Operation of monetary policy

This article covers the three months from mid-May to mid-August 1986.

Review

The period under review remained one in which it was difficult to interpret monetary conditions. On the one hand, the growth of £M3 continued at a high rate and the exchange rate weakened (largely in lagged reaction to a renewed fall in oil prices). On the other hand, M0 remained comfortably within its target range, the rate of inflation, as measured by the retail price index, fell and the real economy lacked strength. Market pressure for a reduction in interest rates emerged from time to time, but was not strong or sustained. In these circumstances, the authorities judged that there was no sufficient case for a move in interest rates in either direction.

On the monetary front, the twelve-month growth of M0 has remained within its target range of 2%–6%. The growth of £M3, on the other hand, has continued well above its target range of 11%–15%. Other monetary aggregates, both broad and narrow, have shown signs of acceleration on the twelve-month comparison. Equally, however, the growth rate of each has decelerated in the latest period as compared with the preceding three months.

On the other side of the balance sheet, growth of credit by both banks and building societies has remained extremely strong. In the period under review, bank lending averaged some £2.6 billion a month; and in the three calendar months June-August the building society figure was £1.8 billion per month. Both continued a trend set in the previous three months (when the flows were £2.4 billion and £1.5 billion a month respectively), but were well above levels seen earlier this year and last year. While it is possible to point to special factors which may have boosted bank lending temporarily— such as lending in connection with takeovers and the buildup to Big Bang—there is no question that underlying credit growth, especially to persons, has been high in recent months.

Sterling weakened quite sharply over the period, from 76.4 to 71.9 on the exchange rate index, mainly against the deutschemark and the yen. This followed a period of four months during which it had been fairly stable in the range 74–76½. The exchange rate depreciation appeared to occur as a somewhat delayed reaction to the renewed fall in oil prices during the period, but it was not reversed when oil prices firmed following the OPEC production agreement in early August. Although it undoubtedly eased financial pressures on companies, it was not a sufficiently large depreciation to offset the beneficial effects on the near-term outlook for inflation of the fall in oil prices that has occurred over the past year.

Other indicators have lent support to the view that there has not been an undue relaxation of monetary conditions. Retail price inflation, which fell in July for the seventh consecutive month to 2.4%, its lowest level since 1967, remained at that level in August. Wholesale input prices continued to be around 10% below their levels a year earlier, while the rate of growth of output prices fell below 4½%. With average earnings growth continuing at about 7½% per annum, however, the underlying rate of inflation is certainly above the current rate of retail price inflation.

The weakness of the real economy has persisted. The output measure of GDP increased by only ½% in the second quarter, and manufacturing output was about 1% lower than a year earlier. Unemployment has also been increasing. The increase in real personal disposable income, implied by the conjunction of decelerating retail price inflation and continued high earnings growth, has not been fully reflected in consumption growth as the savings ratio has risen. The prospect for the rest of the year is for a consumption-led increase in growth. This should be reinforced by increased net demand from abroad, arising both from high overseas consumption growth and, over time, from the competitive benefits of the depreciation of the sterling exchange rate. The strength of the latter effect will be dependent on how well domestic costs are controlled over the period. (The wider implications of the exchange rate/oil price nexus for the current account are discussed in the note on page 331.)

Following the ½% fall in banks' base rates, to 10%, right at the start of the period, there was sporadic market pressure for lower interest rates, largely in response to actual or expected interest rate developments abroad. However, any possibility of a cut in domestic rates in the wake of the US discount rate cut announced on 10 July was vitiated by a concurrent weakening of the exchange rate (somewhat later than might have been expected in relation to the preceding oil price fall). This caused market rates to firm, and the authorities felt it right to resist market pressure for a fall in interest rates following the further ½% reduction in the US discount rate on 21 August.

Monetary aggregates and credit

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

Having increased rapidly during the period mid-February to mid-May, all measures of both broad and narrow money, with the exception of M0, have grown more slowly over the most recent three months. £M3 grew by 2.6% in the latest three months compared with 8.5% in the previous three and PSL2 by 2.8% compared with 5.1%. Nonetheless, the twelve-month growth rates of £M3 and PSL2 have fallen only slightly since mid-May, to 18.5% and 14.5% respectively.

