Operation of monetary policy

This article covers the three months from mid-November 1984 to mid-February 1985.

Review

The period under review was one of serious turbulence in international markets, notably the foreign exchange markets and the oil market. With the domestic monetary situation partly obscured by distortions to the money figures, this turbulence affected sterling financial markets, where short-term interest rates rose by a total of 4½ percentage points.

The marked easing in US monetary policy during the summer did not prevent a continuing rise in the foreign exchange value of the dollar, which gathered pace during the period, partly, no doubt, on account of market fears that US monetary policy could tighten once more. The impact of the dollar's strength on sterling's exchange rate was compounded, particularly in December and January, by market concerns about a possible fall in dollar oil prices. On the domestic front, the £M3 figures for banking November were seriously, though unquantifiably, distorted by the large cash flows associated with the government's sale of shares in British Telecom; this weakened the earlier market confidence that the domestic monetary and fiscal situation was under adequate control.

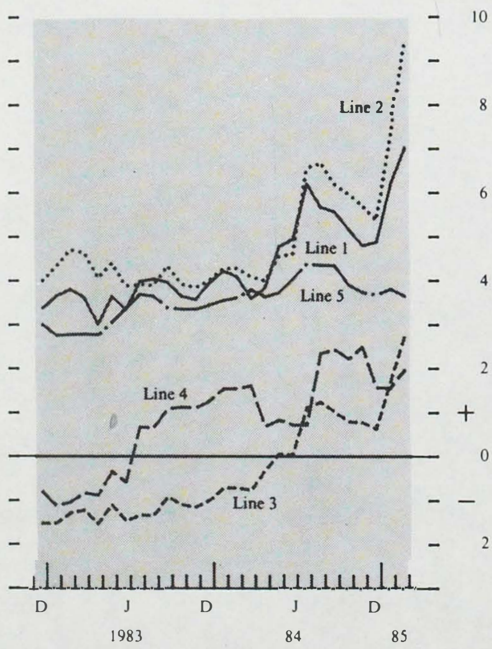
This combination of circumstances made it particularly difficult, both for the authorities and for the markets, to assess monetary conditions during December and early January. With the money figures obscured, it was natural to place greater weight on other indicators of monetary conditions. The weakness of one of the principal other indicators, namely the exchange rate, was, however, plainly reflecting extraneous developments—the strength of the dollar and market uncertainties about oil prices—and the Bank did not therefore regard it as pointing clearly to a loosening of domestic monetary conditions. Likewise, the Bank attributed the strength of the equity market to the improved profitability of the corporate sector. A number of other indicators were reasonably reassuring, including the apparent stability of inflationary expectations, the absence of signs of overheating in the economy generally or in the housing market in particular, despite the high rate of mortgage lending, and the fact that real interest rates continued to be substantially positive, even after allowance for tax. It remained the case, however, that the depreciation of the exchange rate, regardless of its cause, could, if it persisted, reach a point at which its possible inflationary consequences would call for an offsetting tightening of domestic monetary policy.

As the distortions in the monetary figures began to be reversed it became apparent that there had been a substantial increase in the pace of bank lending to the private sector, and that the PSBR was running ahead of earlier expectations. At about the

Real interest rates

Monthly averages

Per cent



Line 1 One year interbank deposit rate *minus* the expected rate of retail price inflation over the following year.

Line 2 The London clearing banks' base rate *plus* 1% *minus* the expected rate of inflation.

Line 3 The London clearing banks' base rate *plus* 1%, adjusted to allow for the deductibility of interest payments for corporation tax purposes *minus* the expected rate of inflation.

Line 4 The building society ordinary share rate, net of basic-rate income tax, *minus* the expected rate of inflation.

Line 5 The gross real redemption yield on 2% Index-Linked Treasury Stock 1996.

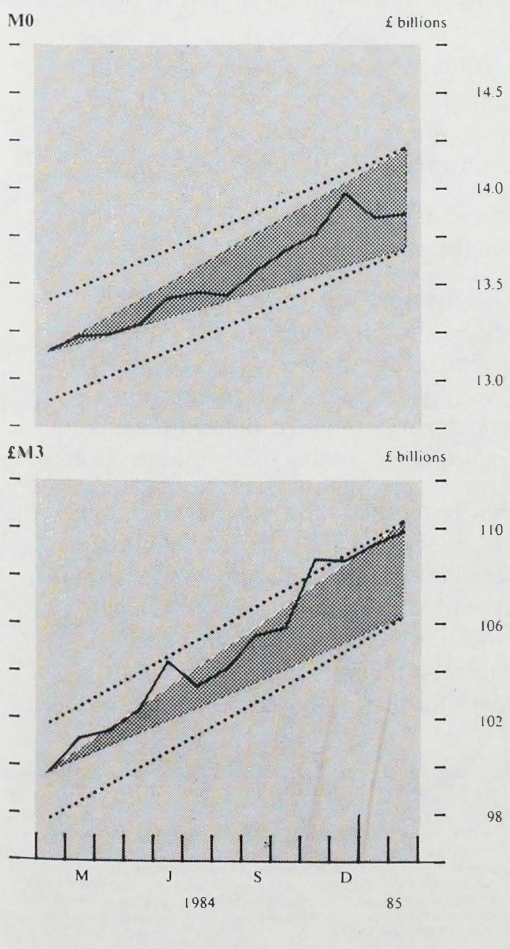
Measures of real interest rates are discussed in the December 1982 *Bulletin*, page 483.

same time sterling weakened sharply, not only against the dollar but, more significantly, against continental currencies, and at this stage, and taking into account all the relevant evidence, the authorities concluded that some rise in domestic interest rates was necessary.

The events leading up to the announcement of a minimum lending rate of 12% on 14 January are described in the later section on the money market. At that stage it appeared that the rise in rates from $9\frac{1}{2}$% to 12% was a sufficient response to the accumulating evidence that monetary conditions had loosened. Nevertheless, anxiety about oil prices mounted further ahead of the OPEC meeting on 28 January, and events at the meeting triggered a further 2% rise in interest rates. The authorities considered that to have sought to resist these pressures would have unsettled the markets further, and risked accelerating monetary growth.

