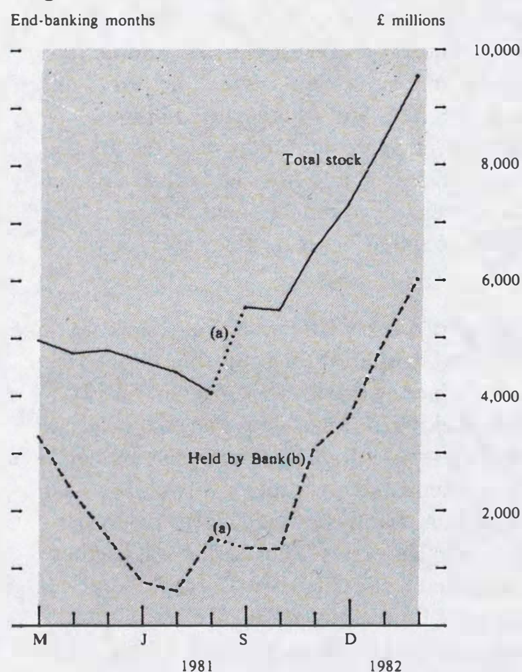
£ millions (rounded); *not seasonally adjusted*
Increase in banks' cash +

Banking months	Mar. 81– May 81	June 81– Aug. 81	Sept. 81– Nov. 81	Dec. 81– Feb. 82
Money market influences				
CGBR excluding strike effect	+2,600	+3,000	—	+ 500
CGBR strike effect(a)	+2,400	+1,900	—	−1,800
All other(b)	−5,100	−3,100	−2,900	−2,000
Total	− 100	+1,800	−2,900	−3,300
Official operations affecting cash				
Net increase (+) in Bank's holdings of eligible bank bills(c)	− 400	—	+1,600	+2,900
Net increase (−) of Treasury bills in issue	+ 300	−1,400	+1,000	+ 100
All other(d)	—	− 200	+ 100	+ 300
Increase (+) in banks' balances at the Bank	− 200	+ 100	− 100	—

(a) Based on Treasury estimates; excludes additional debt interest paid because of the delay in receipts.
(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) Changes in official holdings of local authority bills, discount window lending, etc.

Eligible bank bills

End-banking months £ millions



(a) Eligibility was extended to a further forty-four banks from 20 August (see the September 1981 *Bulletin*, page 348); subsequently, eligibility has been extended to the following banks: Banca Commerciale Italiana; Banca Nationale del Lavoro; Credito Italiano; Dresdner Bank A.G.; Leopold Joseph & Sons Ltd; Nordic Bank Ltd; and Scandinavian Bank Ltd.
(b) Issue and Banking Departments.

Money market rates drifted up a little, but there was no upward pressure on the Bank's bill rates. In general, the market's response to developments in the United States (even when prime rates rose further, to 17%) remained muted and the underlying tone continued firm.

Cash and liquidity

Over the three banking months, the Bank provided over £3¼ billion net of additional cash[1] to the money markets to offset the drain caused (mainly) by the tax revenue season, the collection of tax delayed by the Civil Service dispute, and large sales of central government debt (Table C). The main form of cash injections again consisted of net official purchases of eligible bank bills.

In the process, the Bank's holdings of these bills reached over £6 billion. This compared with a peak of around £3½ billion in 1980/81 and amounted to about two thirds of the stock of eligible bills outstanding at mid-February. This stock has grown substantially since the summer, first because of the extension in mid-August to the list of eligible banks and then in response to market pressures (see chart). As the Bank added to its bill holdings (and thus to the demand for bills), the yields on bills relative to other forms of lending fell, encouraging a switch of lending out of advances and into bill finance.

Because the Bank had never previously had to absorb a cash drain of the size which has occurred in recent months, some commentators forecast towards the end of 1981 that the bill markets would be unable to absorb the pressure and that there would be strong upward pressure on very short interest rates.

In the event, the pressure up to mid-February was absorbed by operations in the bill markets, apart from very limited use by the Bank of the local authority deposit market.[2] Obvious technical problems were encountered only when unexpected payments into Exchequer accounts were received too late in the day for inclusion in the official estimates and were not fully anticipated by the paying bankers. With the reflux of revenue from the dispute particularly uncertain, this was at times (notably in mid-January) a significant problem.