Within £M3, the twelve-month growth rate of non-interest-bearing sight deposits increased over the most recent three months, providing no evidence of an unwinding of the exceptionally large increase recorded in May. Inflows into retail interest-bearing bank accounts were more modest after the rapid growth experienced from mid-February to mid-May. Inflows into building society shares and deposits were unusually low over the period, probably reflecting competition

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

Banking months	12 months to May 86	12 months to Aug. 86	Mar. 86– May 86	June 86– Aug. 86
M0(a)	3.4	4.1	0.9	1.3
£M3	19.5	18.5	8.5	2.6
Non-interest-bearing M1	6.5	7.5	4.5	1.5
M1	22.1	20.9	9.2	4.3
M2(b)	11.8	13.5	..	..
	12.4	*14.1*		
PSL1	18.3	17.8	8.3	2.9
PSL2 (c)	14.6	14.5	5.1	2.8
M3	18.4	19.5	8.0	4.2

.. 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*.
(c) New definition: see June 1986 *Bulletin*, page 186.

Table B
Composition of changes in the money stock

£ billions: *seasonally adjusted*

Banking months	Mar. 86– May 86	June 86– Aug. 86	Level outstanding at mid-Aug. 86
1 Non-interest-bearing M1	+1.6	+ 0.6	36.6
2 Interest-bearing sight deposits	+3.9	+ 2.3	31.3
3 M1 (= 1+2)	**+ 5.5**	**+ 2.8**	**67.9**
4 Private sector holdings of time deposits with banks and bank CDs	+ 5.3	+ 0.8	72.7
5 £M3 (= 3+4)	**+10.8**	**+ 3.6**	**140.5**
Non-bank private sector holdings of:			
6 Building society shares and deposits(a)	+ 3.4	+ 2.3	112.0
7 Building society wholesale liabilities(b)	—	- 0.1	1.8
8 Other	- 2.0	+ 1.4	6.4
9 PSL2 (= 5+6+7+8)(c)	**+12.2**	**+ 7.2**	**260.7**

(a) Including term shares and interest credited.
(b) CDs and time deposits (excluding holdings by building societies themselves).
(c) New definition: see June 1986 *Bulletin*, page 186.

Table C
Changes in £M3 and its counterparts[a]

£ billions: *seasonally adjusted*

Banking months	3 months Mar. 86– May 86	3 months June 86– Aug. 86	3 months June 85– Aug. 85	12 months Sept. 85– Aug. 86
1 Central government borrowing requirement	+5.2	+ 3.8	+2.8	+14.7
of which:				
own account borrowing:	*+0.3*	*+ 3.2*	*+1.6*	*+ 5.4*
on-lending to:				
local authorities	*+5.2*	*+ 0.3*	*+1.5*	*+ 7.6*
public corporations	*-0.3*	*+ 0.4*	*-0.3*	*+ 1.6*
2 Other public sector borrowing	-2.6	- 0.9	-0.9	- 5.7
3 PSBR (= 1+2)(b)	**+2.6**	**+ 2.9**	**+1.9**	**+ 8.9**
4 Net purchases (-) of central government debt by the non-bank private sector	-0.6	- 3.5	-1.3	- 6.4
of which:				
Gilt-edged stocks	*+0.3*	*- 1.8*	*-0.3*	*- 3.4*
National savings	*-0.2*	*- 1.3*	*-1.0*	*- 2.3*
CTD's	*-0.6*	*- 0.4*	—	*- 0.8*
5 External and foreign currency finance of the public sector(c)	—	-0.7	-0.8	- 2.1
of which, gilt-edged stocks (purchases -)	*-0.5*	*- 0.8*	*-1.1*	*- 2.2*
6 Overfunding (-) = (3+4+5)	+1.9	- 1.3	-0.2	+ 0.4
7 Sterling lending by the banking system to the UK private sector(d)	+7.3	+ 7.7	+4.6	+24.2
8 External and foreign currency finance of the monetary sector(e)	+1.3	- 0.7	-0.1	+ 0.8
9 Net non-deposit sterling liabilities (increase -)	+0.3	- 2.2	-0.3	- 3.5
10 Change in £M3 = (6+7+8+9)	**+10.8**	**+3.6**	**+4.0**	**+21.9**

