Operation of monetary policy

This article covers the three months from mid-November 1985 to mid-February 1986.

Review

The period under review was one of considerable turbulence in financial markets. Towards the end of 1985, doubts about the development of broad money, a softening in the exchange rate as the oil price began to weaken, and concern about unit labour costs brought upward pressure on interest rates, which culminated in a 1% rise early in January. Thereafter the situation was dominated by an accelerated fall in oil prices, initially producing further strong upward pressure on interest rates, which was resisted, and then an orderly decline in the exchange rate. By the end of the period the oil price appeared to have steadied and domestic monetary indicators were more reassuring. As a result, the exchange rate stabilised and domestic financial markets also became much more confident.

So far as the monetary aggregates are concerned, the main features of 1985 were the tendency for the broad aggregates to grow much faster than the narrower ones, and for £M3 to accelerate relative to those broader aggregates which include building society liabilities. This complicated the interpretation of the aggregates, although, as explained in earlier *Bulletins,* there were good reasons for believing that the rapid £M3 growth reflected structural changes rather than relaxed monetary conditions.

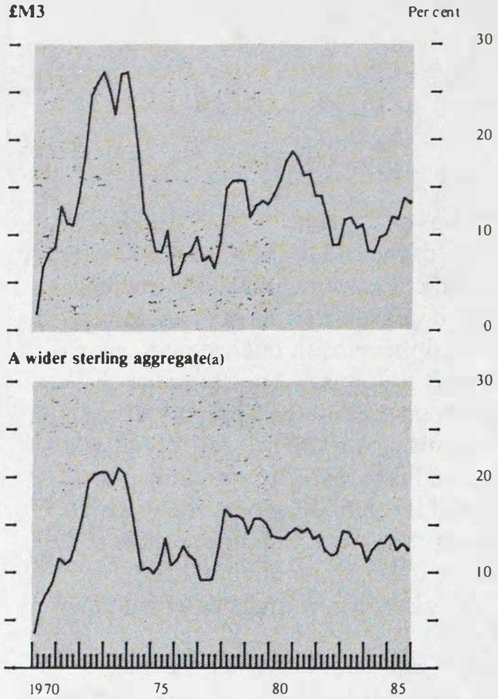
Real economic growth slowed during the second half of 1985, with the output measure of GDP growing by $2\frac{1}{4}$% at an annual rate, down from the $4\frac{1}{2}$% achieved in the previous half year (partly on recovery from the miners' strike). The decline in the annual rate of retail price inflation—to some $5\frac{1}{2}$% by the end of the year—owed more to low commodity prices and a relatively firm exchange rate than to purely domestic factors. The continued strong growth in average earnings, despite the slowdown in productivity growth since 1983, continued to cause concern about unit labour costs.

The fall in oil prices, which began in December, contributed to some increased pressure on the exchange rate in the approach to the Christmas holidays. But with market expectations of a discount rate cut in the United States, the nervousness building up in the domestic money markets was contained until activity returned to normal in the New Year.

In the light of the persisting market pressure, and of the policy concerns described above, on 8 January the Bank signalled a rise in the general level of interest rates to $12\frac{1}{2}$% by lending publicly to the discount market at that rate.

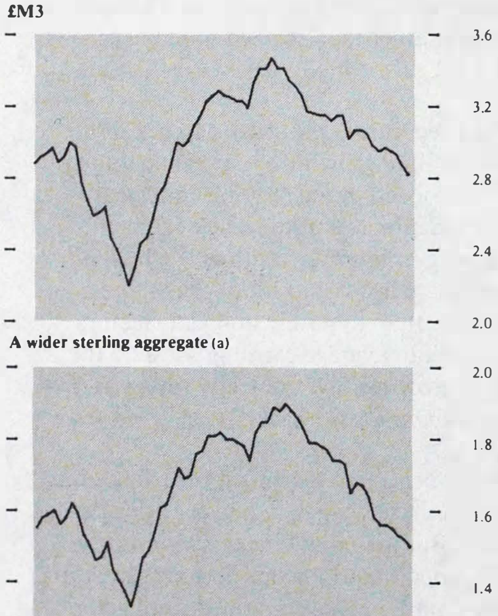
As the oil price fall accelerated, money-market interest rates rose to well above $12\frac{1}{2}$% on the belief that the authorities would

12-month growth rates of broad monetary aggregates



(a) PSL2 *plus* building society term shares and bank deposits with an original term longer than two years.

Velocity of broad monetary aggregates



(a) PSL2 *plus* building society term shares and bank deposits with an original maturity longer than two years.

seek to resist any further fall in the exchange rate. The Bank demonstrated through its money-market operations on 14 January that this was not the official stance. After a time the pressure gradually shifted into the exchange market and sterling declined, though in a reasonably orderly way.

The situation eased early in February as the oil price steadied for a time and was consolidated by the publication of a series of financial figures for January, relating to the monetary aggregates, bank lending, the reserves and (later) the PSBR, which were far better than the markets expected. In a wider context, there was a growing appreciation of the potential benefits of the lower oil prices for inflation and the world economy, so that by the end of the period strong downward pressure on both short and long-term interest rates was emerging generally in the industrial world.

This eventually led to loosely concerted reductions in interest rates in the major countries in early March and to a strong advance in both bond and equity markets worldwide. Long-term bond yields in the United Kingdom finally breached the 10% barrier, which they had tested several times in the past year, towards the end of February. And the general level of short-term sterling interest rates was reduced back to 11½% on 19 March, following the Budget.

Monetary aggregates and credit

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

£M3 increased by only 1.7% during the three months under review, which was less than in the preceding three months, but its twelve-month growth rate remained at 14%–15%. The increase in a broader liquidity aggregate which includes all building society liabilities,[1] at 2.4%, was also less than in the preceding three months, when it was 3.6%. The twelve-month increase in this aggregate continued to be stable, in the region of 12½%–13½%, as it has been almost continuously since mid-1984. The rise in M0, on the other hand, at 1.1%, was somewhat larger than in the previous period, but M0's twelve-month growth rate, at 3.5%, remained close to the bottom of its target range.