The funding programme

Despite the increase in US interest rates over the period, large sales of gilt-edged stocks were possible in the second half of both November and January, when there were strong expectations of a fall in short-term rates. A third index-linked stock was issued. Gross official sales in the three months to mid-February totalled nearly £2 billion, but heavy redemptions and buying-in of near maturities reduced net official sales below £¾ billion. With the holdings of the banking and overseas sectors on balance little changed, net sales to non-bank UK residents were also below £¾ billion, rather less than in recent quarters. However, receipts from national savings continued to benefit from the extension (on 7 September) of eligibility to hold index-linked certificates, and were boosted by the introduction of a new higher-yielding

(1) Suppose that the Bank publishes a forecast cash shortage for a day of £200 million, of which £150 million is the result of the maturity of bills already held by the Bank (such maturities cause cash to flow out of the market to the Bank). To offset the market's cash shortage that day, the Bank's operations would have to provide £200 million gross to the market, say by buying bills, but the net increase in the Bank's provision of cash (and in its bill holdings) would be only £50 million. For a detailed account of the Bank's daily operations in the money market, see the article on page 86.

(2) In December, the Bank revived a practice last used in 1977, and placed deposits in the local authority market as an addition to its techniques for putting cash into the markets. The net sums involved in the period never exceeded £250 million.

certificate in November. In addition, companies bought certificates of tax deposit on a considerable scale. For the fifth consecutive quarter, net sales of central government debt to the UK non-bank private sector exceeded the PSBR,[1] adjusted for the effects of the Civil Service dispute. Over the year to mid-February the PSBR[1] totalled £11 billion, or £8½ billion adjusted for the dispute; net sales of debt amounted to £11½ billion, two thirds of which were gilt-edged stocks.

Gilt-edged stocks

Banking December

At the start of the short (three-week) banking December there were no calls outstanding on previously issued stocks. But with renewed hopes of lower interest rates in the United States, the tender for the partly-paid 14% Exchequer 1986 stock on the first day of the banking month attracted substantial applications (Table D).

More of the stock was sold at £40⅛ (£40 paid) the following day (20 November) and, at the close of business that day, additional tranches of £250 million each of one long-dated and two medium-dated stocks were issued direct to the Bank, to augment the Bank's portfolio. On 23 November, 12¾% Exchequer 1981 matured, involving a repayment to market holders of around £250 million.

Further demand for stock appeared following Chase Manhattan's cut in prime rate (from 16½% to 15¾%) on 24 November, and on the next day substantial sales were made of the short tap, again at £40⅛, and also of the recently issued long-dated tranche. Amid renewed hopes of a cut in clearing banks' base rates, further sales of non-tap stocks were made on 30 November.

When it materialised on 3 December, the cut in base rates (from 15% to 14½%) had largely been discounted, and the impact of this (and of the Chancellor's statement the previous day—see the December *Bulletin* page 462) was outweighed by renewed weakness in US bonds. However, the market rebounded strongly on 4 December after a reduction in the Federal Reserve's discount rate (from 13% to 12%); official sales were made of the 1990 and 1995 tranches, and the tranche of low-coupon 1985 stock (issued on 24 July) was exhausted. But these sales were matched by purchases, mainly of the next maturity (8½% Treasury 1980/82).

Heavy buying in of this next maturity continued after the weekend. The market generally fell back as attention once again focused on the likely size of the US budget deficit over the next three years and the conviction grew that—despite the recent cut in discount rate—the decline in US rates had levelled off. Disappointment with the November banking figures and concern over the miners' rejection of a revised pay offer also prompted some selling and the market ended the banking month on a weak note.

Banking January

Prices fell further at the beginning of banking January, under the influence of rising US and domestic interest rates and weaker sterling. However, the Bank's maintenance of its bill dealing rates and the stabilisation of sterling at an effective rate of around 90 provided support, and on 16 December sizable official sales of non-tap stocks were possible. Prices then fell back as US rates again rose, and the full money figures for banking November (on 17 December) showed the largest recorded monthly rise in bank lending.

Trading over the holiday period was very quiet but there was occasional demand for short-dated (particularly low-coupon)

(1) Strictly speaking, the PSBR *less* public corporation and local authority borrowing from the non-bank private sector.

