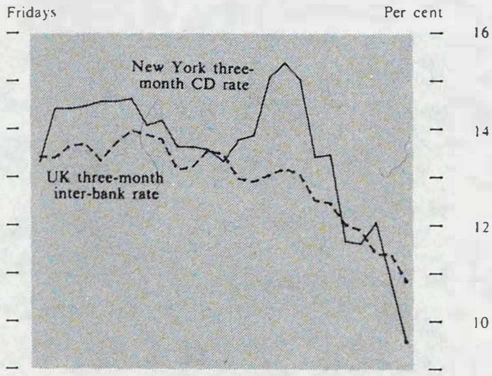
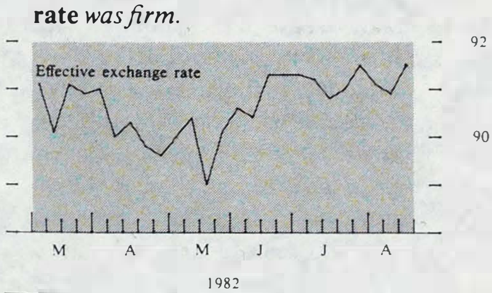
Operation of monetary policy

The fall in UK **interest rates** *steepened from the end of June when US rates turned down . . .*



. . . but sterling's **effective exchange rate** *was firm.*



Review

The background to monetary policy in the three months from mid-May to mid-August consisted of the targets for monetary growth announced by the Chancellor of the Exchequer in the Budget. These targets set a range for increases in sterling M_3, PSL_2 and M_1, over the period from mid-February 1982 to mid-April 1983, of 8%–12% (annual rate).

Over the first six months of the target period, the growth rates of these aggregates were all within the target range (Table A).

Other indicators also suggest that monetary policy continued to exert steady anti-inflationary pressure on the economy. The exchange rate remained firm, in spite of wide fluctuations in US interest rates; and the rate of increase of retail prices continued to fall, reaching 8.7% in the 12 months to July, having been 9.4% three months earlier and 12.0% at the end of 1981.[1]

These generally satisfactory monetary developments provided the basis for a gradual but progressive decline in short-term interest rates. The lowest rates at which the Bank bought short-term bills fell by $1\frac{7}{8}$%–2% over the period, and other money market rates fell in parallel at the short end. London clearing bank base rates came down from 13% to 11%, and building society mortgage rates were reduced to 12%. This general reduction in nominal interest rates followed a fall in the rate of inflation, and did not imply a corresponding reduction in real interest rates or in the anti-inflationary stance of monetary policy. Indeed, real interest rates at mid-August, though lower than for about a year, were nevertheless probably higher than in late 1980 and early 1981 (see chart on page 335 of the Economic commentary).

The speed and timing of the decline in interest rates were influenced by various factors outside the United Kingdom. The most important of these were the conflict in the Falkland Islands and developments in US financial markets. Early in the period, while fighting in the Falkland Islands continued, and uncertainty remained, the authorities considered it generally unwise to allow rates to move far. But as the outcome became clearer they acquiesced in a modest fall in rates on 8 June in response to market pressure. Immediately after fighting in the Falklands ended, however, interest rates and bond yields rose in the United States. This caused the dollar to strengthen in the foreign exchange markets and influenced interest rates and yields in the United Kingdom. While this development in the United States persisted, it inhibited further reductions in interest rates, which would have been against the prevailing sense of the market.

Around the end of June, US financial markets turned round; a fall in interest rates and bond yields began there and continued for the

(1) Recent developments in inflation are described in more detail in the Economic commentary, page 336.

rest of the period under review. This created an environment in which market pressure for further reductions in UK interest rates emerged naturally, and the Bank's lowest dealing rates for bills fell gradually, by a total of $1\frac{3}{8}\%$–$1\frac{1}{2}\%$, between 7 July and 17 August. The London clearing banks, in turn, brought their base rates down to 11%, their lowest since November 1978.

During the three months under review, sales of government debt continued to play an important part in restraining the growth of broad monetary aggregates and in influencing monetary conditions more generally. The gilt-edged market was generally thin until near the end of the Falklands conflict, and official sales correspondingly limited; but after the downturn in US interest rates had begun, demand picked up strongly and official sales were very heavy at times. As in the three preceding three-month periods, net sales of public sector debt to the non-bank private sector exceeded the PSBR, but by the comparatively small amount of £50 million.

The primary purpose of gilt-edged operations was to help to restrain the growth of the broad monetary aggregates: it was not intended though that this should stand in the way of a fall in yields, which could prepare the way for the re-emergence of new corporate bond issues. Over the three months, long-dated gilt-edged yields came down by 2% and medium yields by $2\frac{1}{2}\%$, both to a level of around $11\frac{3}{4}\%$, while short yields fell by some 3% to below 11%. Though there were continuing and at times heavy sales of indexed stocks, demand was largely concentrated on conventional stocks, and official sales were mainly of medium and short maturities.

Large shortages of funds continued in the short-term money markets during the three months under review, but with the CGBR, before seasonal adjustment, roughly matched by net sales of central government debt, the main source of the shortages was bills maturing in the Bank's portfolio. The Bank's money market operations supplied only £0.1 billion of cash to the banking system on balance, but the total of commercial bills held by the Bank rose by £0.4 billion. Although this was a relatively small amount compared with the rises in earlier periods (see Table E), nevertheless certain measures (described in the supplementary note on page 353) were introduced to cover possible future contingencies; these should help to reduce the Bank's need to supply cash to the money market and will remove a technical limitation on the scale of Government borrowing.