Market sentiment changed rapidly after the rise in rates to 14% and pressure for reversal soon developed. Given the underlying volatility of market sentiment, the Bank resisted this pressure; in the event the further strengthening of the dollar caused the market expectation of a fall in rates to be deferred. Thereafter, sterling continued to fall against the ever-appreciating dollar, but was firm against continental currencies, no doubt helped by the high level of UK interest rates.

Growth of the targeted monetary aggregates *is within the target range after 12 months*



Monetary aggregates and credit

The figures in this section are seasonally adjusted, unless otherwise stated.

During the three months under review the growth rate of M0 remained modest, but there were signs of some underlying pickup in £M3 growth. After a year of the 1984–5 target period both of these aggregates were within their targets ranges, M0 just below the middle and £M3 near the top.

All the monetary aggregates were distorted in some degree, though at different times, by the side-effects of the sale by the government of British Telecom shares at the end of November; this made the figures more difficult to interpret during the period under review. The growth rates of the various aggregates quoted are all calculated for periods over which the distortions are thought to have had little net effect.

M0 grew more slowly on average over the period under review (by 3.1% at an annual rate) than earlier in the target period, and fell back to below the middle of its target range. There have been substantial downward revisions to earlier figures for M2, largely as a result of which the growth rate of M2 over the year to mid-February (excluding the effects of changes in the terms of existing accounts) is now put at 8.9%.

As the distortions to £M3 in banking November reversed over the ensuing three months, it became apparent that there had been some modest underlying rise in the growth rate of £M3 over the winter: over the four months to mid-February the annualised growth rate of £M3 was 10.3%, compared with 9.2% over the preceding eight months.

Table A
Change in £M3 and its counterparts[a]

£ billions; *seasonally adjusted*

Banking months	8 months Mar. 84– Oct. 84	4 months Nov. 84– Feb. 85	12 months Mar. 84– Feb. 85
1 Central government borrowing requirement(b)	+ 6.8	+2.1	+ 8.9
2 Other public sector(b)	—	+0.8	+ 0.8
3 Purchases (–) of central government debt by the non-bank private sector	– 8.1	–4.5	–12.6
of which:			
Gilt-edged stocks	*– 4.9*	*–3.7*	*– 8.6*
National savings	*– 2.7*	*–0.6*	*– 3.3*
CTDs	*– 0.5*	*–0.4*	*– 0.9*
4 External finance of the public sector(c)	– 0.1	–0.9	– 1.9
of which, gilt-edged stocks (purchases –)	*– 0.3*	*–0.7*	*– 1.0*
5 Sterling lending by the banking system to the UK private sector(d)	+10.2	+6.9	+17.1
6 External finance of the monetary sector(e)	– 0.3	+2.0	+ 1.7
7 Net non-deposit liabilities (increase –)	– 1.7	–2.8	– 4.5
8 Change in £M3	**+ 6.1**	**+3.5**	**+ 9.6**

(a) Counterparts may not add up to the total change in £M3 because of rounding.

(b) The sum of rows 1 and 2 is the PSBR, *less* net purchases of local authority and public corporation debt by the non-bank private sector.

(c) Net overseas purchases of public sector debt, *less* the public sector's net acquisition of claims on the overseas sector.

(d) Including Issue Department's holdings of commercial bills and, in February 1985, net purchases by the Issue Department of promissory notes relating to shipbuilding paper guaranteed by the Department of Trade and Industry. In July and August, there were reductions in banks' advances to leasing subsidiaries, of some £0.7 billion, following adjustments in respect of deferred tax resulting from the implications of the Finance Act, 1984.

(e) The net external sterling liabilities of the monetary sector (increase –) *plus* the net foreign currency liabilities of the monetary sector to all sectors (increase –).

Table B
Growth of the monetary aggregates

Banking months (inclusive)	12 months Mar. 83– Feb. 84	8 months Mar. 84– Oct. 84	4 months Nov. 84– Feb. 85	12 months Mar. 84– Feb. 85
	Percentage increases (annual rates); *seasonally adjusted*			
M0(a)	6.3	6.1	4.2	5.4
Non-interest-bearing M1	7.8	8.3	3.6	6.7
M1	11.1	19.0	5.3	14.2
£M3	9.5	9.2	10.3	9.6
PSL1	8.7	10.8	9.3	10.3
PSL2	11.6	15.4	14.9	15.3
M3	11.6	9.3	17.6	12.0
	Twelve month increase; *not seasonally adjusted*			
M2(b)	7.8	..	..	8.9
	10.1	..	..	*9.5*

(a) Based on averages of weekly figures.

(b) Not seasonally adjusted. The figures exclude increases arising from changes in the terms of existing accounts which bring them into M2; figures including those increases are shown in *italics*.

Among the counterparts to the growth in £M3 there was a continuing tendency for the PSBR to be larger than expected: in his recent Budget speech the Chancellor suggested that the outturn for the financial year 1984/5 as a whole might be £10½ billion. In spite of this the earlier increase in the pace of bank lending in sterling to the private sector was sustained, so that the average monthly increase over the six months to mid-February was £1.8 billion, compared with £1.2 billion over the preceding six months.[1] Most of the acceleration appears to have been in lending to businesses: the pace of personal lending by banks has not increased. A number of particular factors may have inflated bank lending to businesses, for example the acceleration of VAT payments on imports, the increased scale of takeover activity (takeovers are often financed initially by bank loans), and possibly greater diversity of financial experience among companies. In addition there may at times have been some arbitrage—borrowing on acceptances to redeposit the proceeds at a profitable margin in money market instruments—though the information available to the Bank suggests that the amount involved is unlikely to have been large. More generally it may be that the official statistics understate the extent of direct and other investment abroad, some of which could have been financed by borrowing.[2] Nevertheless there remained a substantial underlying acceleration in bank lending which appears puzzling in the light of the apparently high level of corporate liquidity.