(a) Counterparts may not add up to the total change in £M3 because of rounding.
(b) Strictly the PSBR, *less* net purchases of local authorities' and public corporations' debt by the non-bank private sector.
(c) Includes net overseas purchases of public sector debt, *less* the public sector's net acquisition of claims on the overseas sector.
(d) Including changes in Issue Department's holdings of commercial bills and of promissory notes relating to shipbuilding paper guaranteed by the Department of Trade and Industry.
(e) The net external sterling deposit liabilities of the monetary sector (increase -) *plus* the net foreign currency liabilities of the monetary sector to all sectors (increase -).

from national savings and unit trusts and the fall in the societies' deposit rates at the beginning of June. Transfers within building society accounts from term shares into shorter-term accounts continued, however, so that there was little change in the building societies' total contribution to M2.

Turning to the counterparts of £M3, the growth of bank lending was even larger than that recorded in the previous three months. The slowdown in the rate of growth of £M3 in the latest period partly resulted from the contractionary influence of net public sector transactions, following their expansionary influence in the previous period. External influences were also contractionary, having earlier been expansionary.

The growth in bank lending may have been boosted by lending associated with takeover activity and Big Bang. Figures for the sectoral breakdown of bank deposits and lending are only available on a calendar-quarter basis. These show sterling lending to industrial and commercial companies growing well below its trend in the second quarter after the large first quarter increase, thus supporting the hypothesis that, as last year, companies brought forward investment expenditure to the first quarter of the year to take advantage of capital allowances. Lending to the personal sector was double that of the first quarter, though the average for the two quarters is only slightly higher than last year's quarterly average. Within the personal sector there was a marked increase in lending to unincorporated businesses.

Overfunding of the PSBR (taking sales of public sector debt to the non-bank private sector together with external and foreign currency finance of the public sector) exerted a contractionary influence over the period under review, following the underfund of the previous three months. The CGBR was smaller and mainly reflected own-account transactions, whereas there had been substantial on-lending to local authorities in the three months to mid-May. The overall PSBR, adjusted for sales of debt by local authorities and public corporations to the non-bank private sector, was £2.9 billion. Following a period of heavy gilt redemptions, there was a substantial increase in net sales of central government debt to the non-bank private sector. Within this there was a recovery in national savings after six months of low inflows.

The banks' external and foreign currency transactions were contractionary in the latest three-month period, having been expansionary in the previous three months. One possible influence on these transactions is the relative cost of borrowing in different currencies. At times a relatively cheap method for the UK private sector to obtain sterling finance may be by borrowing foreign currency from abroad (for example, through issues of commercial paper in the United States) and switching the proceeds into sterling on a covered basis. To the extent that the sterling so acquired comes from bank deposits owned by the domestic private sector, there is no expansionary effect on £M3; if, however, the sterling comes from bank deposits held by non-residents, or gives rise to a change in the banks' net position in foreign currency, £M3 is increased. Until June, such transactions were often an attractive source of funds for UK companies; the counterpart to any growth in £M3 was an expansionary contribution from the externals. In July, however,

Table D
Financing of the public sector

£ billions: *seasonally adjusted*

Banking months	Mar. 86–May 86	June 86–Aug. 86	Sept. 85–Aug. 86
Central government borrowing on own account	+ 0.3	+3.2	+5.4
Other public sector borrowing(a)	+ 2.3	–0.2	+3.5
'Modified' PSBR(b)	**+2.6**	**+2.9**	**+8.9**
Net sales of central government debt to the non-bank private sector	–0.6	–3.5	–6.4
of which:			
Gilt-edged stocks	*+ 0.3*	*–1.8*	*–3.4*
National savings	*– 0.2*	*–1.3*	*–2.3*
CTDs	*– 0.6*	*–0.4*	*–0.8*
External and foreign currency finance of the public sector	—	–0.7	–2.1
of which, gilt-edged stocks	*– 0.5*	*–0.8*	*–2.2*
Total financing of the government from the non-bank private and overseas sectors(c)	**–0.7**	**–4.3**	**–8.5**