Monetary aggregates and credit

As noted in the review, monetary developments in the first six months of the current target period to mid-August were generally satisfactory, with the growth rates of sterling M_3, PSL_2 and M_1 within the target range. Within those six months there was some acceleration in the monetary aggregates, particularly the narrow ones, which had had a period of no growth in the spring.

The annualised rate of growth of sterling M_3, which was as low as 5.4% in the three months to mid-April, rose to 12.5% in the three months to mid-August. Building society deposits grew rapidly during the period under review, but this was not fully reflected in PSL_2, since much of the growth was in holdings of term shares, which are not included in PSL_2. Some term shares, with limited

Table A
Growth of the monetary aggregates

Percentage increases (annual rates); *seasonally adjusted*

Banking months	Dec. 81– Feb. 82	Mar. 82– May 82	June 82– Aug. 82	Mar. 82– Aug. 82
Wide monetary base (M_0)	6.8	– 7.3	0.6	– 3.4
Non-interest-bearing M_1	2.6	0.3	15.2	7.5
M_1	8.4	– 0.1	17.7	8.4
Sterling M_3	7.5	9.8	12.5	11.2
M_3	3.1	14.5	13.5	14.0
PSL_1	9.0	11.3	10.3	10.8
PSL_2	9.3	10.4	7.2	8.8

withdrawal facilities, have attracted large inflows in recent months. Growth in M_1 recovered sharply in the three months to mid-August, after three months of no growth.

The somewhat faster growth in sterling M_3 in the most recent three months may be largely attributed to a change in the Exchequer's financial position, which reverted to a more nearly normal state after its exceptional strength earlier in the year, when tax revenues delayed by the Civil Service strike in 1981 were being recovered.

The PSBR[1] increased to £2.3 billion in the three months ending mid-August from only £0.8 billion in the preceding three months. Much of the expansionary effect of this rise in the PSBR on the monetary aggregates was offset by a slowing down of sterling bank lending, particularly to businesses. Bank lending to businesses may have increased by around £2 billion in the three months to mid-August, compared with some £3½ billion in the three months to mid-May.

Within the total of lending to businesses, statistics for the second calendar quarter suggest that the slowdown in business lending was concentrated in lending to industrial and commercial companies: the rate of lending to financial companies picked up slightly, and an earlier increase in the rate of lending to unincorporated businesses was sustained. Lending to persons may have been boosted slightly at the end of the period by the abolition of official restrictions on the terms of hire purchase agreements.

Table B
Sterling M_3 and its counterparts

£ millions (rounded); *seasonally adjusted*

Banking months	Sept. 81–Nov. 81	Dec. 81–Feb. 82	Mar. 82–May 82	June 82–Aug. 82
Central government borrowing requirement	+1,200	– 100	– 100	+3,200
Purchases(–) of central government debt by non-bank private sector	–2,900	–2,500	–2,400	–2,400
of which:				
Gilt-edged stocks	*–2,300*	*– 800*	*–1,700*	*–1,900*
National savings	*– 600*	*–1,100*	*– 800*	*– 400*
Other public sector(a)	+ 500	—	+ 900	– 800
Sterling lending to UK private sector	+4,500	+4,600	+5,200	+3,900
External and foreign currency finance	– 400	– 300	– 800	–1,100
Net non-deposit liabilities (increase–)	+ 100	– 200	– 800	– 200
Sterling M_3	**+3,000**	**+1,500**	**+2,000**	**+2,600**

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

Table C
Lending for house purchase

£ millions; *not seasonally adjusted*

	Quarterly rates			
	1981		1982	
	H1	H2	H1	Q3
Building societies	1,700	1,400	1,600	2,100(a)
Monetary sector(b)	300	800	1,100	..
Other lenders	200	300	100(c)	..

.. not available.

(a) July and August, at a quarterly rate.
(b) Up to end-1981, trustee savings banks are included in 'other lenders'.
(c) Q1 figure.

Net lending for house purchase from all sources continued at a high rate and may have reached some £1¼ billion a month during the summer (Table C). In spite of this, house price rises remained modest. (For further details of developments in the housing market, see the Economic commentary, page 341). Three of the London clearing banks have recently announced that they intend to slow down their rate of increase in mortgage lending.

Foreign currency deposits held by the private sector with UK banks rose by £0.6 billion in the period under review, only half as much as in the previous three months, whilst foreign currency borrowing rose by £1.1 billion. The total external influence on sterling M_3 was contractionary by £1.1 billion; this was more than in other recent three month periods. The figures imply that the private sector had a balance of payments deficit totalling £1.3 billion on current and capital accounts in the three months to mid-August. This deficit was matched by short-term banking and public sector inflows without any effective depreciation of sterling; the main form of these inflows was a rise in overseas sterling deposits with UK banks of £0.6 billion more than the rise in sterling lending overseas by UK banks. The banks increased their net foreign currency liabilities by £0.4 billion.