Although there appears to have been some welcome deceleration in broad money growth within the three months under review, the figures continue to exhibit the now familiar pattern of relatively high broad money growth alongside much slower growth of narrow money. The tendency for broad monetary aggregates to grow faster than nominal incomes—that is, for their velocity of circulation to decline—has been evident since about 1980 (see charts), but it became more marked in 1985. This has been particularly the case with £M3. The reasons for the secular decline in the velocity of the broader liquidity aggregates were described in detail in the December 1985 *Bulletin*, pages 519–20.

As Table A shows, the tendency for £M3 to grow faster than wider liquidity aggregates including building society liabilities

(1) Equal to PSL2 *plus* building society term deposits and bank deposits with an original term longer than two years.

Table A
Growth rates of the monetary aggregates
Percentages: *seasonally adjusted*

Banking months	12 months to Nov. 85	12 months to Feb. 86	Sept. 85– Nov. 85	Dec. 85– Feb. 86
M0(a)	3.4	3.5	0.7	1.1
£M3	14.4	14.8	4.6	1.7
Non-interest-bearing M1	1.5	2.7	0.9	0.4
M1	17.1	20.2	4.9	1.2
M2(b)	8.9	8.9		
	9.6	*9.6*		
PSL1	13.4	13.8	4.3	1.3
PSL2	14.2	14.5	4.7	3.1
PSL2 *plus* term shares with building societies and bank deposits with an original term longer than two years	12.9	12.9	3.6	2.4
M3	13.1	11.6	4.2	1.9

not available.
(a) Weekly average.
(b) Not seasonally adjusted: excluding the effect of changes in the terms of existing accounts. Figures including such effects are shown in *italics*.

Table B
Composition of changes in the money stock
£ billions: *seasonally adjusted*

	Banking months	Sept. 85– Nov. 85	Dec. 85– Feb. 86	Level outstanding at mid-Feb. 86
1	Non-interest-bearing M1	+0.3	+0.1	34.4
2	Interest-bearing sight deposits	+2.5	+0.6	25.2
3	**M1 (= 1+2)**	**+2.8**	**+0.7**	**59.6**
4	Private sector holdings of time deposits with banks and bank CDs	+2.7	+1.3	66.6
5	**£M3 (= 3+4)**	**+5.5**	**+2.0**	**126.2**
	Non-bank private sector holdings of:			
6	Building society shares and deposits(a)	+5.0	+4.9	89.7
7	Building society wholesale liabilities(b)	—	+0.1	1.8
8	Other	−0.8	−0.3	4.9
9	**PSL2 (= 5+6+7+8)**	**+9.7**	**+6.7**	**222.6**
10	Building society term shares(c)	−1.6	−1.2	16.6

(a) Other than term shares; including interest credited.
(b) CDs and time deposits (excluding holdings by building societies themselves).
(c) Including interest credited.

Table C
Sterling credit extended to the private and overseas sectors
£ billions: *seasonally adjusted*

	Banking months	June 85– Aug. 85	Sept. 85– Nov. 85	Dec. 85– Feb. 86	Level out-standing at mid-Feb. 86
1	Bank lending in sterling to the non-bank private sector	+4.7	+5.0	+4.1	139.2
	of which:				
2	To building societies(a)	+0.1	+0.1	+0.4	2.4
3	To persons(a)	+2.1	+2.3	+1.6	41.7
4	*of which, for house purchase*(a)	*+1.2*	*+1.3*	*+0.8*	*21.1*
5	Building society lending(b)	+3.3	+3.9	+4.1	99.7
6	**Total lending (= 1−2+5)**	**+7.9**	**+8.8**	**+7.8**	**236.5**
7	*of which, for house purchase (= 4+5)*	*+4.5*	*+5.2*	*+4.4*	*120.8*
8	Bank lending in sterling to overseas non-banks	−1.3	−0.1	+0.3	18.2
9	**Total lending in sterling other than to banks and building societies (= 6+8)**	**+6.6**	**+8.7**	**+8.1**	**254.7**

(a) Provisionally seasonally adjusted.
(b) Figures are on a calendar month basis (and outstanding level at end-February 1986).

has been reversed in the latest period. Some possible reasons for this change can be identified.

In the first place, the rapid increase in banks' interest-bearing deposits over the middle months of 1985 was in part at least the result of a deliberate strategy by the banks aimed at wooing deposits away from building societies. This strategy may have been in turn prompted to some extent by fears about the effects on banks' competitiveness of the introduction of the composite rate tax arrangements in respect of bank deposits. It is possible that the banks' success in this strategy, which raised £M3 growth relative to the broader aggregate, occasioned a stock adjustment by depositors. After this initial adjustment, the growth of £M3 moderated relative to that of the broader aggregates.

Second, £M3 growth had been increased earlier in 1985 in part because the building societies themselves shifted a proportion of their holdings of liquid assets, no doubt on relative yield grounds, from public sector debt into bank deposits; this coincided with a slowdown in the pace of government debt sales. This shift was interrupted in the fourth quarter, though it may subsequently have resumed.

Turning to the counterparts of £M3 growth, the main expansionary element continued to be bank lending to the domestic non-bank private sector. This grew by £4.1 billion in the three months to mid-February, which was nonetheless £0.9 billion less than in the previous period. Over two thirds of this slowdown was in bank lending to persons, including lending for house purchase (see Table C).

The central government was in small surplus (£0.1 billion) on own account during the period. Central government on-lending to the rest of the public sector (£0.9 billion) was used mainly by the local authorities to reduce bank borrowing and by the public corporations to increase deposits with banks and the National Loans Fund. The overall public sector borrowing requirement, adjusted for sales of debt by local authorities to the non-bank private sector, was £0.7 billion, well down from the £2.7 billion recorded in the previous period.

The external counterparts as a whole were less contractionary than in recent periods, partly reflecting a much lower take-up of gilt-edged stock by overseas purchasers. In the six months between mid-May and mid-November, overseas purchases of gilt-edged, at £1.7 billion, effectively accounted for all the contractionary impact of the external counterparts on the growth of £M3. In the latest period, however, overseas gilt-edged purchases were only £0.2 billion, compared with total external counterparts of £0.5 billion.