(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
Building society funding

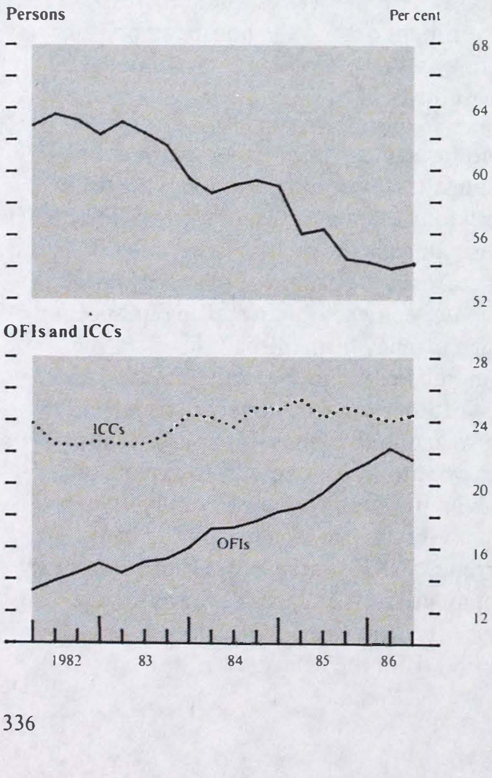
£ millions

	Net increase in shares and deposits outstanding(a)	Net wholesale borrowing(b)	*Of which, eurosterling*
1985 Q1	3,088	– 89	—
Q2	3,467	337	—
Q3	3,333	472	—
Q4	3,160	1,742	*1,140*
1986 Q1	4,091	502	*560*
Q2	3,159	964	*574*

(a) Seasonally adjusted.

(b) Net increase in wholesale borrowing *less* increase in societies' holdings of other societies' CDs.

Sectoral shares of £ bank deposits



borrowing abroad in foreign currency seems to have become a less attractive source of finance. To the extent that UK companies replaced that source with sterling borrowing from UK banks, the counterpart to any associated growth in £M3 would have changed. (If—as may be the case—overseas companies have switched from foreign currency to sterling finance, £M3 will not have been directly affected, the transaction giving rise in the first instance to offsetting changes within the externals.)

Changes in interest rate differentials could thus explain some of the fluctuations in the banking externals, which were strongly expansionary in the spring but have since become contractionary. They may also explain some of the recent strength of sterling lending to the private sector.

On a longer-term view of the monetary aggregates, during 1985 and early 1986 the signals given by the broad aggregates were conflicting. The twelve-month growth rate of £M3 increased sharply. Acceleration in PSL2 was less marked, although building society lending grew almost as rapidly as bank lending in the first half of the year. With building societies financing lending in part by the run-down of bank deposits, selling gilt-edged and raising funds through borrowing in the wholesale market (see Table E), which may have been largely from the overseas sector, the twelve-month growth rate of PSL2 remained below that of £M3.

The twelve-month growth rates of M2 and non-interest-bearing M1 have accelerated noticeably over the last six months and M1 continued to grow rapidly. The growth of M1 and, to a lesser extent, M2 reflects that of high-interest chequeing accounts. M2 growth has also been boosted as maturing building society term shares have been shifted into these short-term accounts. The growth of multi-purpose accounts makes it increasingly difficult to distinguish savings from transactions balances and hence blurs the distinction between the broad and narrow aggregates. Thus some of the recent increase in the narrow aggregates may reflect a buildup of savings rather than an increase in transactions balances.

The velocity of £M3 has continued to decline, although the sectoral composition of deposit growth associated with this fall has changed. Prior to the autumn of last year, the fall was associated with the growth in the bank deposits of industrial and commercial companies and of other financial institutions (OFIs). The latter increased particularly rapidly, roughly in line with the growth of OFIs' assets. Personal sector liquidity has been increasing faster than incomes in recent years and has been concentrated in building society accounts rather than in bank deposits. This may in part be the result of easier access to credit, particularly in the mortgage market, and some of the leakage of funds from this market may have been used to rebuild liquid asset holdings depleted during the period of credit rationing in the late 1970s. As a result the sectoral composition of £M3 has changed noticeably, with the OFIs' share growing by 9 percentage points since 1981 at the expense of the personal sector (see chart). Since the third quarter of last year, however, personal sector £M3 has grown broadly in line with the aggregate as a whole.