The acceleration in M_1 noted above may largely be attributed to the delayed effects of the series of gradual reductions in short-term interest rates which began in mid-October 1981. Though it is impossible to be certain, those reductions may also have contributed to the acceleration in the broad aggregates.

(1) Strictly, the PSBR *minus* net sales of local authority and public corporation debt to the non-bank private sector.

Table D
Official transactions in gilt-edged securities

£ billions; *not seasonally adjusted*

Banking months	Sept. 81– Nov. 81	Dec. 81– Feb. 82	Mar. 82– May 82	June 82– Aug. 82–
Gross official sales	+3.2	+1.9	+1.9	+3.6
less				
Redemptions and official purchases of stocks close to maturity	−0.9	−1.3	−0.7	−1.4
Equals net official sales	+2.3	+0.6	+1.2	+2.2
of which, net purchases by:				
monetary sector	*−0.2*	*−0.4*	*−0.3*	*+0.3*
overseas sector	*+0.2*	*+0.2*	*−0.1*	—
non-bank private sector	*+2.3*	*+0.8*	*+1.7*	*+1.9*

Table E
Influences on the cash position of the banking system

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

Banking months	Sept. 81– Nov. 81	Dec. 81– Feb. 82	Mar. 82– May 82	June 82– Aug. 82
Money market influences				
CGBR	—	−1,300	+1,100	+3,300
All other(a)	−2,700	−2,100	−2,800	−3,400
Total	−2,700	−3,400	−1,700	− 100
Official operations affecting cash				
Net increase (+) in Bank's holdings of eligible bank bills(b)	+1,600	+2,900	+1,300	+ 400
Net increase (−) of Treasury bills in the market	+1,000	+ 100	+ 200	− 100
All other(c)	—	+ 400	+ 200	− 200
Increase (+) in banks' balances at the Bank	− 100	—	—	—

(a) Change in note circulation, sales of Government debt, change in the official reserves, etc.
(b) By the Issue and Banking Departments of the Bank.
(c) Changes in official holdings of local authority bills, discount window lending, etc.

Official operations in financial markets

Against the monetary and credit background already described, the Government's funding programme continued to play an important part in moderating the growth of the monetary aggregates. Net sales of central government debt to the non-bank private sector totalled £2.4 billion in the period under review, much the same rate as in other recent three-month periods.

Within the total, the share of national savings declined.[1] The terms offered on the 24th issue of conventional savings certificates were for much of the period uncompetitive with alternative savings instruments, especially those offered by building societies. A correspondingly larger amount of finance was, however, raised through the gilt-edged market. Redemptions and official purchases of stock near to maturity were heavy, and the monetary and overseas sectors made net purchases of gilt-edged stock (Table D). Accordingly, against net sales to the non-bank private sector of £1.9 billion, gross official sales of gilt-edged totalled £3.6 billion.

The money markets remained short of cash in the three months under review, the daily shortages averaging about £400 million. In other recent periods the Exchequer's financial position has been the main factor generating these shortages, but their principal cause in the latest three months was the maturing of earlier assistance (Table E). The CGBR was much larger than in preceding periods, both for seasonal reasons and because recovery of tax delayed by the civil service strike of 1981 was tailing off; and it was just about offset by other influences on the money market.

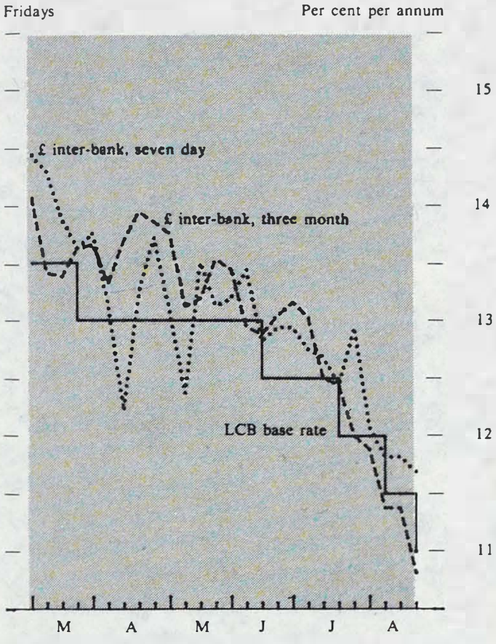
In these circumstances there was a continuing need for the Bank to provide cash to the market. As far as possible the Bank aimed to purchase bills outright, but at times when this proved difficult, for example because the discount houses expected interest rates to fall and were therefore reluctant to sell longer-maturity bills at discounts acceptable to the Bank, the Bank entered into repurchase agreements instead. Over the three months as a whole, the Bank's total holdings of commercial bills rose by £0.4 billion, although within the period there were more substantial fluctuations in the total.