Foreign currency lending by banks to the private sector also accelerated: it increased by an average of £1.2 billion a month in the three months under review compared with £0.5 billion a month in the preceding three months (excluding the effect of exchange rate changes on the value of outstanding loans). This too was puzzling, though some of the increased lending represents nothing more than the routing by UK banks of foreign currency loans to non-residents through their non-monetary sector subsidiaries in the Channel Islands.

The funding operations undertaken to contain broad monetary growth are described in the next section.

The rate of building society mortgage lending slowed down over the winter from its earlier very high rate: the monthly average in the three calendar months December–February was £1.1 billion. Building society lending commitments, however, increased at a faster rate during the period than earlier, and this is likely to be reflected in mortgage lending in the months to come.

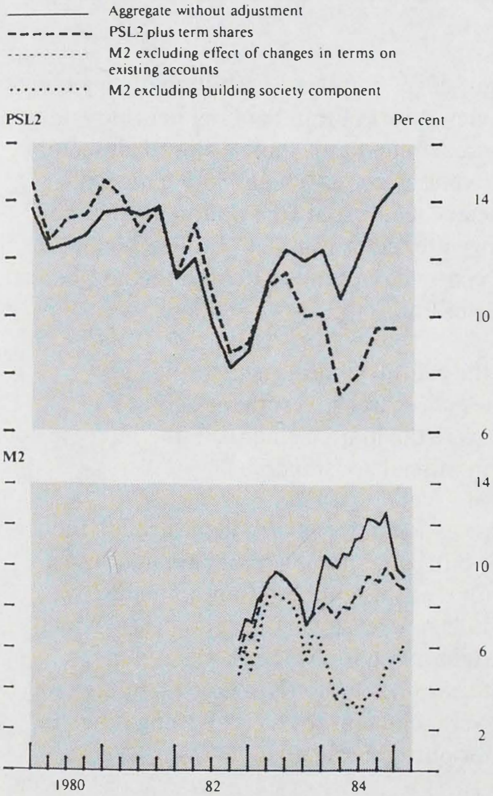
PSL2 continued to grow faster than most other aggregates and nominal incomes during the period under review.[3] As the chart shows, the building society component has grown more rapidly than the rest in recent years (this was also true of M2), partly because the building societies have become increasingly involved in money transmission but also because of the well-established tendency for their importance in the financial system to increase.

(1) After allowance for the repayment of £0.7 billion of advances to banks by their leasing subsidiaries in banking July and August 1984.

(2) The scale of industrial and commercial companies' unidentified financial transactions is described in the Economic commentary, page 17.

(3) For long runs of statistics, the *Economic Trends Annual Supplement* contains quarterly figures for PSL2 (and also for M1, £M3 and PSL1) back to 1963 Q1. The March 1984 *Bulletin* (page 80) contained monthly figures for wide monetary base, M0, back to 1969 (and an article in the March 1981 *Bulletin* (pages 59–65) presented monthly statistics of liabilities of the monetary authorities from 1961 and annual figures from 1919). Statistics of M2 are available only from June 1982.

Changes in terms on building society accounts have affected **M2 and PSL2 growth**[(a)]



(a) Percentage change on a year earlier.

There has been a trend in recent years towards readier access to building society accounts, either by the introduction of new accounts with more favourable withdrawal terms, or by changes in the terms of existing accounts. In a number of instances, particularly at the end of 1983, the change in terms has brought the balance on such accounts within M2 for the first time (for example, by reducing the period of notice of withdrawal without significant penalty from three months to twenty-eight days). Two lines for M2 are therefore shown on the chart, beginning in late 1983: the line showing the more rapid M2 growth makes no allowance for changes in the terms on which funds may be withdrawn; the line showing slower M2 growth excludes existing balances on accounts drawn into M2 by such changes in terms.

PSL2 in not affected by the changes in terms discussed above, since it includes all the building society liabilities in question; it does not, however, include term shares with building societies (nor Save as You Earn deposits).[(1)]

Building society term shares typically yield a premium over the society's ordinary share rate for a stated period of time. In the past this premium compensated for the fact that the funds were placed for a lengthy period without the possibility of early withdrawal. More recently, however, building societies have commonly offered withdrawal facilities on term shares; though in most cases the conditions are restrictive, they have become increasingly less so. The amount placed on term shares with withdrawal facilities has grown rapidly, from £5.3 billion late in 1981 to £15 billion in mid-1984, while the amount in term shares without withdrawal facilities has dwindled from £4.5 billion to some £3.5 billion. Adding these building society term shares to PSL2 would have raised its growth rate between 1981 and mid-1984. In recent months, by contrast, the amount of withdrawable term shares has fallen slightly as maturities of some of the very heavy placements made between one and three years earlier have exceeded new deposits, and non-withdrawable term shares have continued to decline. If these items were included, PSL2 growth since mid-1984 would be somewhat reduced (see chart), and would not have accelerated during the past year.

Even if the recent acceleration in PSL2 reflects primarily changes in particular features of building society liabilities, the growth rate of broad liquidity nevertheless is, and has been for the last few years, well above the growth rate of nominal income. In the case of PSL2 this reflects in part increased competition among building societies, and between them and other financial institutions. More generally, however, this trend in velocity must also reflect an increased demand for monetary assets as a home for savings, which may be explained by the gradual easing of inflationary expectations and the persistence of positive real rates of return on monetary assets. On this basis, and other things being equal, faster growth of broad liquidity than of nominal incomes need not indicate looseness in monetary conditions. This view is supported by the apparent absence of overheating in the economy generally and in particular in the housing market—where the main impact of any excessive lending by building societies would be expected to have fallen.

(1) These items have been published since March 1983 in Table 12 of the statistical annex, alongside the two aggregates of private sector liquidity, but not forming part of them.