Table F
Official transactions in gilt-edged stocks
£ billions; *not seasonally adjusted*

Banking months	Sept. 85– Nov. 85	Dec. 85– Feb. 86	Mar. 86– May 86	June 86– Aug. 86
Gross official sales(a)	+2.7	+2.7	+3.3	+4.6
less				
Redemptions and net official purchases of stock within a year of maturity	-1.0	-2.0	-3.0	-1.2
Equals net official sales(b)	+1.7	+0.6	+0.3	+3.4
of which, net purchases by:				
Monetary sector(b)	*-0.3*	*-0.1*	*+0.1*	*+0.6*
Overseas sector	*+0.6*	*+0.2*	*+0.5*	*+0.8*
Non-bank private sector	*+1.3*	*+0.6*	*-0.3*	*+1.9*

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.

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

Banking months	Mar. 86– May 86	June 86– Aug. 86	Sept. 85– Aug. 86
Factors affecting the market's cash position			
CGBR (+)	+6.8	+4.2	+13.9
Net sales (-) of central government debt(a)	-1.7	-5.1	- 9.4
of which:			
Gilt-edged	*-0.4*	*-3.4*	*- 6.0*
National savings	*-0.3*	*-1.0*	*- 2.3*
CTDs	*-1.0*	*-0.7*	*- 1.1*
Currency circulation (increase -)	-0.4	-0.3	- 0.6
Other	+1.4	-0.1	+ 0.6
Total (A)	**+6.1**	**-1.3**	**+ 4.5**
Official offsetting operations			
Net increase (+) in Bank's holdings of commercial bills(b)	-3.3	+1.1	- 0.5
Net increase (-) in Treasury bills in market	-0.3	—	+ 0.1
Securities(c) acquired (+) under purchase and resale agreements with banks	-1.9	—	- 3.5
Other	-0.4	+0.2	- 0.4
Total (B)	**-5.9**	**+1.3**	**- 4.3**
Change in bankers' balances at the Bank (= A + B)	+0.2	-0.1	+ 0.2

(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.

Official operations in financial markets

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

During the period under review the central government borrowing requirement of £4.2 billion was exceeded by central government debt sales and other financing, so that the need for official assistance to the money market increased by £1.3 billion.

Central government own-account borrowing in the three months under review was £3.5 billion, nearly double that in the previous three months. On the other hand, central government on-lending to local authorities and public sector corporations fell sharply, from £4.9 billion to £0.7 billion. In sum, the overall central government borrowing requirement fell to £4.2 billion from £6.8 billion.

Gross official sales of gilt-edged stocks totalled £4.6 billion. There were relatively few redemptions during the period and only insignificant official purchases of near maturities. The consequence was that net official gilt sales, at £3.4 billion, were exceptionally large. Of these, some £1.8 billion were taken up by the non-bank private sector, with the remainder split between the overseas sector (£0.8 billion) and the monetary sector (£0.6 billion). Inflows into national savings were buoyant, totalling £1 billion in the period. They benefited from the crediting of the index-linked supplement in August. Net sales of certificates of tax deposit raised a further £0.7 billion.

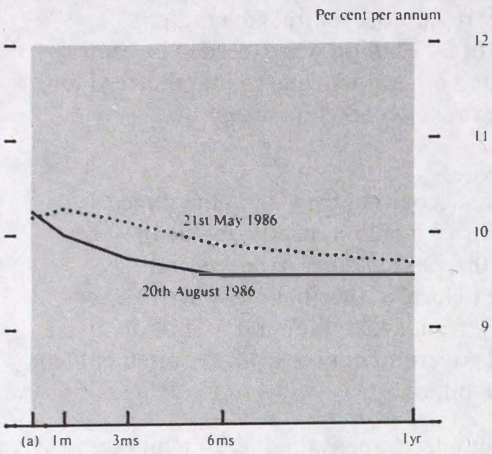
The PSBR was overfunded during the period by £1.3 billion, taking sales of debt to the non-bank private sector together with external and foreign currency finance of the public sector. The drain on the cash position of the money market which this implied was, however, mitigated by the continuing tendency for the central government borrowing requirement to exceed the PSBR. In the previous three-month period this was mainly because the local authorities borrowed direct from the central government greatly in excess of their total borrowing needs, the surplus being used largely to pay off bank borrowing or to build up bank deposits. In the latest period, the main factor has been the underlying surplus of the local authorities and public corporations together, supplemented to a small extent by further central government on-lending to them.