The background to the Bank's operations in the money market was described in an article on page 86 of the March 1982 *Bulletin*, and in a note on page 201 of the June 1982 *Bulletin*. The Bank needs to provide cash to the money market through its open market operations whenever the Government borrows more than enough to cover its current needs and there is consequently a net flow of cash to the Exchequer. The Exchequer uses cash to redeem short-term government debt, typically in recent months Ways and Means advances from the Issue Department of the Bank, and this frees the resources of the Bank to purchase bills in the market, thus restoring cash to the banking system. There were technical constraints on the amount of Government borrowing, which were not reached in the period under review, but against the possibility that they might in future cause an undesired interruption to the funding programme three measures were announced by the Chancellor of the Exchequer on 25 June and introduced in the *Finance Act.* These are described in more detail in a supplementary note on page 353, but briefly the *Finance Act* provided for the National Loans Fund to be able to

(1) A fuller account of the role played by national savings, including recent changes in the terms offered, is given on page 350.

accumulate balances in the Banking Department of the Bank beyond working needs. It also provided for the Public Works Loans Board and the National Loans Fund to offer more competitive loan facilities to local authorities and public corporations: within a given PSBR this should allow the CGBR to be higher, which should reduce the Bank's need to provide cash to the banking system, while having no direct effect upon either the PSBR or on the rate of growth of the broad monetary aggregates (this point is explained in the box on page 201 of the June *Bulletin*).

The downward trend in **short-term interest rates** *in London continued.*



Money markets and interest rates

As already noted, there were almost continuous large shortages of cash in the money market during the period under review arising for the most part from the maturing of earlier assistance to the market. The shortages were relieved mainly by official purchases of bills, either outright or against repurchase agreements. Over the three months interest rates fell: the seven-day inter-bank rate came down by $2\frac{1}{8}\%$ to $11\frac{3}{8}\%$ and the three-month rate by just under 3% to $10\frac{5}{8}\%$. London clearing bank base rates fell by 2% to 11% and the Bank's dealing rates for bills fell by $1\frac{7}{8}\%$–2%.

In the early part of the period, until early June, fluctuating fortunes in the Falklands crisis led to nervous and volatile conditions in the money market. During this phase the Bank sought, as it had earlier in the conflict, to maintain some stability in interest rates, meeting the moderate daily cash shortages through bill operations at unchanged rates. This had the effect at some times of restraining a rise in market rates and at other times, when the Falklands news was encouraging, of moderating a tendency for rates to fall.

At the beginning of June a more broadly based confidence emerged, helped by military progress in the Falklands and the resilience of sterling against a very strong US dollar. News about the domestic monetary situation emerging at this time continued to be satisfactory, and a downward sloping yield curve began to emerge as the market came to assume success in the Falklands and to look for a modest fall in clearing banks' base rates. Against this background the authorities considered it appropriate to acquiesce in the market pressure for lower interest rates: the Bank accepted progressively lower dealing rates in its money market transactions between 4 June and 8 June, when the clearing banks announced a $\frac{1}{2}\%$ reduction to $12\frac{1}{2}\%$ in their base rates which had been unchanged at 13% since mid-March.

Following the end of the fighting in the Falkland Islands in mid-June, adverse monetary developments in the United States, and industrial relations problems in this country, emerged as the dominant influences and it took some time before the market consolidated the new level of short-term rates. Indeed longer-term money rates, for periods up to a year, increased for a time. At the Treasury Bill tender on June 25 the average rate of discount rose to above $12\frac{1}{4}\%$, and this increase was reflected in the Bank's dealing rate for 3 month bills, which, had it remained unchanged, could have resulted in profitable arbitrage possibilities.

Market sentiment began to improve again in the last two days of June when eurodollar rates softened, encouraged by the absence of any further unsettling news from the United States; longer term sterling money rates fell back and the yield curve out to a year become more nearly flat. Again, in view of the generally satisfactory monetary situation, the authorities acquiesced in a fall in rates and the Bank's dealing rates fell further, by $\frac{1}{2}\%$–$\frac{9}{16}\%$, between 5 and 13 July, when the London clearing banks announced reductions of another $\frac{1}{2}\%$ in their base rates.

The downward pressure on market interest rates exerted by developments in the United States intensified in mid-July. This followed publication of better-than-expected money supply figures for the first week of July, a cut in the Federal Reserve discount rate, and the Federal Reserve Chairman's testimony to the Senate Banking Committee; the stronger pressure persisted, with only minor interruptions, until the end of the period under review. In this atmosphere, and with domestic monetary indicators still suggesting that policy was continuing to exert an anti-inflationary influence, there appeared to be scope for a further moderate decline in rates; the Bank's bill dealing rates therefore were allowed to decline in response to the lower rates offered by the bill markets, and they fell gradually by a further $\frac{7}{8}\%$–1% between 19 July and 17 August; during that period London clearing bank base rates fell by a further 1% in two steps.

At that point the downward pressure on interest rates emanating from the United States, where the Federal Reserve was thought to have shifted its policy stance, became intense. The Bank acted to moderate the decline in market rates on 18 August by obliging the discount market to borrow from the Bank for seven days at $11\frac{1}{4}\%$, the Bank's dealing rate for band 1 bills; and the Bank maintained its dealing rates unchanged for the rest of that week.