Official operations in financial markets

The figures in this section are not seasonally adjusted, unless otherwise stated.

The substantial sales of central government debt during the period under review, combined with the surplus in the central government's cash flow, which reflected the sale of British Telecom shares as well as normal seasonal influences, led to a large increase in the need for official assistance to the money market. This was provided in part through temporary facilities made available directly to the banks, as well as through bill operations with the discount houses.

Gross official sales of gilt-edged totalled £3.5 billion during the three months under review, most of it in banking February; after purchases of stocks approaching maturity net sales to all sectors were £2.9 billion. The overseas sector bought £0.6 billion of stock net, but the monetary sector sold £0.4 billion, so that net sales to the non-bank private sector were £2.7 billion. Net sales of other forms of central government debt to the non-bank private sector were £0.3 billion.

In the money market, the central government surplus of £1.6 billion and net sales of central government debt (to all sectors) of £3.1 billion were the main elements in the increase of £4.6 billion needed in official assistance.

Some £1.5 billion of this assistance was provided through the purchase of bills—both outright, and on a purchase and resale basis. The latter technique was useful both in mobilising over three-month bills and bills not yet seven days run down, which are not eligible for outright purchase by the Bank, and in providing assistance at times when discount houses, hoping for a fall in interest rates, were reluctant to offer anything other than short-dated bills for outright sale.

The remainder of the additional assistance—some £3.2 billion—was provided, as in previous years, through purchase and resale agreements directly with the banks in gilt-edged stocks and the provision to them of finance against promissory notes related to export credit and domestic shipbuilding paper. The dates of the various agreements and the amounts supplied are listed in Table 10 of the statistical annex. The Bank resorted to this technique because of the risk of putting undue strain on the supply of eligible bills, which might have resulted in large amounts of bill arbitrage. Beginning with the agreements which came into effect on 15 January, the Bank removed the embargo, which had accompanied earlier agreements, on net additions to gilt-edged holdings by banks taking funds under the agreement; those banks were nevertheless asked to exercise suitable restraint in adding to their gilt-edged portfolios, in recognition of the fact that any such additions would give rise to a correspondingly increased need for money-market assistance.

The total stock of assistance outstanding rose from nearly £12 billion at mid-November to £16½ billion at mid-February; the increase over the year to mid-February was £5 billion.

Daily shortages of cash in the money market averaged some £570 million a day during the period, though on seven days the

Table C
Official transactions in gilt-edged stocks

£ billions; *not seasonally adjusted*

Banking months	Mar. 84– May 84	June 84– Aug. 84	Sept. 84– Nov. 84	Dec. 84– Feb. 85
Gross official sales(a)	+2.9	+4.6	+3.4	+3.5
less				
Redemptions and net official purchases of stock within a year of maturity	-1.2	-2.0	-0.7	-0.7
Equals net official sales(b)	+1.7	+2.6	+2.7	+2.9
of which, net purchases by:				
Monetary sector(b)	*-0.1*	*+0.4*	*+0.4*	*-0.4*
Overseas sector	*+0.4*	*-0.3*	*+0.3*	*+0.6*
Non-bank private sector	*+1.4*	*+2.5*	*+2.0*	*+2.7*

Note: Sales are recorded in this table on a payments basis, so that payments made on partly-paid stocks are entered when they are paid rather than at the time of the commitment to make the payment.

(a) Gross sales of gilt-edged stocks are defined as net official sales of stocks with over one year to maturity apart from transactions under purchase and resale agreements.

(b) Apart from transactions under purchase and resale agreements.

Table D
Influences on the cash position of the money market[(a)]

£ billions; *not seasonally adjusted*
Increase in the market's cash +

Banking months	Sept. 84– Nov. 84	Dec. 84– Feb. 85	Mar. 84– Feb. 85
Factors affecting the market's cash position			
CGBR (+)	+3.4	-1.6	+ 9.3
Net sales (-) of central government debt(b)	-4.8	-3.1	-13.8
of which:			
Gilt-edged	*-2.7*	*-2.9*	*- 9.9*
National savings	*-1.4*	*-0.6*	*- 3.3*
CTDs	*-0.6*	*+0.3*	*- 0.6*
Currency circulation (increase -)	—	—	- 0.7
Other	+0.5	—	- 0.1
Total (A)	**-0.8**	**-4.7**	**- 5.2**
Official offsetting operations			
Net increase (+) in Bank's holdings of commercial bills(c)	+0.8	+1.5	+ 1.9
Net increase (-) in Treasury bills in market	+0.2	-0.1	—
Securities(d) held under purchase and resale agreements with banks	—	+3.2	+ 3.2
Other	—	—	+ 0.1
Total (B)	**+1.0**	**+4.6**	**+ 5.1**
Change in bankers' balances at the Bank (= A + B)	+0.2	-0.1	- 0.1

(a) Components may not add up to totals because of rounding.

(b) Other than Treasury bills.

(c) By the Issue and Banking Departments of the Bank of England.

(d) Gilt-edged stocks and promissory notes related to guaranteed export credit and shipbuilding paper.

shortages exceeded £1 billion; they would have been greater still but for the purchase and resale agreements with the banks.

The money market

The fall in the general level of interest rates which took place on 22 November last year was described in the December *Bulletin;* this fall left base rates at $9\frac{1}{2}$%–$9\frac{3}{4}$% and interbank rates at levels consistent with these base rates, with the three-month rate at $9\frac{3}{4}$%. Conditions in the money market were calm for some weeks thereafter until mid-December, when market concerns about declining oil prices caused sterling's exchange rate to weaken more sharply than earlier, particularly against the strengthening dollar, and raised worries in the interbank market about a possible rise in interest rates. Sterling's exchange rate index (ERI) had fallen by 2.5% by the end of the year (to 73.0) from its level on 23 November and the pound had fallen from $1.2200 to $1.1580 and from DM 3.6948 to DM 3.6535.(1) The three-month interbank rate, reflecting market concerns, had risen to $10\frac{1}{32}$%.