In consequence the need for money-market assistance increased by no more than £1.3 billion during the period. This was largely met by an increase, of £1.1 billion, in the Bank's holdings of commercial bills. This brought the total stock outstanding of official assistance (other than that provided through dealings in Treasury bills) to £11.2 billion. Of this, £9.3 billion consisted of outright holdings of eligible bills, £1.7 billion represented bills bought on purchase and resale agreements, and the remainder (£0.2 billion) was in the form of secured market advances. Average daily shortages in the money market were £675 million in the latest period, below the £725 million recorded in the previous three months.

The money market

Following a reduction of ½% in base rates at the very beginning of the three months under review, the period was one of stable

Sterling interbank rates



(a) For one week.

domestic interest rates. Market hopes early in the period of a further reduction in base rates were dissipated as the exchange rate fell, reflecting lower oil prices, and as the rapid pace of money and credit growth continued. At the very end of the period, however, a revival in oil prices together with expectations of further interest rate cuts abroad brought about an improvement in sentiment. Against this background, the authorities' actions were generally aimed at moderating market enthusiasm for lower interest rates, although not excluding that option completely if a sustained and general movement in that direction emerged.

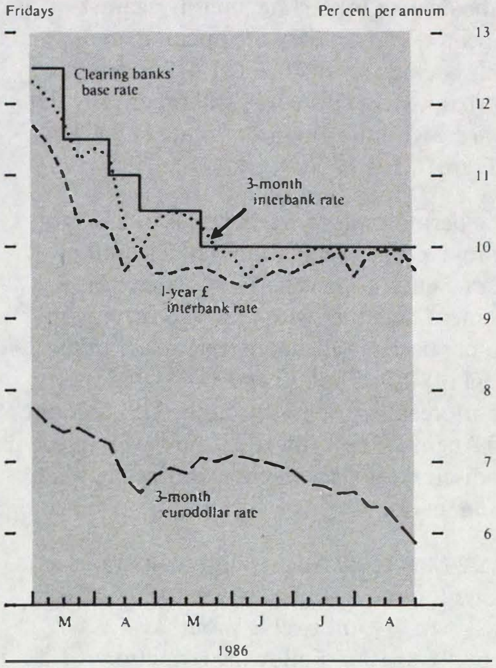
The period opened (22 May) with a yield curve in the interbank market which sloped downwards from the one-month maturity. The one-month rate was at 10$\frac{9}{32}$%, the three-month rate at 10$\frac{1}{8}$% and the twelve-month rate at 9$\frac{11}{16}$%. Banks' base rates were 10$\frac{1}{2}$%, and the ERI was 76.4 ($1.5085 and DM 3.4160). Market hopes of a cut in base rates had been disappointed the previous week, despite the good RPI figure for April (3% over the previous twelve months) published on 16 May. This proved to be only a temporary delay, however, and, on 22 May, National Westminster Bank cut its base rate by $\frac{1}{2}$%, to 10%. The three other major banks reduced their rates similarly on the following day, and the new pattern of rates was validated by the Bank in its bill operations. In order to dampen market hopes of any imminent further reduction in rates, the Bank engaged in 2.30 lending on 23 May at a rate of 10$\frac{1}{2}$% for seven days.

Bullish expectations continued after the Bank Holiday weekend, with the interbank yield curve continuing to slope downwards. The Bank undertook further 2.30 lending on 28 May, at a rate of 10$\frac{1}{2}$% for 6 days. By the close on 29 May, the one-month rate was at 10%, the three-month rate at 9$\frac{13}{16}$% and the twelve-month rate at 9$\frac{7}{16}$%. The continued resilience of sterling—the ERI reached 76.5 that day—contributed to a general market expectation that rates had further to fall. Further 2.30 lending on 6 June—at a rate of 10$\frac{3}{4}$% for seven days—served to dampen further downward pressure on rates.

By the close on 9 June, the downward sloping interbank yield curve had become steeper, with the one, six and twelve-months maturities at 9$\frac{29}{32}$%, 9$\frac{5}{8}$% and 9$\frac{3}{8}$% respectively. This had occurred despite a weakening of the exchange rate, to an ERI of 75.4, reflecting in particular slippage against the yen and the deutschemark (to DM 3.3500, down from DM 3.4375 on 29 May). There were market expectations that the banking May money figures, published on 10 June, would provide the occasion for a further cut in base rates, but when the figures were published, showing a 3% rise in £M3, money-market rates firmed and the exchange rate rose sharply (to an ERI of 76.5 and $1.5265).