Official operations in financial markets

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

The surplus in the central government's cash position in the three months under review was larger than is usual at that time of year. Although net sales of central government debt were only modest, consistent with the aim of fully funding the PSBR over the year as a whole, official assistance to the money market increased by £2.7 billion.

Analysis of bank lending—special survey covering lending in categories 'other financial' and 'other services'

The quarterly 'industrial' analysis of bank lending[1] identifies lending to four specific categories of non-monetary sector financial institution, namely building societies, investment and unit trusts, insurance companies and pension funds, and leasing companies. Other bank lending to financial institutions is put in a residual category, which has become very large, containing nearly 45% (£8.7 billion at mid-February 1986) of the banks' recorded sterling lending to non-monetary sector financial institutions and nearly three quarters (£10.7 billion) of their foreign currency lending to such institutions. More information about the destination of such a large amount of lending was considered desirable.

Lending in a separate residual category in Table 5.1, 'other services', includes lending to securities dealers, stockbrokers and jobbers, which are presently classed as services in the Standard Industrial Classification. It was thought important, with major changes in securities markets in prospect, to know the broad magnitude of bank lending to such borrowers.

About 100 banks, accounting for over 80% of lending in these residual categories, provided an analysis of this lending as at 20 November 1985. The Bank of England is very grateful to these institutions. The results of the survey are summarised in the table.

'Other financial'

Nearly three quarters of *sterling* lending in the 'other financial' category was to *non-monetary sector finance houses, HP etc companies* and *consumer credit grantors,* which number several thousand, and to *mortgage finance companies.* Much of the lending in these categories would be destined for the personal sector.

The pattern of *foreign currency* lending in the 'other financial' category was quite different. Most of it went to *bank-type* (but not monetary sector) *institutions in the Channel Islands and the Isle of Man* and to *certain institutions extending credit abroad.* In both cases, it is likely that most of the funds flowed abroad.

More surprising was the substantial amount of foreign currency lending reported as being made to *finance houses, HP etc companies* and *consumer credit grantors.*

Some institutions in the 'other financial' category make statistical reports on their own behalf. Exact comparison with transactions as reported by banks is not possible, because of timing and coverage differences. In some cases, the correspondence was as close as could be expected; in other cases, however, there were substantial discrepancies which are being further investigated in the hope of achieving a closer correspondence.

'Other services'

The survey shows that the banks had lent some £½ billion in sterling and £3½ billion in foreign currency to *securities dealers, stockbrokers and jobbers.* As might be expected, a large part of sterling lending in the 'other services' category (though a much smaller part of foreign currency lending) went to a variety of other business and professional services.

In the light of the impending changes in the organisation of the UK securities markets, it has been decided to transfer securities dealers, stockbrokers and jobbers to the 'other financial institutions' sector. However, detailed information about the transactions of such firms and institutions will not be available for some time. Meanwhile, securities dealers' transactions in overseas securities (which are available from balance of payments sources) and in the UK government FRN issued in October (which are attributed by residual) are being allocated to the OFI sector, together with an equivalent amount of foreign currency lending reported by banks as made to industrial and commercial companies. It is intended that the banks should, later this year, report their transactions with securities dealers, stockbrokers and jobbers as transactions with OFIs. The change of sector will be complete when these institutions begin to make regular returns of their financial transactions; it is hoped to recruit them to reporting panels soon.

Analysis of two residual categories of bank lending[a] as at 20 November 1985

£ millions

	Sterling	Other currencies
'Other financial'		
Total	**6,070**	**8,940**
of which:		
Bank-type institutions in Channel Islands and Isle of Man; certain institutions extending credit abroad(b)	200	6,910
Finance houses, HP etc companies; 'other' consumer credit grantors; mortgage finance companies	4,300	1,210
Other	1,560	830
'Other services'		
Total	**7,900**	**4,930**
of which:		
Securities dealers, stockbrokers and jobbers	500	3,600
Holding companies not included elsewhere(c)	910	220
Miscellaneous services etc	6,500	1,110

(a) Loans, advances and acceptances as reported by banks participating in the survey.

(b) Banking institutions in the Channel Islands and Isle of Man which are not part of the UK monetary sector; institutions both on the mainland and in the Channel Islands and Isle of Man specialising in extending credit abroad.

(c) Lending to holding companies whose principal area of interest can be identified is recorded as lending to that activity. Other lending to holding companies is recorded here.

(1) See Table 5.1 of the statistical annex.

Table D
Financing of the public sector
£ billions: *seasonally adjusted*

Banking months	12 months to mid-Mar. 85	11 months to mid-Feb. 86
Central government borrowing on own account	+ 6.0	+4.5
Other public sector borrowing(a)	+ 4.3	+2.2
'Modified' PSBR(b)	**+10.3**	**+6.7**
Net sales of central government debt to the non-bank private sector	−13.1	−5.6
of which:		
Gilt-edged stocks	*− 9.4*	*−3.6*
National savings	*− 3.1*	*−2.3*
CTDs	*− 0.8*	*+0.2*
External and foreign currency finance of the public sector	− 2.0	−2.3
of which, gilt-edged stocks	*− 1.1*	*−2.4*
Total financing of the government from the non-bank private and overseas sectors(c)	**−15.1**	**−7.9**

(a) Includes on-lending from central government to local authorities and public corporations.

(b) Equals the PSBR *less* net purchases of local authorities' and public corporations' debt by the non-bank private sector.

(c) This total excludes net purchases of local authorities' and public corporations' debt by the non-bank private sector. As explained in footnote (b), the impact of such purchases is included, indistinguishably, within the 'modified' PSBR.

Table E
Official transactions in gilt-edged stocks
£ billions: *not seasonally adjusted*

Banking months	Mar. 85– May 85	June 85– Aug. 85	Sept. 85– Nov. 85	Dec. 85– Feb. 86
Gross official sales(a)	+4.0	+3.9	+2.7	+2.7
less				
Redemptions and net official purchases of stock within a year of maturity	−0.6	−2.5	−1.0	−2.0
Equals net official sales(b)	+3.4	+1.4	+1.7	+0.6
of which, net purchases by:				
Monetary sector(b)	*+0.5*	*+0.1*	*−0.2*	*−0.2*
Overseas sector	*+0.7*	*+1.1*	*+0.6*	*+0.2*
Non-bank private sector	*+2.2*	*+0.3*	*+1.3*	*+0.6*

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

(a) Gross official 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.