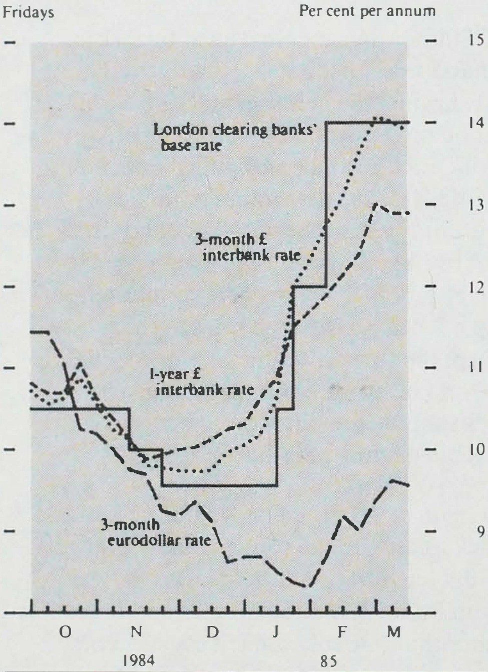
In the first few days of January sterling weakened further in the foreign exchange markets against a strengthening dollar; it also depreciated slightly against the deutschemark on further market anxieties about oil prices, so that by the close of business on 7 January the ERI had fallen by a further 0.5% to 72.6 ($1.1446, DM 3.6341). This development, in combination with uncertainty about the monetary and fiscal situation in the wake of the November money figures, led to heightened market anxiety about a rise in short-term interest rates. A substantial gap opened up between rates in the interbank market—where the three-month rate rose to a peak of $10\frac{1}{2}$% on 3 January—and base rates, which remained at $9\frac{1}{2}$%–$9\frac{3}{4}$%. The Bank resisted the pressure for higher interest rates by maintaining its bill dealing rates unchanged.

The December money figures, published on 8 January, showed that £M3 had fallen back to around the top of its target range and provided some initial reassurance to the market. After their publication, the gap between interbank rates and base rates narrowed—the three-month interbank rate fell back to $9\frac{15}{16}$% on 9 January. At the same time sterling weakened, in part reflecting a market perception that any rise in short-term interest rates had been at least deferred by the figures. Late in the morning of 10 January, however, sterling came under heavy selling pressure in the foreign exchange markets, not only against the dollar but against the generality of currencies, and the ERI fell 1% on the day to 71.6 ($1.1325, DM 3.5713). Earlier fears about interest rates were immediately reawakened, so that interbank rates hardened.

In the light of these developments National Westminster Bank raised its base rate to $10\frac{1}{2}$%, in line with interbank rates, on Friday morning, 11 January, and the other clearing banks followed suit. The Bank endorsed this move by buying bills that day at rates 1% higher than previously. The announcement of the rise in rates had been fully discounted in the foreign exchange market and sterling fell to a new low point of $1.1225 against the dollar shortly after it. Later that day, however, the pound

(1) Developments in the foreign exchange markets are described in more detail on pages 41–4.

Short-term interest rates in London
climbed steeply early this year but moderated in March



steadied in quieter conditions in London, though it weakened to close at $1.1185 and DM 3.5440 in New York.

Market turbulence re-emerged on the morning of Monday 14 January following confusing weekend press reports about the Government's attitude to the exchange rate. The sterling/dollar rate touched a new low point of $1.1020 in the Far East that morning before recovering to $1.1132 at 8.30 a.m. in London, when the ERI was 70.6 (DM 3.5255).

In those particular circumstances there was a clear tactical need for firm official action, and the Bank therefore announced a minimum lending rate of 12% for that day; the clearing banks followed by raising their base rates from $10\frac{1}{2}$% to 12%. The occasional use of MLR in such situations had been envisaged in the arrangements for official operations in the money market which were introduced in August 1981 and therefore did not involve any basic change in operational technique. It was, however, the first time that the Bank had set a rate for MLR since the arrangements were introduced.

After a period of some continuing nervousness sterling steadied in the foreign exchange market for a time, helped by the market perception of co-ordinated central bank intervention; and in the interbank market, rates settled at levels consistent with the new 12% level of base rates. On 23 January, market anxieties about oil prices, combined with demand for dollars came back to the fore, causing yet further general weakening of sterling in the foreign exchange market and renewed concern about a possible rise in sterling interest rates. Oil price anxieties came to a head at the time of the OPEC meeting on 28 January. After closing at $1.1140 (ERI 70.6; DM 3.5292) in London on Friday 25 January, sterling weakened sharply to close at $1.1080 that evening in New York. On the morning of Monday 28 January, in the atmosphere of extreme market nervousness created by these exchange market developments and by events at the OPEC meeting, interbank rates rose very sharply: the three-month rate, which had closed at $12\frac{5}{16}$% on the preceding Friday, rose to $13\frac{3}{4}$% by midday. On this basis the clearing banks raised their base rates to 14% and the Bank endorsed the increase through its money-market operations that day.

Anxiety continued the next day about the possibility of yet a further increase in interest rates. But after the announcement on 30 January by OPEC of a broad measure of agreement on oil prices, the anxiety soon gave way to euphoric expectations of an imminent fall to 13% or even 12%. In this extremely uncertain atmosphere the Bank continued to deal in the money market at unchanged rates. A renewed surge in the dollar in the first few days of February deferred expectations of lower rates until 5 February, when the UK money figures were to be published, but these figures when they appeared were not sufficiently decisive to trigger strong market pressure for a fall in rates against the background of the surging dollar. As a result interbank rates for up to a month moved up to 14% or above, but the downward slope in the yield curve beyond a month indicated a continuing expectation that the next movement in rates would be downwards. This situation persisted until the end of the period under review, despite a continuing appreciation of the dollar which took the sterling/dollar rate down to $1.0868 on 20 February, when the ERI was 71.4 (DM 3.6196).