Market expectations of a base rate cut had by now diminished and even the publication of another very good inflation figure on 13 June had little impact. The change in sentiment was also fuelled by a falling exchange rate against, in particular, the deutschemark and yen. By the end of banking June (18 June), the ERI was down to 75.6 ($1.5002 and DM 3.3622). Interbank rates were 9$\frac{15}{16}$% at one month, 9$\frac{25}{32}$% at three months and 9$\frac{9}{16}$% at twelve months.

Short-term interest rates in London



Within a week or so, however, a degree of optimism began to return, as the market focussed on the prospects for interest rate cuts overseas, particularly after the Japanese general election (6 July). The prospect of a cut in the US discount rate helped to strengthen the sterling exchange rate against the dollar, which reached $1.5452 on 1 July (ERI of 76.4). The buoyancy of Wall Street and of the gilt-edged market also contributed to improved sentiment, particularly in the discount market, but this was not reflected in interbank rates. Hesitation was reinforced by the money figures for banking June, published on 8 July, which were regarded as disappointing despite the moderation of broad money growth, and which caused interbank rates to firm, so that, by the close on that day, rates at the one, three and twelve-months' maturities were $10\frac{3}{16}$%, $10\frac{1}{32}$% and $9\frac{3}{4}$% respectively.

By this time, oil prices, which had fallen from around $15 per barrel in mid-May to below $10 on 8 July, were beginning to affect sterling. There was no sign of a Japanese discount rate cut, or of an imminent cut in the United States (the Dow-Jones index fell by 60 points on 7 July and part of the Gramm-Rudman-Hollings deficit reduction legislation was declared unconstitutional by the Supreme Court). Together, these developments undermined the market, causing the interbank yield curve to flatten. By the close on 10 July, the one and three-months interbank rates were $\frac{1}{16}$% above, and the one-year rate only $\frac{1}{8}$% below, 10%.

The $\frac{1}{2}$% cut in the US discount rate announced on 10 July therefore came as a surprise to the market, and particular interest centred on the Bank's operations on the following day. Disappointment that the Bank did not show itself ready to buy paper outright at lower rates was to some extent tempered by the Bank's willingness to offer an opportunity for bill sale and repurchase transactions of relatively short maturity, namely for 11 days until 22 July. This was interpreted in the market as not completely closing the door on hopes of a modest early reduction in interest rates, should market developments as a whole be favourable. However, the exchange rate, which closed on 11 July at an ERI of 74.6, fell after the weekend in reaction principally to the continuing fall in oil prices, and by the close on 14 July sterling's effective rate was at 73.4 ($1.4835 and DM 3.2343). The gilt-edged market also weakened sharply, and this contributed to a new mood of pessimism in the markets.

A short-lived recovery in the exchange rate, particularly against the dollar, failed to dispel this mood. The market's conviction that a downward move in interest rates was not in near prospect was reinforced when the exchange rate, still reacting to an oil price below $10 per barrel, began to slide further on 18 July. By 28 July the ERI was down to 71.7 ($1.4699 and DM 3.1272). Interbank rates were remarkably stable during this time, with the yield curve from one month onwards almost flat just below 10%.

Early reports of the OPEC agreement on oil production cuts led to a firming of oil prices on 4 August, and prices leapt to almost $14 per barrel on 5 August when details of the agreement were made public. This helped the sterling exchange rate to recover from the level of 70.7 reached on 4 August, and the longer interbank rates eased marginally. But publication of the July money figures on 5 August, which showed £3 billion growth in bank lending, again disappointed market expectations. Sentiment was adversely affected by a reappraisal of the consequences of the OPEC agreement, and this was reflected in a sharp fall in the equity market on 6 August and a resumption of the decline in sterling, mainly against the Continental European currencies. By the opening on 11 August, the ERI was back down to 70.7, ($1.4735 and DM 3.0339). The interbank yield curve was still practically flat from one month onwards, with the one-month rate at $9\frac{31}{32}$% and the longer-period rates all at $9\frac{7}{8}$%.