The central government had a cash surplus of £3.0 billion on own-account transactions during the period under review. This seasonal surplus was unusually large, mainly reflecting heavy corporation tax receipts. In addition, on-lending to local authorities and public corporations was lower than in recent periods; the total central government cash surplus during the period was £2.1 billion.

Gross official sales of gilt-edged were £2.7 billion during the three months to mid-February, the same as in the previous three months. Once again, the full-fund policy meant that gross sales were at a rate well below that of earlier periods. Although only one stock was redeemed during the period, there were substantial official purchases of stocks approaching maturity, in anticipation of the heavy schedule of maturities (some £9 billion in total) in the 1986/87 financial year. The consequence was that net official sales, at £0.6 billion, were well below those of recent periods. As in the previous three months, the monetary sector was a net seller of gilts (£0.2 billion). With small net purchases by the overseas sector (£0.2 billion), the non-bank private sector bought only £0.6 billion, again well down on earlier periods.

Inflows into national savings were subdued and there were substantial net surrenders of certificates of tax deposit.

There was an increase of £2.7 billion in the need for official assistance to the money market. Of this, some £2.1 billion was met through the outright purchase of commercial bills. In addition, market holdings of Treasury bills fell by £0.4 billion. Finally, £0.2 billion of assistance was provided 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. This represented the net result of the expiry of two such arrangements and the introduction of two new ones, of which the details are given in Table 10 of the statistical annex.

At mid-February, the total stock outstanding of official assistance to the money market (other than that provided through dealings in Treasury bills) totalled £15½ billion. Of this, £13½ billion consisted of outright holdings of eligible bills; with no bills bought on purchase and resale agreements, the remainder, about £2 billion, represented other securities bought directly from banks on purchase and resale agreements.

There were unusually large revisions during the period to the Bank's published forecasts of the daily shortages in the money market. The bulk of these revisions—which were generally such as to increase the estimated flows of cash out of the market—related to the net Exchequer position (although on some days, as is usual over the Christmas period, there were large shifts in the forecast note circulation). The principal reasons for the revisions to forecast during the period were unexpectedly large gross purchases of certificates of tax deposit and temporary deposits by public corporations with the National Loans Fund. Moreover, the actual shortages in this period were even greater than implied by the published revisions, owing to late movements (after the last published forecast) against the market. These were again partly the consequence of large gross inflows to certificates of tax deposit;

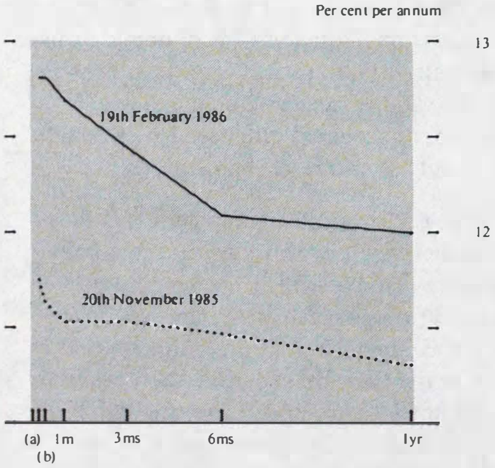
but were mainly caused by late developments in government current revenue and expenditure.[1]

Table F
Influences on the cash position of the money market
£ billions; *not seasonally adjusted*
Increase in the market's cash +

Banking months	Sept. 85– Nov. 85	Dec. 85– Feb. 86	Mar. 85– Feb. 86
Factors affecting the market's cash position			
CGBR (+)	+4.9	-2.1	+10.2
Net sales (-) of central government debt(a)	-2.4	-0.2	- 9.5
of which:			
Gilt-edged	*-1.7*	*-0.6*	*- 7.2*
National savings	*-0.7*	*-0.3*	*- 2.4*
CTDs	—	*+0.7*	*+ 0.1*
Currency circulation (increase -)	+0.2	—	- 0.5
Other	-0.3	-0.4	+ 0.8
Total (A)	**+2.4**	**-2.7**	**+ 1.0**
Official offsetting operations			
Net increase (+) in Bank's holdings of commercial bills(b)	-0.4	+2.1	+ 0.2
Net increase (-) in Treasury bills in market	—	+0.4	+ 0.2
Securities(c) acquired (+) under purchase and resale agreements with banks	-1.8	+0.2	- 1.3
Other	-0.1	—	—
Total (B)	**-2.3**	**+2.7**	**- 0.9**
Change in bankers' balances at the Bank (= A + B)	+0.1	—	+ 0.1

(a) Other than Treasury bills.
(b) By the Issue and Banking Departments of the Bank of England.
(c) Gilt-edged stocks and promissory notes related to guaranteed export credit and shipbuilding paper.

Sterling interbank rates



(a) Overnight.
(b) For one week.

The average daily (actual) cash shortages in the money market fell further in the latest three-month period to some £650 million, compared with £700 million in the previous three months. There was a marked fall in average daily shortages in the course of the period, from £900 million in banking December to £500 million in banking February, which reflected a lower rate of maturing assistance as the period progressed.