The funding programme

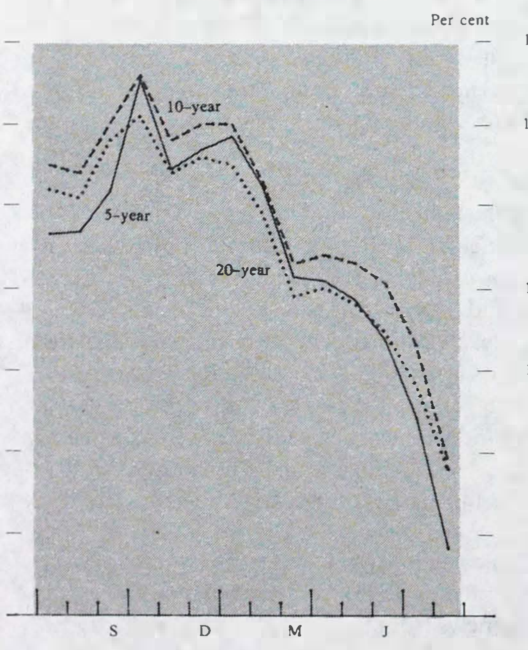
During the three months under review, net purchases of central government debt by the non-bank private sector totalled £2.2 billion. Of this some £1.9 billion consisted of gilt-edged; gross official sales of gilt-edged, however, were £3.6 billion (Table D). Gilt-edged yields fell markedly: long yields fell by 2% and medium yields by $2\frac{1}{2}\%$ —so that the hump in the yield curve flattened out—while short yields fell by some 3% to below 11%. National savings, by contrast, were subdued, with the twenty-fourth issue of conventional certificates uncompetitive in the market for personal savings for much of the period; they raised only £0.4 billion. There were net sales of certificates of tax deposit totalling £0.1 billion.

The gilt-edged market

The market began the period on an unsettled note as it became increasingly unlikely that there would be a negotiated settlement of the Falklands crisis. Sentiment improved, however, on 24 May following the British landing, although trading was thin. In order to provide the Bank with stock to sell as opportunities arose in such unpredictable market conditions, three £200 million tranches of existing stocks—12% Treasury 1987, 11% Exchequer 1991 and 12% Treasury 1995—were announced on 28 May.

A sizable amount of these tranches was sold early on 1 June in firm conditions following the news of military successes in the Falklands over the holiday weekend, and during the rest of that week the market extended its gains and further official sales were made. In these more robust market conditions an offer for sale of £750 million of $12\frac{1}{4}\%$ Treasury Convertible 1986 was announced on 4 June. This stock embodies options to convert into 13% Treasury 2000 at a

Gross redemption **yields on British government stocks**[(a)] *continued to fall— shorts rather more than longs.*



(a) Based on yields of particular representative stocks.

Table F
Issues of gilt-edged stock

Stock	Total amounts issued (£ millions)	Date announced	Date issued	Date exhausted	Price per £100 stock (£)	Payable per £100 stock: On issue (£)	Payable per £100 stock: Further instalments (£)	Redemption yield (per cent)
12% Treasury 1987	200(a)	28/5	28/5	—	—	—	—	—
11% Exchequer 1991	200(a)	28/5	28/5	—	—	—	—	—
12% Treasury 1995	200(a)	28/5	28/5	—	—	—	—	—
12¼% Treasury Convertible 1986(b)	750	4/6	9/6	12/7	97.75	30	67.75	12.99 (to 1986)
11½% Treasury 1985	100(a)	12/7	12/7	—	—	—	—	—
13% Treasury 1990	100(a)	12/7	12/7	—	—	—	—	—
12¼% Exchequer 1992	100(a)	12/7	12/7	—	—	—	—	—
12½% Exchequer 1994	100(a)	12/7	12/7	—	—	—	—	—
12¾% Treasury Loan 1995	100(a)	12/7	12/7	—	—	—	—	—
12% Exchequer 1998	100(a)	12/7	12/7	—	—	—	—	—
11½% Treasury 1989	300(a)	21/7	21/7	—	—	—	—	—
12% Exchequer 1998	300(a)	21/7	21/7	—	—	—	—	—
12% Treasury 1987 'A'	500(a)	3/8	3/8	13/8	99.625	—	—	12.10
10½% Exchequer 1987	800	16/8	19/8	20/8	98.75	40	58.75	10.84
2½% Index-Linked Treasury 2001	250	20/8	26/8	—	94.00	94	—	2.91

(a) Issued to the Issue Department of the Bank.

(b) Holdings may, at the option of holders, be converted in whole or in part into 13% Treasury Stock 2000, as on the following dates and at the indicated rates:

Date of conversion	Nominal amount of 13% Treasury Stock 2000 per £100 nominal of 12¼% Treasury Convertible Stock 1986	Implied redemption yield on 13% Treasury 2000 (% pa)
14 January 1983	£97	12.86
14 July 1983	£95	12.58
14 January 1984	£93	12.32
14 July 1984	£91	12.09
14 January 1985	£89	11.89

series of dates between January 1983 and January 1985, at progressively lower overall yields (see Table F for details). The overall gross redemption yield on the 2000 stock implicit in the first conversion option (12.86%) was some ½% lower than the market yield on 13% Treasury 2000 at the time the issue was announced; and the overall yield on the latest option is 11.89%. Therefore the stock, while attractive in its own right as a conventional short-dated stock, offered the Government the prospect of long-term funding on better terms than were available on conventional long-term issues, and indicated to the market that the authorities were not prepared to borrow long-term at the then prevailing level of yields. Although market conditions were mixed until mid-June, there were significant official sales of this convertible stock.

Around the beginning of banking July, financial developments in the United States—firmer interest rates and concern about the budget deficit—became the dominant influences: in addition industrial unrest in the United Kingdom began to affect market sentiment adversely and yields drifted up in thin trading.