Table D
Issues of gilt-edged stock

Stock	Amount issued (£ millions)	Date announced	Date issued	Date exhausted	Minimum price per £100 stock (£)	Payable per £100 stock: On tender (£)	Payable per £100 stock: Second instalment (£)	Redemption yield (per cent)
14% Exchequer Stock 1986	1,000	13/11	19/11	19/1	95.75	40.00	55.75	15.27
13% Treasury Stock 1990	250(a)	20/11	20/11	—	—	—	—	—
12% Treasury Stock 1995	250(a)	20/11	20/11	—	—	—	—	—
13½% Treasury Stock 2004/08	250(a)	20/11	20/11	—	—	—	—	—
3% Treasury Stock 1987	500	30/12	7/1	23/2	64.50	64.50	—	11.97
2½% Index-Linked Treasury Stock 2011	750	22/1	28/1	—	(b)	35.00	55.00	(b)
13¼% Exchequer Stock 1987	750(a)	8/2	8/2	22/2	(b)	(b)	(b)	(b)

(a) Issued to the Issue Department of the Bank.
(b) See text.

stocks, as money market rates eased slightly. On 30 December a new low-coupon stock—3% Treasury 1987—was announced to provide a reinvestment opportunity for holders of 3% Treasury 1982, which matured on 15 February. As usual with such stocks, few applications were received at the tender (on 7 January).

In the New Year prices again fell, following declines in the US bond market, but sentiment was helped by significantly better-than-expected sterling M_3 figures for banking December (on 5 January). Short-dated stocks were marked down briefly on 7 January, when a discount house known to have been a large holder of short-dated gilt-edged stocks announced large losses, but this influence soon faded.

On 8 January, the Federal Reserve announced figures which, as for some weeks previously, were worse than the market had expected, and after the weekend the gilt-edged market awaited rather nervously the reaction of US bond prices. Sterling fell by 3¼ cents on 11 January, but the underlying tone in the gilt-edged market remained surprisingly resilient, although trading was subdued. Demand for low-coupon stocks reappeared on 13 January.

On the following Friday (15 January) the Federal Reserve released money figures that were much worse than expected, and after the weekend the gilt-edged market was initially very nervous. However, strong speculation that the miners had voted against strike action, a fall in the Bank's bill dealing rates and a comparatively good opening to the US bond market encouraged gains of up to one pound in longer-dated stocks and permitted modest official sales of non-tap stocks. The rally continued the next day as it became clearer that the miners would not strike and the remaining supplies of the short-dated tap (14% Exchequer 1986) were sold to the market at £93. For the rest of the week, the market remained strong, with demand encouraged by falling money market rates at home and in Europe. Further sizable official sales of stock were made, particularly on 22 January.

Banking February

At this point, receipts in the short term from sales of gilt-edged stocks and of national savings (see below) looked to be running well ahead of the PSBR. The authorities therefore announced a new partly-paid stock on 22 January—2½ % Index-Linked Treasury Stock 2011—with the main call set for banking March.

The choice of an index-linked stock reflected the longer-term aim of developing an adequate range of maturities for this kind of

instrument; it was convenient to pursue this aim at a time when there was little funding pressure. The previous index-linked issue (with a 2006 maturity) had been announced seven months earlier, in July 1981. The new stock carried a longer maturity than its predecessors (2011 against 1996 and 2006) and was smaller (£750 million against £1,000 million). Reflecting the discount at which the existing index-linked stocks were standing in the market, the coupon was set at $2\frac{1}{2}$%, compared with 2% previously. As before, the stock was to be sold by tender, without a published minimum price, and was available only to eligible holders.[1]

A new index-linked stock had not been expected by the market. The immediate response was a slight rise in the price of conventional stocks and a cut in the price of the existing index-linked stocks—by £$1\frac{1}{2}$ (for the 1996 stock) and by £$2\frac{1}{4}$ (for the 2006 maturity), at which point they yielded 3.21% and 3% respectively. On 25 January, prices of conventional stocks fell back sharply, after a further set of worse-than-expected US money figures. The longer conventional stocks recovered a little after hours, when the US bond market appeared fairly steady; good trade figures also helped. But over the day there were losses of up to £$1\frac{1}{2}$ in short-dated stocks and £$\frac{7}{8}$ in longs; the index-linked stocks fell again, by up to £1.

On the following day, there was a modest recovery in sentiment, especially late in the afternoon when the Chairman of the Federal Reserve Board said that there were no immediate plans for a rise in the Federal Reserve's discount rate; by Wednesday, longer-dated conventional stocks were up to £1 higher than when the new issue had been announced. The existing index-linked stocks, however, recouped only a little of their earlier falls.