The money market

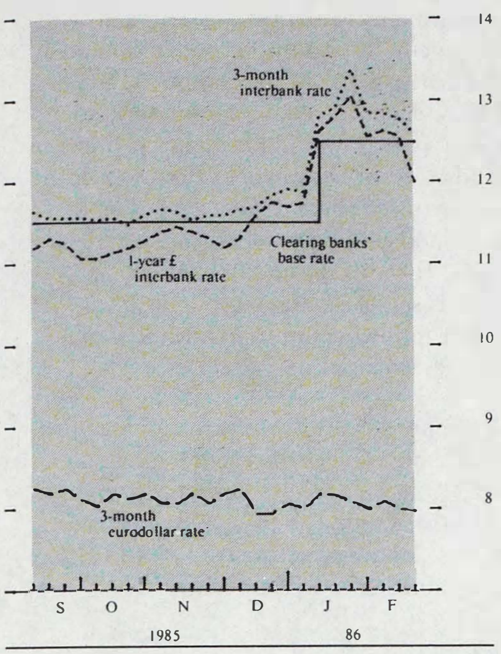
The period opened with a gently downward-sloping yield curve in the interbank market, with the one-month rate at $11\frac{19}{32}$%, the three-month rate at $11\frac{9}{16}$%, and the twelve-month rate at $11\frac{5}{16}$%. Banks' base rates stood at $11\frac{1}{2}$%. Hopes of a discount rate cut in the United States and some strengthening of sterling's exchange rate (which peaked at 81.7 on the exchange rate index on 2 December—up 2.1% from the start of the period— as the pound touched $1.5020) led to bullish expectations in the domestic money markets, and the downward slope of the yield curve became more pronounced reflecting the expectation of lower interest rates. The authorities, however, made it clear by their actions in the bill market at the beginning of December that the monetary situation did not warrant a fall in the general level of interest rates. Market optimism was soon dented as oil price worries mounted, particularly after OPEC's decision on 9 December to base its pricing policy on a 'fair market share', which caused the exchange rate to weaken; and sentiment was further depressed by the announcement of the money figures for banking November on 10 December. The nervous state of the markets had by this time caused the interbank yield curve to become flatter at the end of banking December (11 December) with the one-month rate at $11\frac{11}{16}$%, the three-month rate at $11\frac{13}{16}$% and the twelve-month rate at $11\frac{13}{16}$%.

The market began to recover its poise on 12 December, as the exchange rate firmed on a calmer oil market. Sentiment was aided by a sharp rise in the US bond market, associated with renewed hopes of a US discount rate cut. But oil price worries began to resurface and interest rates firmed as the exchange rate began to fall back. By 23 December, partly under the influence of end-year distortions, the three-month interbank rate had reached $11\frac{7}{8}$%, although the exchange rate was fairly steady at ERI 78.2 (despite a weakening rate against the deutschemark, to DM 3.5803) and $1.43. Shorter rates were easier during this period, however, reflecting the modest scale of the money-market shortages at that time.

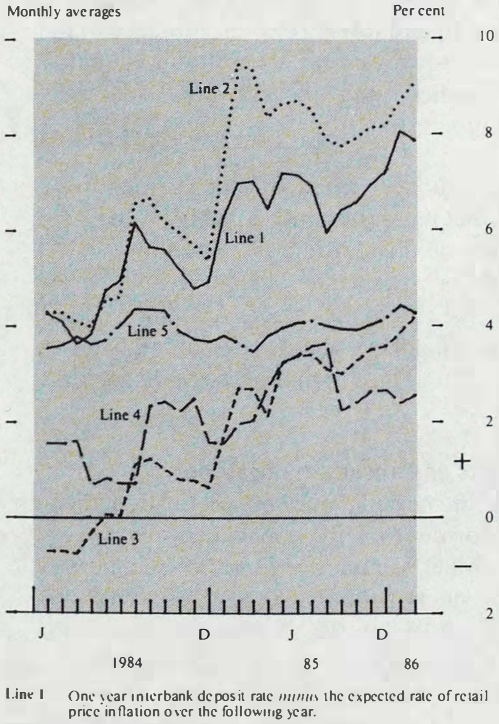
This period of relative calm was ended on 6 January when, as hopes of a decline in interest rates abroad receded, sterling fell sharply, by $\frac{3}{4}$% against the deutschemark. The domestic markets were unsettled further the next day by the announcement of the banking December money figures,

(1) The net Exchequer position is separately identified in the initial published daily forecasts (at 9.45 am). These forecasts indicated average daily flows *from* the Exchequer of some £40 million during the period under review. The published revisions (at 2.15 pm), which do not separately identify the net Exchequer position, indicated an average daily variation from forecast *against* the market of some £55 million. In fact, the actual Exchequer position was on average some £90 million more *against* the market than in the original forecast (implying an average daily cash flow *to* the Exchequer of £50 million).

Short-term interest rates in London



Real interest rates



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

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

Line 3 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.

particularly the large rise in bank lending for the third successive month, and the three-month interbank rate rose to $12\frac{1}{16}$%. On both days discount houses offered some bills to the Bank at rates up to $\frac{1}{8}$% higher than established dealing rates. By noon on Wednesday 8 January the one and three-month rates were quoted at $12\frac{5}{16}$% and $12\frac{7}{16}$%. The Bank announced that it would buy no bills that day; instead, the discount houses were invited to borrow at 2.30 pm, at $12\frac{1}{2}$%. This move was followed by corresponding rises in banks' base rates.

Despite some firming in the exchange rate, however, nervousness persisted in the following days, sustained by further oil price falls and, on 8 January, the largest one-day fall on the US stock market since 1929. Political concerns emanating from the Westland affair also began to disturb the markets during this period. Renewed oil price worries at the beginning of the following week, coupled with a firmer dollar, drove the one-month rate up to $12\frac{3}{4}$% and the three-month rate up to well over 13%. The next morning, Tuesday 14 January, amid heightened political and oil price uncertainties, the one-month and three-month rates reached $13\frac{5}{8}$% and $13\frac{3}{4}$%. For the reasons given above, the Bank was not ready to acquiesce in a further rise in the general level of short-term interest rates and, therefore, at 10.15 am, announced that further gilt-edged sale and repurchase facilities would be provided the following week at $12\frac{1}{2}$%, rather than, as is customary, at the prevailing market rate. In addition, the Bank indicated that it would, for the first time, buy bills that day for forward settlement (there being no market shortage that day), at existing dealing rates. The authorities let it be known that these actions reflected their view that the market was being affected by temporary factors. After the Bank's announcement, the one and three-month interbank rates fell back to $12\frac{7}{8}$% and 13% and, although political nervousness persisted, period rates eased a little more over the following days, with sentiment buoyed by hopes that the meeting of the G5 on the weekend of 18–19 January would result in a co-ordinated reduction of interest rates.