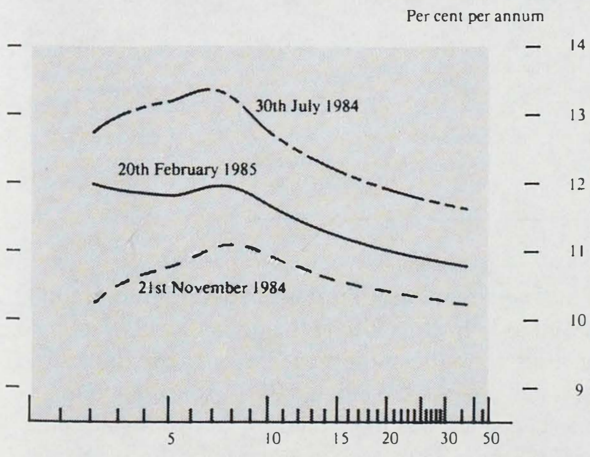
Over the period as a whole (from 23 November to 20 February) interest rates increased sharply, with the largest increases at the shortest maturities. In the interbank market, the one-month rate went up by $4\frac{15}{32}$% to $14\frac{3}{16}$%, the three-month rate by $4\frac{1}{8}$% to $13\frac{29}{32}$% and the one-year rate by $2\frac{11}{16}$% to $12\frac{5}{8}$%. Clearing bank base rates increased by $4\frac{1}{4}$%–$4\frac{1}{2}$% to 14%.

The Building Societies' Association Council had concluded at its meeting on 9 November that building society interest rates should be reduced by about 1%, and during December most societies reduced their base annuity mortgage rates from $12\frac{3}{4}$%–13% to $11\frac{3}{4}$%–12% and their ordinary share account rates form $7\frac{3}{4}$% to $6\frac{3}{4}$% (net). By the end of December most societies had reduced the rates paid on short notice accounts further by some 0.3%. After the increases in bank rates on 11 and 14 January the BSA Council concluded that rises in mortgage rates of 1%–$1\frac{1}{4}$% and in share rates of $\frac{3}{4}$% were appropriate. With effect from 1 February most societies raised their base annuity mortgage rates to $12\frac{3}{4}$%–13% and ordinary share account rates to $7\frac{1}{2}$% (net).

The gilt-edged market

The authorities began the period with some expectation that the funding pressure would become easier over the winter. Moreover, some £0.3 billion of receipts had already been secured for banking December and a further £0.3 billion for banking January through earlier partly-paid sales of $9\frac{3}{4}$% Exchequer 1998 'A'.

Time/yield curves of British government stocks



During banking December the gilt-edged market was generally quiet, despite sterling's persistent softness. There was demand for index-linked stocks which led to the exhaustion on 5 December of the small tranche of 2016 stock issued in October. The announcement on 11 December of the large increase in £M3 in banking November, distorted though the figure was, unsettled market sentiment, which thenceforth seemed more vulnerable to adverse developments of all kinds.

On 17 December, the Bank announced the issue of three small additional tranches of stock: £250 million of $2\frac{1}{2}$% Exchequer Stock 1987, £150 million of $2\frac{1}{2}$% Index-Linked Treasury Stock 2001 and £100 million of $2\frac{1}{2}$% Index-Linked Treasury Stock 2011. The purpose of these issues was to replenish official supplies of low-coupon and index-linked stocks, and thereby to push the funding programme forward without putting additional pressure on the mainstream conventional market.

The gilt-edged market remained weak until the end of the year, reflecting both sterling's softness and developing market concerns about the fiscal and monetary situation. Conditions deteriorated early in the new year as fears of a rise in base rates intensified, but the announcement on 8 January of the banking December money figures, showing a $\frac{1}{2}$% fall in £M3, led to a sharp improvement. There were heavy official sales of stock on 8 and 9 January, including the exhaustion of the remaining official supplies of the tap stock, $9\frac{3}{4}$% Exchequer 1998 'A', though at a lower price than earlier sales of this stock.

The exchange rate weakened sharply on 10 January and short-term interest rates rose in two steps to 12% on 14 January.

Table E
Issues of gilt-edged stock

Stock	Amount issued (£ millions)	Date announced	Method of issue	Date issued	Price per £100 stock (£)	Payable per £100 stock: Initial payment (£)	Payable per £100 stock: Further instalments (£)	Redemption yield (per cent)	Date exhausted
2½% Exchequer 1987	250	17/12	Direct to Bank	17/12	—	—	Fully paid	—	28/2
2½% Index-Linked Treasury 2001	150	17/12	Direct to Bank	17/12	—	—	Fully paid	—	21/1
2½% Index-Linked Treasury 2011	100	17/12	Direct to Bank	17/12	—	—	Fully paid	—	21/1
10½% Exchequer 2005	800	14/1	Direct to Bank	14/1	98.00	40.00	58.00 (18/2)	10.73	22/1
2½% Index-Linked Treasury 2003	150	25/1	Direct to Bank	25/1	—	—	Fully paid	—	8/2
2½% Index-Linked Treasury 2020	100	25/1	Direct to Bank	25/1	—	—	Fully paid	—	5/2
10½% Treasury 1989	200	30/1	Direct to Bank	30/1	—	—	Fully paid	—	7/2
12% Treasury 1995	200	30/1	Direct to Bank	30/1	—	—	Fully paid	—	7/2
10¼% Conversion 1999	100	30/1	Direct to Bank	30/1	—	—	Fully paid	—	5/2
11% Exchequer 1989	150	30/1	Direct to National Debt Commissioners	30/1	—	—	Fully paid	—	..
11¾% Treasury 1991	150	30/1	Direct to National Debt Commissioners	30/1	—	—	Fully paid	—	..
11% Exchequer 1990(a)	1,000(b)	8/2	Minimum price tender	13/2	97.50	20.00	77.50 (18/3)	11.67	12/3
2½% Index-Linked Treasury 2013	400	15/2	Tender, no minimum price	21/2	88.00(c)	—	Fully paid	3.11(d)	28/2
2½% Index-Linked Treasury 2009	150	1/3	Direct to Bank	1/3	—	—	Fully paid	—	—
2½% Index-Linked Treasury 2016	150	1/3	Direct to Bank	1/3	—	—	Fully paid	—	15/3
9% Treasury 1994	200	8/3	Direct to Bank	8/3	—	—	Fully paid	—	—
10½% Treasury 1999	200	8/3	Direct to Bank	8/3	—	—	Fully paid	—	11/3
10% Conversion 2002	200	8/3	Direct to Bank	8/3	—	—	Fully paid	—	12/3
10½% Exchequer 1997	100	8/3	Direct to National Debt Commissioners	8/3	—	—	Fully paid	—	..
11% Exchequer 1991	250	18/3	Direct to Bank	18/3	—	—	Fully paid	—	—
9¾% Conversion 2001	500	18/3	Direct to Bank	18/3	—	—	Fully paid	—	22/3