A wide range of bids were submitted at the tender for the index-linked stock on 28 January, a number of them implying yields far higher than those ruling for the existing index-linked stocks. Given the comparative strength of the funding position, the Bank was able to establish a minimum price of £90 (equal to a yield of 3% in real terms) and reject all lower bids, announcing—as with the second index-linked stock in July—that the balance of the stock would not be sold into the secondary market at a price below this minimum.

The price set for the stock underpinned the market and sentiment was helped further when the New York bond market opened firm. Over the day, conventional stocks rose by up to £$\frac{5}{8}$. The existing index-linked stocks also rose after the results of the tender. All stocks opened higher the next morning as sterling continued strong, and as short-term US rates showed signs of declining. The Bank sold modest amounts of the new stock at a premium of £$\frac{1}{2}$–£$\frac{3}{4}$, as buyers switched out of the 2006 stock, and also (for the third time in a week) sold small amounts of 3% Treasury Stock 1987.

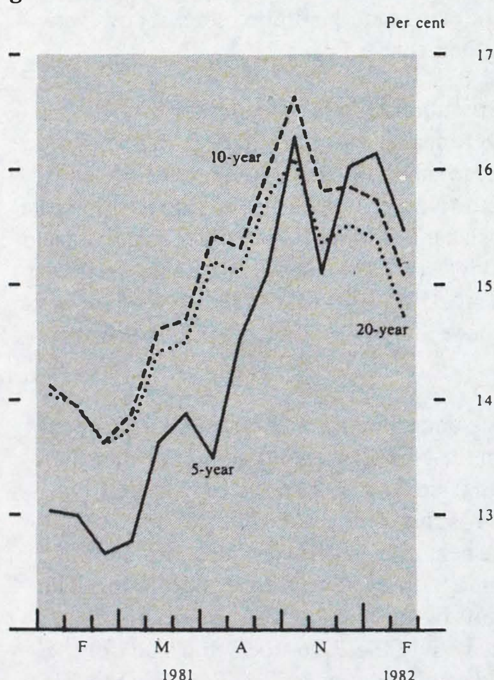
Yet another set of disappointing US money figures produced a temporary set-back on 1 February. But falls in the Bank's bill dealing rates that day, somewhat more encouraging US news, and the continuing strength of sterling (in effective rate terms) all helped to produce a firm undertone with prices rising in quiet trading.

(1) Essentially, approved pension funds or schemes and, in respect of their UK pension business, life insurance companies and friendly societies. The restrictions on eligibility were removed in the Budget on 9 March.

A new issue of conventional stock was announced on Monday 8 February. The unusual choice of a Monday(1) reflected the difficulty of pricing an issue sensibly on Friday afternoon, given the particular volatility at that time of the US bond market in response to the weekly US money figures announced each Friday, some hours after UK markets have closed. As it happened, the figures announced on that Friday evening were again disappointing and, with suggestions that the US Budget to be published shortly would show massive Federal deficits, gilt-edged prices did fall back after the weekend. Judging that US news had been absorbed, the Bank then announced a new tranche of an existing short-dated stock ($13\frac{1}{4}$% Exchequer Stock 1987) on the afternoon of 8 February. In order to avoid having subscriptions from the public on the following Friday—that is, immediately ahead of the next weekly US money figures—the stock was not offered for public subscription but was taken up initially by the Bank for sale to the market from 10 February. For the same reasons as in the case of the index-linked stock, the new tranche was partly paid, with the bulk of the funds falling due in banking March and April.

For the rest of the banking month, the underlying tone remained firm, with prices, particularly of the longer-dated stocks, rising by up to £$1\frac{1}{2}$. Index-linked stocks did not generally share in this advance, but the Bank sold a small amount of the 2011 stock on 11 February. On the same day, a modest amount of the new short-dated tap was also sold.

Gross redemption yields on British government stocks(a)



(a) Based on the yields of particular representative stocks.

Over the three months to mid-February, short-dated gilt-edged yields rose on balance, but were lower than the peak reached in the New Year. Longer-term yields fell to around $14\frac{3}{4}$%.

In the Budget, the Chancellor announced the removal of all restrictions relating to eligibility to hold index-linked stocks. At the same time, the Bank announced a new issue of such stock (2% Index-Linked Treasury Stock 1988).