On Monday 20 January, the price of Brent oil for delivery in April fell below \$20 per barrel. This, coupled with market disappointment at the outcome of the G5 meeting and temporary domestic political uncertainties, caused a sharp fall of $1\frac{1}{4}$% in the sterling ERI to below 77.0. With oil prices continuing to fall, the one-month and three-month interbank rates reached $13\frac{7}{16}$% and $13\frac{5}{8}$% in the middle of the week, but began to ease thereafter. Nevertheless, on 24 January, the Bank declined to allot any bills at the Treasury bill tender to avoid any impression that the authorities considered a rise in rates to be appropriate. The following Monday (27 January) the exchange rate fell to an ERI of 73.3 and to \$1.3745 and DM 3.3084. By that time, however, the one and three-month interbank rates had begun to fall back, having ended the previous week at 13% and $13\frac{1}{4}$%, as market concerns about both the oil and political situations eased somewhat.

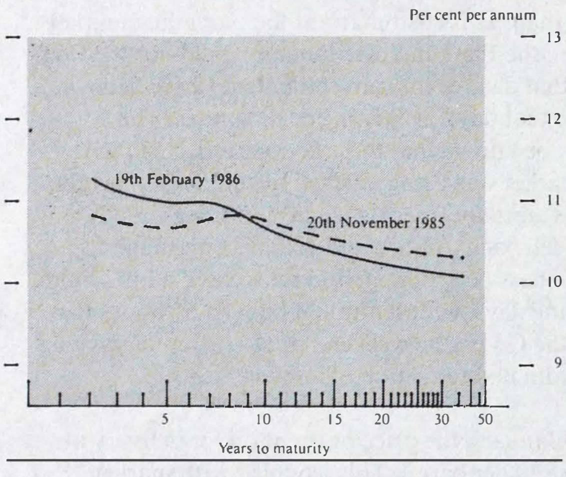
This proved to be a short-lived respite, however, as renewed oil price worries, heightened by the meeting of an OPEC ministerial committee, caused further pressure on the pound at the beginning of the following week, reinforced by unease ahead of the announcement of the January money figures.

Sterling reached its lowest point in the period under review on 4 February, touching ERI 73.0, \$1.3665 and DM 3.3052 and the one-month and three-month interbank rates were back at $12\frac{15}{16}$% and $13\frac{3}{16}$%. In the event, the figures for both £M3 and bank lending were much better than market commentators had expected, and their effect was reinforced by the announcement that the reserves had risen by \$132 million in January. In the interbank market, period rates fell back by $\frac{1}{4}$% or more later that day while the exchange rate rose. There followed a period of consolidation, with the pound gaining slowly in value and interest rates fairly steady. Towards the end of banking February, the longer rates eased back, and more bullish sentiment came to the fore following the announcement of a £$4\frac{1}{2}$ billion surplus in the PSBR in January.

The period ended with a more steeply downward-sloping yield curve than at the start, around a level of $12\frac{1}{2}$%. Interbank deposit rates rose by $1\frac{3}{32}$% to $12\frac{11}{16}$% at the one-month maturity, by $\frac{13}{16}$% to $12\frac{3}{8}$% at three months, and by $\frac{1}{2}$% to $11\frac{13}{16}$% at twelve months. Clearing bank base lending rates rose by 1% to $12\frac{1}{2}$%. Building society rates remained broadly unchanged.

The gilt-edged market

Time/yield curves of British government stocks



The authorities' objectives in the gilt-edged market in the period under review were set by the policy, enunciated in the Chancellor's Mansion House speech, of fully funding the PSBR over the year as a whole through debt sales to the non-bank private sector and external and foreign currency finance of the public sector. Successive downward revisions to the estimated PSBR meant that the implied rate of monthly gross sales was reduced as the period progressed.

Only one stock ($12\frac{1}{4}$% Exchequer 1985), of which some £0.9 billion was in market hands at mid-November, was redeemed during the period; in addition, the market was holding virtually all of $11\frac{3}{4}$% Exchequer 1986, which was due to mature shortly after the end of the period. A call of £0.5 billion in respect of 10% Treasury 2001 (issued partly-paid in banking November) had been secured for the first of the three banking months under review.

There were no tap stocks or tranches in the authorities' portfolio at the start of the period. With the recent strengthening of the market, the authorities took the opportunity to announce, on 22 November, the issue of £1 billion of a new partly-paid convertible stock, $10\frac{1}{4}$% Exchequer Convertible 1989, for sale by tender on Wednesday 27 November—£40 to be paid on tender with the balance in banking January. This stock had the novel feature of being convertible into two stocks—10% Conversion 1996 and $9\frac{3}{4}$% Conversion 2006. The stock was comfortably oversubscribed at the tender, and was allotted in full at a premium of one quarter over the minimum tender price, giving a yield of 10.64% to 1989, 10.39% to 1996, or 9.94% to 2006 (in the latter two cases assuming conversion at the first optional date).

A quieter period followed, reflecting both market absorption of the new stock and mounting worries about oil prices, so that no further substantial sales were made in banking December. On the first day of banking January (12 December), however,

Table G
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
10¼% Exchequer Convertible 1989	1,100(a)	22/11	Minimum price tender	27/11	98.75(b)	40.00	58.75 (13/1)	10.64(c)	27/11
10% Treasury 1992	150	13/12	Direct to Bank	13/12	—	—	Fully paid	—	16/1
10½% Exchequer 1997	150	13/12	Direct to Bank	13/12	—	—	Fully paid	—	8/1
9¾% Conversion 2001	150	13/12	Direct to Bank	13/12	—	—	Fully paid	—	8/1
9½% Conversion 2004	150	13/12	Direct to Bank	13/12	—	—	Fully paid	—	8/1
2½% Exchequer 1990	400	17/1	Minimum price tender	22/1	77.00	—	Fully paid	8.38	10/3
10% Treasury 2003	1,000	24/1	Direct to Bank	24/1	93.50	35.00	58.50 (14/4)	10.83	28/1
10% Treasury 1993(d)	1,200(e)	7/2	Minimum price tender	12/2	94.50(b)	20.00	20.00 (7/4) 54.50 (19/5)	11.15	17/2
9½% Conversion 2005 'A'	800	25/2	Direct to Bank	25/2	96.50	20.00	40.00 (28/4) 36.50 (2/6)	9.91	27/2
9% Conversion 2000 'A'	1,000	14/3	Direct to Bank	14/3	96.25	25.00	25.00 (12/5)	9.49	19/3
9% Treasury 1994	150	21/3	Direct to Bank	21/3	—	—	46.25 (16/6)	—	24/3
8¾% Treasury 1997	150	21/3	Direct to Bank	21/3	—	—	Fully paid	—	24/3
8% Treasury 2002–6	100	21/3	Direct to Bank	21/3	—	—	Fully paid	—	—

(a) Of which £100 million was reserved for the National Debt Commissioners.