At the end of June, however, the US bond market began to strengthen, while encouraging US money supply figures were published early in July, and US interest rates fell. In the atmosphere created by these developments there was substantial demand for stock and the 1986 convertible was exhausted on 12 July. On the same day the issue of six £100 million tranches of stocks with maturities ranging from 1985 to 1998 was announced, in order to enable the authorities to take advantage of the firm market conditions. Renewed hopes of lower interest rates continued to provide support to the gilt-edged market, and the tranches were exhausted after news of a lower than expected 'July bulge' in US money supply and the end of the second rail strike. These influences were reinforced by the reduction in the Federal Reserve discount

National savings

Since September 1980 national savings have become a much more important source of financing the public sector borrowing requirement (PSBR). This revival has been the result of a sustained Government initiative aimed at tapping directly the large volume of personal savings: pressure on the gilt-edged market and hence on long-term interest rates could then be relieved. It was hoped that in due course this would encourage companies to go into the capital market, which would help reduce their dependence on bank finance. Monetary pressure would thereby be relieved without imposing strains on the liquidity of the banking system.

Over the last twenty years, national savings have faced greatly increased competition from other savings institutions, notably the building societies. As a percentage of persons' identified gross liquid assets, national savings fell from about a third in 1963 to around an eighth by the late 1970s. During the same period, the percentage accounted for by building society shares and deposits rose from a fifth to over 40%.

Despite these long-term changes, it was possible to increase significantly the contribution of national savings to financing the PSBR in the three years to 1978/79. New instruments were introduced —index-linked retirement certificates in June 1975 and index-linked Save As You Earn (SAYE) in July 1975—and, from the fourth quarter of 1976 onwards, there were much larger receipts from conventional national savings certificates as rates on these were deliberately made more competitive. The contribution from national savings fell back in 1979/80, and by the late summer of 1980 the Government decided that a fresh initiative was required to restore a more diversified pattern of funding.

Accordingly, in September 1980 measures were announced to increase the inflow into national savings. As a first step, a new issue of index-linked certificates was made available to everybody aged 60 or over (only persons of national retirement age had been eligible to hold the first issue), and the maximum holding was raised to £3,000. This was expected to raise £1.5 billion (net) during the remainder of the 1980/81 financial year and make a major contribution to achieving a target of £2 billion for the year as a whole. In addition, it was announced that the limit on monthly payments under the SAYE scheme would be increased from £20 to £50; this came into effect on 1 May 1981.

Although in the event the net inflow from index-linked certificates was somewhat less than expected, the overall target of £2 billion for 1980/81 was comfortably achieved, and national savings financed 17% of the PSBR compared with 10% in the previous financial year. In subsequent Budgets a target for national savings in the coming financial year was announced. Such targets were not intended to be rigid. Nevertheless, they demonstrated the Government's determination to achieve a diversified funding programme and thus helped to provide valuable reassurance to the gilt-edged market.

For the financial year 1981/82, a target of £3 billion was announced in the 1981 Budget. Once again index-linked certificates were seen as the main means of achieving this objective and the Budget introduced two changes to the second issue: the age of eligibility was reduced from 60 to 50 and a minimum bonus of 4% was provided for all holders, new and existing. These measures were supplemented later in the year by the complete removal of the age restriction (with effect from 7 September) and an increase to £5,000 in the maximum holding limit (with effect from 19 October). By these means the Government was able to maintain receipts; indeed at the end of July 1981 the target was increased to £3½ billion. The outturn was £4.2 billion, almost half of the PSBR, and more than even the revised target. In large measure, this reflected the size of the contribution from index-linked certificates. But the other main elements of national savings—conventional certificates and, to a lesser extent, the National Savings Bank investment account—also played an important role during those periods when their rates of return were particularly competitive: in the first quarter of the financial year when there were heavy sales of the 19th issue of certificates and large inflows into the NSB investment account, and in the final quarter when the 23rd issue of certificates was much in demand.

Gross liquid assets of persons: market shares

Percentages:

End-years	1963	1966	1970	1974	1978	1980	1981
Building society shares and deposits	20	24	32	35	43	43	43
Bank deposits(a)	40	40	40	44	35	37	36
National savings(b)	30	25	18	12	13	12	14
Other liquid assets	10	11	10	9	9	8	7
Total gross liquid assets	100	100	100	100	100	100	100
£ billions	*20.2*	*24.3*	*31.8*	*52.1*	*84.4*	*115.6*	*131.3*

(a) Including trustee savings banks throughout.

(b) Including all National Savings Bank deposits but omitting any trustee savings banks' deposits thoughout.

The outturn for 1981/82 was boosted by a number of special factors which made it unlikely that it could be easily repeated. This, together with the reduced size of the projected borrowing requirement for 1982/83 and the likely smaller acquisition of financial assets by the personal sector, made it appropriate to revert to a target of £3 billion. However, after the earlier heavy inflows, net receipts in the four months April–July slowed to £500 million.

An important reason for the reduced inflow into national savings has been greatly intensified competition for personal savings; thus the building societies have relied much more on instruments which offer returns 1% or 2% higher than the basic share rate. The availability of such rates of return has clearly affected demand for the 24th issue of conventional certificates, though with the recent general decline in interest rates that issue has now become much more competitive: its yield grossed up at the basic rate of income tax is 12¾%, while the grossed-up building society ordinary share rate fell on 1 September from 12½% to just over 11%.