Other central government debt

Net receipts of *national savings* amounted to £1 billion (seasonally adjusted) in the three months to mid-February, the most since last spring. Index-linked certificates continued to benefit from the abolition, last autumn, of the age restriction on holders and the increase in limits on holdings. Sales of the twenty-third issue of conventional certificates (introduced on 9 November) were also substantial.

Net official sales of *certificates of tax deposit* also made a significant contribution in the period, with £$\frac{1}{2}$ billion (seasonally adjusted) in banking February alone.(2) Because the yield on these certificates is generally set for a week at a time, sales were concentrated in weeks where expectations of a fall in money market rates were strong.

Other capital markets

Four months to end-February

With borrowers continuing to be discouraged by high nominal interest rates, there was little new issue activity in the fixed-interest market until long-term yields began to fall towards the end of

(1) The timing of new issues has varied in the past and there are no rules. The most common pattern, however, is that offers for sale to the public are announced on a Friday, for tender the following Wednesday or Thursday.

(2) In non-seasonally adjusted terms, net sales in banking February only amounted to £200 million; but this is a month in which sizable net redemptions would normally be expected.

January. There was, however, a 25-year 'bulldog' placing of £30 million by a French borrower in December. This was the tenth bulldog stock in 1981, and brought the total amount announced in the year to £440 million. Early in February, with long-term yields considerably lower than a month earlier, Barclays Bank announced the placing of £100 million of 2002/07 fixed-interest stock, to yield 16%—roughly 1% above a comparable gilt-edged stock. This was the first large conventional fixed-interest sterling stock issued by a commercial borrower since the early 1970s, and was sizable even in relation to clearing bank issues in dollars in recent years. In early February, Reed International raised £25 million in the eurosterling market by means of a seven-year issue; this was the first use of this market by a UK manufacturing company since the abolition of exchange controls. Towards the end of February, a Canadian company announced the first bulldog issue of 1982, with a £25 million placing. This revival in activity did not extend to the droplock market, where only one new arrangement was negotiated in the period (Table E).

Table E
Outstanding droplock arrangements

Trigger levels(a)	Amount committed as at mid-February (£ millions)
11% up to 11½%	14
10½% up to 11%	47
10% up to 10½%	38
9½% up to 10%	81
9% up to 9½%	20
8½% up to 9%	20
No specified level	26

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

Issues of loan stock

In addition to the new issues queue, in which prospective borrowers can book a firm date for an issue a month or two ahead, the Bank also maintains a 'waiting list' of borrowers who have a firm intention to make an issue in the reasonably near future, but who are not yet ready to commit themselves to a date or are waiting to be assigned a date in the queue. In recent months the waiting list has lengthened, as many borrowers who entered it with the intention of making an early issue have, in the face of prevailing interest rates, not done so. To avoid congestion, the operation of the waiting list has therefore recently been modified. Henceforth, borrowers who decline two invitations to book a firm date in the queue will be removed from the waiting list and must then wait three months before applying to rejoin the bottom of the list. These arrangements, which apply to both domestic and foreign borrowers, are designed to facilitate a regular flow of new issues on a fair basis.

Equity prices, as measured by the FT-Actuaries all-share index, rose by about 10% over the four months to end-February. This helped to generate a modest revival in the flow of announcements of new equity issues, which had fallen off during the autumn. The amount of new equity capital raised in the period, excluding the final call on the BP shares issued last summer, was still the lowest for over a year (Table F). Nevertheless, in 1981 as a whole around £1¾ billion of new equity was issued, a record in nominal terms and the highest in real terms since 1976.

Table F
Other capital markets

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

Calendar months	Feb. 81–Apr. 81	May 81–July 81	Aug. 81–Oct. 81	Nov. 81–Jan. 82
Local authorities				
Stocks	− 8	+ 3	− 84	− 36
Negotiable bonds	− 39	− 18	− 39	− 8
UK private sector				
Loan capital and preference shares(a)	− 25	+ 34	+ 51	− 22
Equity capital(a)	+215	+636(b)	+362	+504(c)
Unit trusts	+175	+144	+ 91	+110

(a) Net issues by listed UK public companies.
(b) Includes some £285 million in respect of a BP rights issue.
(c) Includes some £350 million in respect of the final instalment on a BP rights issue.