(b) Price at which the stock was allotted.

(c) Yield to 1989. Holdings may, at the option of the holder, be converted in whole or in part into 10% Conversion Stock 1996 or 9¾% Conversion Stock 2006, or any combination thereof, as on the following dates:

Date of conversion	Nominal amount of 10% Conversion Stock 1996 per £100 nominal of 10¼% Exchequer Convertible Stock 1989	Implied redemption yield (%) to 1996	Nominal amount of 9¾% Conversion Stock 2006 per £100 nominal of 10¼% Exchequer Convertible Stock 1989	Implied redemption yield (%) to 2006
15 May 1986	£101	10.35	£100	9.91
15 November 1986	£100	10.22	£99	9.83
15 May 1987	£99	10.10	£98	9.76
15 November 1987	£98	9.99	£97	9.70
15 May 1988	£97	9.90	£96	9.64
15 November 1988	£96	9.81	£95	9.59

(d) The prospectus includes provision for exemption from UK taxation in favour of non-resident holders and for the stock to be available in bearer form.

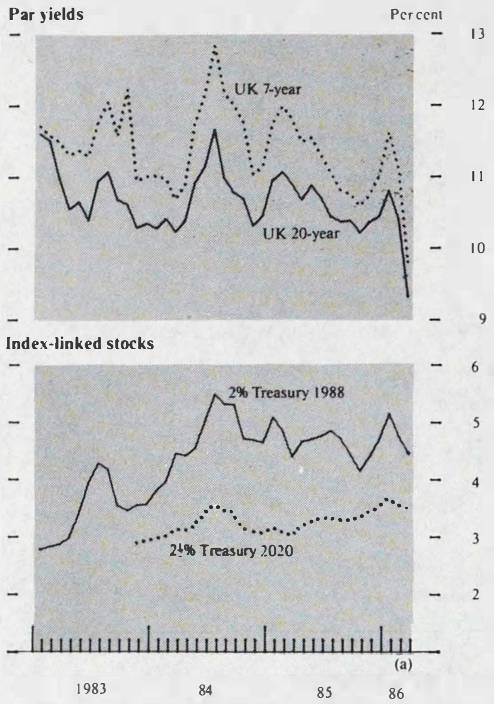
(e) Of which £200 million was reserved for the National Debt Commissioners.

the market firmed, helped by strong gains in the US bond market. The next step was the replenishment of the Bank's holdings of full-coupon conventional stock, with the announcement on 13 December of small tranches (£150 million each) of four stocks—10% Treasury 1992, 10½% Exchequer 1997, 9¾% Conversion 2001, and 9½% Conversion 2004.

Conditions remained quiet over the following few weeks, which included the Christmas and New Year holidays. Thereafter, as concern about oil prices continued to mount, the market began to weaken. This tendency was reinforced by the poor bank lending figures announced on 7 January. Discounting a rise in interest rates, the market fell back the following morning, thus encouraging buying, and the authorities were able to sell out the 1997 and 2004 tranches. There was further demand for stock in after-hours trading which led to the selling-out of the 2001 tranche.

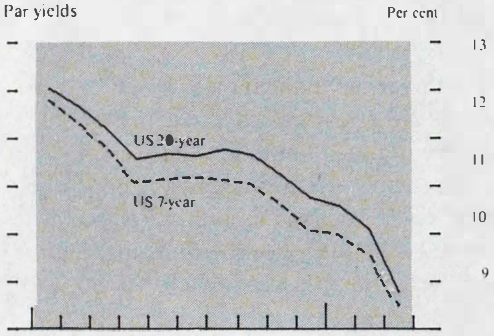
There was a sharp deterioration in sentiment at the beginning of the following week, partly reflecting diminishing hopes of an early cut in the US discount rate, and partly in reaction to concerns about oil prices and the political situation. The Bank's actions on 14 January to sustain the 12½% level of base rates led to a short-lived rally. After a further softening, the market rallied again towards the end of that week as hopes mounted that agreement at the forthcoming G5 meeting would be reached on co-ordinated interest rate reductions. This led to the exhaustion of the 1992 tranche (the last of the four tranches issued on 13 December) on 16 January (the first day of banking February). The authorities took advantage of the improvement in market

Gross redemption yields on UK government stocks



(a) Yields for March 1986 are as at 11 March.

Gross redemption yields on US government securities



(a) Yields for March 1986 are as at 11 March.

sentiment to replenish their holdings of low-coupon short-dated stock, which had been depleted in early October. Accordingly, the issue by tender was announced on 17 January of £400 million of 2½% Exchequer 1990, applications being allotted in full at the minimum tender price on 22 January. The market drifted lower thereafter, but an upturn in interest in index-linked stock on 24 January enabled the authorities to sell out their remaining supplies of the 2020 tranche (which had been issued on 20 September).

In order to replenish their supplies, the authorities on the same day issued direct to the Bank, in £35-paid form, £1,000 million of 10% Treasury 2003, for dealing on 27 January, at a yield of 10.83%. No call on the stock was set in the immediately following banking month (March) and the residual payment was set for banking April, the first month of the next financial year, reflecting both the good progress made in meeting the funding objectives for the 1985/86 financial year and the need to offset the very heavy series of maturities that fall in the early part of the 1986/87 financial year. With better news on both the oil and political fronts at the beginning of the following week, the new tap stock was sold out on 28 January at a five-eighths premium over its issue price (a yield of 10.76%).