(a) The prospectus includes provision for exemption from UK taxation in favour of non-resident holders and for the Loan to be available in bearer form.
(b) Of which £200 million was reserved for the National Debt Commissioners.
(c) Price at which the stock was allotted at the tender.
(d) Real yield, calculated on the basis of a 5% annual rate of increase in the retail price index.

At the close of business that day, in order to advance the funding programme as well as help consolidate the higher level of interest rates, the authorities announced the issue direct to the Bank of £800 million of a new long-dated stock, 10½% Exchequer 2005, at a price of £98. The stock was to be paid for in two instalments, both in banking February. This issue was greeted calmly, and there were substantial official sales of other stocks even before dealings in the new issue began. The two small tranches of index-linked stock issued in December were exhausted on 21 January, and the next day the new 2005 stock itself was sold out. On 25 January the Bank announced two further small tranches of index-linked stock: £150 million of 2½% Index-Linked Treasury Stock 2003 and £100 million of 2½% Index-Linked Treasury Stock 2020.

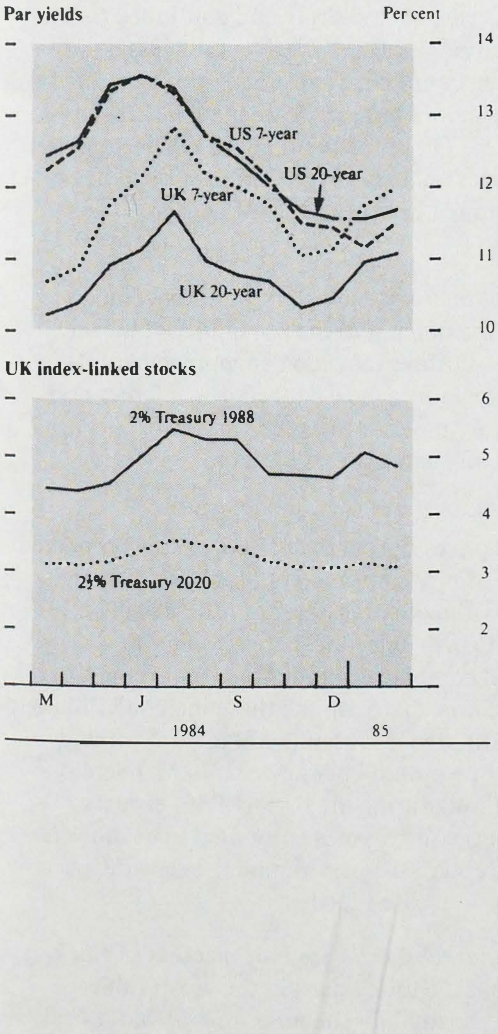
As had happened two weeks earlier, events in the foreign exchange and money markets then supervened. On Monday 28 January, following sterling's sharp fall the preceding Friday, and amid market concern about developments at the OPEC meeting, short-term interest rates rose and gilt-edged prices opened sharply lower and fell heavily during the morning. The price movements were so violent that the market closed for 45 minutes at midday, when the increases in base rates to 14% were announced. When dealings resumed prices were up to 4½ points below their closing levels on the preceding Friday; but there was a sharp recovery of about 1½ points in the afternoon. In these confused conditions, and with the funding programme by this time considerably more advanced, the authorities did not immediately issue new stock after this rise in interest rates, as they had done two weeks earlier, when rates had risen to 12%.

After a pause on 29 January the market's recovery continued strongly on 30 and 31 January, and there were further official sales of stock. On 30 January the Bank announced the issue of more new tranches of existing stocks: £200 million each of $10\frac{1}{2}$% Treasury 1989 and 12% Treasury 1995, and £100 million of $10\frac{1}{4}$% Conversion 1999. In addition, £150 million each of 11% Exchequer 1989 and $11\frac{3}{4}$% Treasury 1991 were issued directly to the National Debt Commissioners.

Demand for stock, including index-linked stock, persisted, and market optimism about the money figures for banking January led to particularly heavy sales of stock on 5 February, including the exhaustion of the tranches of 2020 index-linked stock and 1999 conventional stock. Over the remainder of the week the tranches of 1989 and 1995 conventional stock, and of 2003 index-linked stock, were also sold out.

Funding receipts for banking February at this stage were ample, and the Bank therefore announced a £20 paid issue on 8 February, of £800 million of 11% Exchequer Loan 1990.(1) As in the case of $10\frac{1}{2}$% Treasury Convertible 1992 issued in August 1984, the stock's prospectus includes provision for exemption of non-resident holders from UK taxation; in addition the stock may be converted into bearer form on or after the first dividend date.