The Chancellor of the Exchequer announced on 22 July two measures to raise the rate of inflow into national savings. First, a new instrument, the Income Bond, which pays interest monthly, was introduced with an initial interest rate of 13½%; it went on sale from 2 August. Second, the holding limit on the second issue of index-linked certificates was doubled (to £10,000) from 26 July. A further step was taken on 27 August when the holding limit on the 24th issue was doubled to £5,000.

The contribution of national savings to the financing of the PSBR

£ millions

	1975/76	1976/77	1977/78	1978/79	1979/80	1980/81	1981/82
PSBR	10,640	8,520	5,590	9,230	9,910	13,190	8,830
Amount financed by national savings	500	1,000	1,090	1,620	970	2,240	4,230
of which:							
National savings certificates:							
conventional	*– 40*	*650*	*380*	*1,170*	*440*	*620*	*1,500*
index-linked	*250*	*250*	*230*	*270*	*750*	*1,290*	*2,120*
Index-linked SAYE	*20*	*60*	*90*	*110*	*130*	*130*	*100*
Investment Account						*450*	*670*
National savings as percentage of PSBR	5	12	20	18	10	17	48

Note: The PSBR includes interest and index-linking on national savings instruments when it accrues rather than when it is paid out (on securities) or added to accounts (in savings banks). Amounts accruing less amounts paid out are therefore treated as reinvested, and the financing flows above include them as well as the net flows of cash.

rate announced on 19 July, and the testimony of the Federal Reserve Chairman to the Senate Banking Committee. Against this background the authorities announced, on 21 July, the issue of two £300 million tranches of stocks maturing in 1989 and 1998.

The nature of the issues announced on 12 and 21 July, as on a number of earlier occasions, was determined by the prevailing volatility associated with uncertainties about US financial developments which continued to dominate sentiment in the gilt-edged market. In particular, because the market was sensitive to the weekly US money figures, announced at the weekend, there was a particular advantage in the small tranche technique which enables stock to be made available for sale very quickly when demand emerges, without major impact on prices.

The pressure for lower yields remained generally strong, and at times intense, until the end of banking August. After the exhaustion of the tranche of 1989 stock, £500 million of 12% Treasury 1987 'A' was announced on 3 August, as a replacement, designed to help refinance the very large next maturing stock, and sold out on 13 August. On 16 August, after an abrupt fall in yields, the offer for sale was announced of a new stock—£800 million of $10\frac{1}{2}$% Exchequer 1987—with the aim of consolidating the market's advance; this stock was issued on a partly-paid basis, with the main call timed for immediately after the maturity date on $9\frac{1}{4}$% Exchequer 1982. In the event prices continued to rise strongly after the announcement and the stock was therefore allotted at £98.75, that is £2 above the minimum tender price.

The market's enthusiasm persisted, and prices—particularly for long-dated stock—rose to the point where a period of consolidation seemed likely. In these circumstances, the Bank did not increase the supply of conventional stock to the market, which at that time could have made consolidation more difficult. Instead, on 20 August, it announced the offer for sale of £250 million of $2\frac{1}{2}$% Index-Linked Treasury Stock 2001, to replenish its supplies of this form of stock following the exhaustion on 4 August of official holdings of the 2011 maturity.

Other capital markets

Three months to end-August

Despite periods of weakness, the *equity* market remained generally steady and showed a modest gain over the three months. After a rise in early June on expectations of interest rate reductions, prices fell back during the rest of that month amid concern about US interest rates and domestic industrial disputes; concern about the prospects for the economy emerged as an additional, depressing, influence. In mid-July equity prices began to rise under the same influences as affected gilt-edged prices—viz the fall in interest rates in the United Kingdom and the United States, and the expectation of further falls; and the progress being made in lowering the rate of inflation in the United Kingdom. After some reaction in late July and early August equity prices, like gilt-edged prices, rose very fast in mid-August, and the FT-Actuaries All-Share Index reached a new peak of 345.94 on 20 August. At the end of August the index stood at 343.29, compared with 337.46 three months earlier. There was a modest recovery in new equity issues in the three months to end-August, after the fall in the previous quarter (Table G).

New *fixed-interest* issues were slightly higher than in the preceding three months. The main domestic issue in the period under review

Table G
Other capital markets

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

Calendar months	Sept. 81– Nov. 81	Dec. 81– Feb. 82	Mar. 82– May 82	June 82– Aug. 82
UK private sector				
Loan capital and preference shares(a)	− 57	−	+ 72	+ 75
Equity capital(a)	+333	+595(b)	+193	+312
Unit trusts	+ 97	+ 88	+107	+116
Local authorities				
Stocks	− 64	−	− 96	− 68
Negotiable bonds	− 23	− 27	− 14	+ 42
Overseas	+ 43	+ 26	+113	+161

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

was a long-dated stock of £100 million issued by Midland Bank in June. In the same month, the Inland Revenue provided clarification of the tax treatment of deep discount and indexed issues by companies; but none have so far appeared. There are indications, however, that the sustained fall in rates in recent months has significantly quickened interest amongst companies in the possibility of capital market issues; and early in September the BOC Group p.l.c. proceeded with a placing of £100 million of Unsecured Loan Stock, due 2012/17. This was the first substantial stock issue by an industrial company for over ten years; its successful placing suggests that, despite the absence of corporate issues over the past decade, the capital market has the capacity to provide long-term fixed-rate funds for corporate borrowers on a sizable scale. In the *local authority* market, an earlier droplock issue by the City of Birmingham was triggered . The fall in rates has also brought an increase in the volume of short-term bond issues by local authorities in the sterling market: scope for this was provided by an increase in the limits on such issues.