Although quieter conditions prevailed in the market over the next week and a half, the undertone was steadily improving, encouraged particularly by the announcement of the money supply figures for banking January and by the performance of the US bond market. Against that background the issue by tender of £1,000 million of 10% Treasury 1993 was announced on 7 February. This stock, which was free of tax to non-residents, was issued in £20-paid form, with the balance of the calls coming in banking April and banking May.[1] The stock, although undersubscribed at the tender on 12 February, was allotted at a one-half point premium (yielding 11.15%). With encouragement being taken from the prospects for the Budget, the market moved ahead strongly, and the tap stock was exhausted on 14 February at a premium of three eighths over the allotment price. The market moved strongly ahead thereafter on receipt of the news of the large PSBR surplus in January, together with sharp exchange rate gains, particularly against the dollar.

The market was close to the 10% 'yield barrier' at the long end by the close of banking February, and breached it on Monday 24 February, the third working day of banking March. Once this was clearly established, the Bank announced, on 25 February, the placing with itself of 9½% Conversion Stock 2005 'A' (£20-paid) at a yield of 9.91%. This step, which represented the first issue of a longer-dated stock with a yield below 10% since 1973, served to consolidate yields at those levels. This tranche of stock was sold out at a premium of one half over its issue price (representing a yield of 9.85%) on its first day of trading, 27 February. The strength of the gilt-edged market since the beginning of the year is also evidenced by the fact that each of the last three issues of stock was sold out within a few days at a premium over the issue price.

Index-linked stocks were generally neglected during the period, and the real rate of return on the 1988 stock exceeded 5%

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

(assuming 5% inflation) for some of the time. In banking February, however, there was a modest revival of interest in index-linked issues, and the authorities were able to make some sales from their holdings. Over the period as a whole, the yield on the 1988 stock rose from $4\frac{1}{2}$% to $4\frac{3}{4}$%, while yields on long-dated indexed stocks rose by less, that on the 2020 stock from $3\frac{1}{2}$% to $3\frac{9}{16}$%.

Over the three months to mid-February, yields on conventional 5-year stocks rose by $\frac{1}{4}$% to 11% while yields on 10 and 20-year stocks fell by $\frac{1}{16}$% to $10\frac{7}{8}$% and $10\frac{7}{16}$% respectively. Yields on long-dated stocks fell below 10% on Monday, 24 February.

Other capital markets

The *equity market* began the period at a record level, and advanced further towards the end of November, with the FT-Actuaries all-share index reaching a high point of 702.06 on 25 November. Thereafter, the market entered an unsettled period. The closure of the Singapore Stock Exchange at the beginning of December and, subsequently, the fall in the price of crude oil and the decline in the sterling exchange rate disturbed the markets, and the all-share index fell to a low point of 662.51 on 17 December. There was a brief recovery in a thin market at the end of December. But the rise in base rates early in January, along with the unsettled political situation, falling oil prices, pressure on the exchange rate, and renewed worries about the outlook for interest rates, led to a further decline. Confidence returned towards the end of the month, as the prospect of another rise in base rates receded and political uncertainties abated. A strong recovery in the last week of January continued into February, buoyed by a weaker dollar and speculative buying associated with a further round of large and well-publicised takeover bids. The all-share index closed the period up 4.2% overall at 726.85. The all-share yield fell over the same period by 0.16% to 4.09%.

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

Banking months	Mar. 85– May 85	June 85– Aug. 85	Sept. 85– Nov. 85	Dec. 85– Feb. 86
UK private sector				
Loan capital and preference shares	+ 159	+ 485	+ 147	+218
Equity capital(a)	+1,916	+1,119	+ 443	+598
Unit trusts(b)	+ 456	+ 470	+1,030	+494(c)
Issues on the unlisted securities market	+ 67	+ 48	+ 28	+ 45
Local authorities				
Stocks	– 14	– 3	– 90	—
Negotiable bonds	– 122	– 88	– 108	– 68
Overseas	+ 164	+ 175	+ 134	+245

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

In 1985, companies raised a total of £5,250 million by means of equity issues, much the largest amount raised in one year on the UK equity market. (This total excludes the proceeds of privatisation sales by the government and issues in exchange for the shares of companies taken over.) The total raised in the period under review was slightly more than in the previous quarter. Attention centred on the relatively small offer for sale by Laura Ashley at the end of November, which was massively oversubscribed, and on the much larger Cable and Wireless issue which, despite a weakening market, was successfully made in early December. There were relatively few new issues in January, but a £350 million offer for sale by the Wellcome Foundation at the end of the month was also substantially oversubscribed.

In the *domestic fixed-interest market,* eight UK borrowers announced issues to raise a total of £148 million. These included a stepped coupon issue by Whitbread Investment Company, with the coupon rising by one percentage point each year (from 7% to 12%) over the first six years of the issue. There were no issues by overseas borrowers during the period. In the *eurosterling market,* six fixed-rate issues were made to raise a total of £335 million, and three building societies made floating-rate note issues totalling £500 million. In addition, Burton issued a US$80 million five-year eurobond with warrants exercisable into sterling equity.

Table J
Debt issues announced on the London capital market, mid-November to mid-February 1986

Date of Announcement	Issuer	Nominal amount (£ millions)	Coupon (per cent)	Maturity
Domestic borrowers				
26 November	Rosehaugh Greycoat Estates	40	11	2014
2 December	Whitbread Investment Company	15	7–12(a)	2010
10 December	TT Finance	15	$11\frac{5}{16}$	2018
17 December	Estates and Agency Holdings	8	$11\frac{1}{4}$	2020
6 January	First Scottish American Trust	20	$11\frac{1}{2}$	2016
11 February	Mecca Leisure	20	$11\frac{1}{2}$	2011
12 February	Centrovincial Estates	10	$11\frac{1}{4}$	2016
19 February	Samuel Properties	20	11	2016

(a) 'Stepped' coupon.