Gross redemption yields on government stocks



The further worldwide strengthening of the dollar dampened market demand for conventional stock, and only a little of 11% Exchequer 1990 was sold at the tender on 13 February. There was, however, substantial demand for it in the secondary market on 15 February. With demand for index-linked stock also continuing, the Bank announced on 15 February the issue of a small new stock of this type, £400 million of $2\frac{1}{2}$% Index-Linked Treasury Stock 2013, thus widening the range of maturities available. In view of the amount of stock already sold in banking February, the tender for the new stock was set for 21 February, the first day of banking March. At the tender, there was substantial demand for the stock, which was allotted at a price of £88, implying a real yield of 3.11%.

Over the period as a whole yields on 5-year gilt-edged stocks rose by 1% to $11\frac{3}{4}$%; on 10-year stocks by $\frac{13}{16}$% to $11\frac{3}{4}$% and on 20-year stocks by $\frac{5}{8}$% to 11%. Index-linked yields, by contrast, fell: on the 1988 stock by $\frac{1}{2}$% to $4\frac{1}{2}$% and on the 2020 stock by $\frac{1}{8}$% to 3%.

Other capital markets

The *equity market* was buoyant during the period under review: the all-share index rose on balance by a further 11.2%. The period began quietly with investors discouraged by falling oil prices and the continuing miners' strike. This mood soon changed, however, after it became known that there had been a very high level of applications for the British Telecom share offer. The market gained further encouragement from an optimistic CBI survey about growth prospects for 1985 and

(1) A further £200 million was reserved for the National Debt Commissioners.

share prices climbed steadily. On 3 December the FT-Actuaries all share index, which had been 552.89 on 21 November, closed at a new record level of 571.94.

Prices subsequently drifted in fairly quiet conditions until 10 December when the market resumed its earlier advance, fuelled by press comment about shortages of British Telecom shares. Investors' confidence was further strengthened by news of record retail sales in November and improved prospects for Sunday trading. After a brief period of consolidation the market advanced sharply on 14 December, and insurance companies' shares in particular benefited from the announcement of agreed terms for BAT's acquisition of Hambro Life. Shortly before Christmas apprehension about the effects of end-year squaring of books and concern over sterling arising from downward pressure on spot oil prices caused share prices to fall back, but they recovered sharply again at the end of the year on reports that OPEC had reached an agreement on production levels and pricing.

In early January profit-taking and fears of higher interest rates discouraged investors but the December banking figures, announced on 8 January, prompted strong demand for leading equities. The FT-Actuaries all-share index rose above 600 for the first time, closing at 606.91 on 10 January. On Monday 14 January share prices fell back sharply and continued to fall after the announcement of MLR at 12%. Nevertheless, investors soon regained confidence and prices moved strongly ahead. On 22 January the FT-Actuaries all-share index closed at a new peak of 627.28. The subsequent fall in sterling and the 2% increase in base rates on 28 January then prompted heavy price falls which continued until after the OPEC agreement was announced.

During the first half of February investors were concerned about the strength of the dollar and the possibility of higher sterling interest rates. At times they took encouragement from other developments, including the Chancellor's statement on economic strategy. Share prices moved within a narrow range and the FT-Actuaries all-share index closed on 20 February at 614.71.

The strength of share prices during the period was accompanied by a substantial level of *new equity issues* (Table F), although few companies were willing to offer shares until after the subscription lists for British Telecom shares closed on 28 November. Several companies announced rights issues to raise very large amounts of new share capital: these included Pilkington Brothers (£105 million) in mid-December, Bank of Scotland (£115 million) about one month later and Standard Telephones and Cables (£168 million) during the first half of February. Announcements of new equity issues amounted to as much as £1.2 billion; since the end of the period under review the pace of announcements has increased further.

In the *fixed-interest market* there were four placings of stock by domestic issuers but the total raised in this way (Table G) was sharply down on the total for the preceding period. Local authorities again made no issues and no stock was issued under droplock arrangements by local authorities or other borrowers. (Droplock arrangements currently outstanding

Table F
Amounts raised in the capital market
£ millions; *not seasonally adjusted*
Net cash raised +

Banking months	Mar. 84– May 84	June 84– Aug. 84	Sept. 84– Nov. 84	Dec. 84– Feb. 85
UK private sector				
Loan capital and preference shares	+ 99	+109	+ 69	+ 84
Equity capital(a)	+314	+497	+535	+322
Unit trusts(b)	+372	+275	+294	+302(c)
Issues on the unlisted securities market	+ 42	+ 41	+ 48	+ 10
Local authorities				
Stocks	− 11	—	− 11	− 47
Negotiable bonds	− 66	− 61	− 88	−116
Overseas	+260	+216	+296	+159

(a) Net issues by listed UK public companies.
(b) Calendar months.
(c) December and January only.

Table G
Debt issues announced on the London capital market, mid-November to mid-February 1985[(a)]

Date of Announcement	Issuer	Nominal amount (£ millions)	Coupon (per cent)	Maturity
Domestic borrowers				
27 November	Glasgow Stockholders Trust	4	$11\frac{1}{2}$	2009
5 December	Gartmore American Securities	3	$11\frac{3}{8}$	2014
7 December	Commercial Bank of Wales	3	$13\frac{1}{2}$	1997
20 February	Mid-Sussex Water Company	3.5	12	2010
Overseas borrowers				
10 December	Inter American Development Bank	100	$9\frac{3}{4}$	2015
17 December	European Economic Community	11.5	$11\frac{1}{2}$	2004
18 February	Kingdom of Spain	60	$11\frac{1}{8}$	2010

(a) The issues by the European Community and all issues by domestic borrowers were placed. Issues of convertible loan stock and issues of less than £3 million are not included.

remain as shown in the June 1984 *Bulletin*.) Overseas borrowers continued to tap the market but the total of £159 million raised by them was lower than during the previous three months.

In his Budget speech the Chancellor announced regulations under the Banking Act to facilitate the issue of 1–5 year corporate bonds; details are given in a Bank of England market notice reprinted on the next page.

In the *eurosterling market* there was increased interest in raising fixed-rate finance and eight borrowers, including one UK company, issued bonds totalling some £400 million. There were also four issues of floating-rate notes with a total value of £275 million.