Net issues in the London market by overseas borrowers during the quarter totalled £161 million, £48 million more than in the preceding three months. In addition there were four issues by foreign borrowers in the *sterling eurobond* market in this period; all were for £30 million and their maturities were either five or seven years. While sterling eurobonds continue mainly to be sold abroad, there have recently been signs that they can on occasion attract domestic investment interest. Accordingly, in a guidance notice issued in July the Bank outlined arrangements to provide where necessary that sterling eurobond issues do not prove a source of disturbance to issues in the domestic market; the notice is reproduced on page 354.

A note on measures concerning the finance of the public sector

In recent years the authorities have sold very large amounts of public sector debt to UK non-banks in order to restrain the growth of the broad monetary aggregates. The June *Bulletin* (page 201) explained why this was necessary, and went on to describe the important but complex link between this funding and the Bank's money market operations. In particular, it noted that any increase in the CGBR which left the PSBR unchanged would add cash to the money markets (because money had flowed from the Exchequer) without much direct effect on the monetary aggregates. Such a rise in the CGBR, which might come about for example if public corporations and local authorities borrowed a higher proportion of the finance they needed from central government and a lower proportion from the banks, would reduce the amount of cash the Bank needed to provide through its own operations.

On 25 June the Chancellor announced three measures of particular relevance to this area of policy. New loan facilities were provided to local authorities and nationalised industries with the Public Works Loans Board (PWLB) and the National Loans Fund (NLF) respectively. If taken up, these will increase the CGBR while leaving the PSBR more or less unchanged, and will therefore reduce the need for the Bank to provide cash to the money markets. The third measure removes a limit on the Government's freedom to conduct its funding operations.

The Public Works Loans Board variable rate facility
The PWLB introduced a new variable rate loan facility on 25 August 1982 to supplement its existing fixed rate facilities for local authorities. Under the new facility, local authorities may borrow up to the whole of their 'quota' entitlement to PWLB funds in variable rate form. PWLB variable rate loans are available for periods of 3–10 years and bear interest at Libor,[1] defined by reference to the average three month offered rates of the four largest clearing banks, plus a margin which has initially been set at $\frac{3}{8}$%. Borrowers have an option, exercisable at any roll-over date, to convert their variable rate loans to fixed rate loans of an equivalent or longer maturity.

The course of inflation and interest rates in recent years, has led local authorities, like many other borrowers, to wish to maintain a sizable proportion of their borrowing in variable rate form. Their fixed rate borrowing both from the PWLB and directly in the capital market has declined as a proportion of the total. Instead, the local authorities have had increasing recourse to variable rate term loans from the banking system since such loans were not available from the PWLB. It is this gap in the PWLB facilities that has now been filled. The new facility will not increase the total amount of finance available to local authorities but it should lead to cost savings. The $\frac{3}{8}$% margin is competitive with the margins paid by local authorities on 8–10 year loans from the banking system; the new facility, therefore, should be an attractive source of variable-rate term borrowing for local authorities, both for their future borrowing needs and as a means of refinancing some of their existing market borrowing, the total of which was some £21.6 billion at end-June. Quite apart from the cost savings which could accrue to the public sector, the new facility should also reduce the scale of cash shortages in the money market and so ease the conduct of the Bank's money market operations. To the extent that the local authorities take advantage of the new facility, the CGBR will be larger; however, the PSBR will be unchanged (or slightly lower if there are cost savings) and there will be virtually no direct effect on the broad monetary aggregates.

The National Loans Fund temporary facility
The Chancellor also announced a new short-term NLF facility for nationalised industries. This will supplement the NLF variable rate facility introduced in 1981 which offers 3–5 year money on Libor-related terms. The new facility will offer the industries short-term fixed rate funds at a small margin over Libor. The terms to be offered are intended to be competitive with those available to the industries in the market. Although their requirement for short-term finance is modest in comparison with the local authorities' need for medium-term variable rate funds, the new facility could, by displacing part of the industries' borrowing from the banking system, have similar effects to the new PWLB facility, though on a smaller scale.

National Loans Fund balances
At times when sales of central government debt have exceeded the CGBR, the Government has normally repaid the Treasury bills held in the market, mainly by the banks and discount houses. But on occasions when the stock of Treasury bills has reached its minimum practical level, the Government has then begun to repay Ways and Means advances from the Bank. From time to time the remaining amount of Ways and Means outstanding has become very low. The National Loans Act 1968 has now been amended in order to ensure that a technical limitation on this process is not allowed artificially to interrupt funding policy. The amendment allows the Treasury to borrow where necessary to maintain sound monetary conditions, even if such borrowing causes balances to be accumulated in the National Loans Fund in excess of the working balances previously permitted under the Act; these can be held on deposit in the Banking Department of the Bank, which can use such balances when necessary to provide cash to the money markets. Such balances are not included in sterling M3.

(1) London inter-bank offered rate.