Towards the end of the period under review, hopes of an early cut in base rates were revived by speculation that a round of international interest rate cuts, such as had last occurred in March, might be imminent, together with renewed firming in oil prices towards $15 per barrel, and a consequent rise in the exchange rate to an ERI of 71.9 ($1.5030 and DM 3.0822). This optimism was reinforced by the $\frac{1}{2}$% cut in the US discount rate announced on 20 August. The authorities, however, rejected offers of paper by the discount houses the next day at rates below established intervention levels.

Over the period from 22 May to 20 August, interbank rates fell by $\frac{9}{32}$% to 10% at the one-month maturity, by $\frac{3}{8}$% to $9\frac{3}{4}$% at three months, and by $\frac{5}{32}$% to $9\frac{17}{32}$% at twelve months. Banks' base rates fell by $\frac{1}{2}$% to 10%. Following reductions of $\frac{3}{4}$% in some societies' deposit and mortgage rates on 1 June, which had been foreshadowed earlier in the year, building society interest rates were largely unchanged during the remainder of the period (although some rates on 90-day deposit accounts were raised by $\frac{1}{4}$%).

The gilt-edged market

The objective of the authorities during the period under review continued to be that of fully funding the PSBR over the financial year as a whole through debt sales to the non-bank private sector and external and foreign currency finance of the public sector.

In the first half of the period, the performance of the gilt-edged market was notably weak. To some extent this represented a correction to the exceptional rally earlier in the year and reflected a growing awareness that the benefits for inflation of the oil price fall, which had been the driving force behind the earlier declines in interest rates and bond yields both in the United Kingdom and elsewhere, were essentially once-for-all.

Yields at the start of the period were below 9% at the short end and just above it at the longer end. The upward correction caused a flattening of the yield curve, so that yields reached $9\frac{1}{2}$%–$9\frac{3}{4}$% throughout the maturity range during the second half of July. This adjustment generated greater domestic interest in gilt-edged, so that the market exhibited a generally stronger tone in the second half of the period. Reviving hopes of interest rate cuts also served to stimulate the market strongly towards the end of banking August.

On 2 July capital gains tax was lifted from transactions in gilt-edged securities and qualifying corporate bonds (as foreshadowed last year—see the September 1985 *Bulletin*, page 368).

Table H
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 (percent)	Date exhausted
10% Treasury Convertible 1990	150	20/6	Direct to Bank	20/6	—	—		—	25/6
9% Treasury 1994(a)	150	20/6	Direct to Bank	20/6	—	—		—	25/6
9¾% Exchequer 1998	150	20/6	Direct to Bank	20/6	—	—		—	24/6
9¾% Treasury 2002	150	20/6	Direct to Bank	20/6	—	—		—	24/6
10% Treasury 1992	150	27/6	Direct to Bank	27/6	—	—		—	10/7
8¾% Treasury 1997 (a)	150	27/6	Direct to Bank	27/6	—	—		—	3/7
9½% Conversion 2004	150	27/6	Direct to Bank	27/6	—	—		—	2/7
8½% Treasury 2007(a)	900(b)	11/7	Minimum price tender	16/7	94½	25.00	69.50 (18/8)	9.09	19/8
2½% Index-Linked Treasury 2016 'A'	400	25/7	Tender, no minimum price	30/7	97(c)	40.00	57.00 (8/9)	3.41(d)	30/7
2½% Index-Linked Treasury 2013	200	8/8	Direct to Bank	8/8	—	—	Fully paid	—	19/8
2½% Index-Linked Treasury 2020	100	8/8	Direct to Bank	8/8	—	—	Fully paid	—	14/8
11% Exchequer 1990(a)	200	22/8	Direct to Bank	22/8	—	—	Fully paid	—	—
10% Conversion 1996	150	22/8	Direct to Bank	22/8	—	—	Fully paid	—	27/8
9¾% Treasury 2002	150	22/8	Direct to Bank	22/8	—	—	Fully paid	—	—
11% Exchequer 1989	100	22/8	Direct to National Debt Commissioners	22/8	—	—	Fully paid	—	—
10½% Exchequer 1997	100	22/8	Direct to National Debt Commissioners	22/8	—	—	Fully paid	—	—

(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 £100 million was reserved for the National Debt Commissioneers.

(c) Price at which the stock was allotted at the tender.

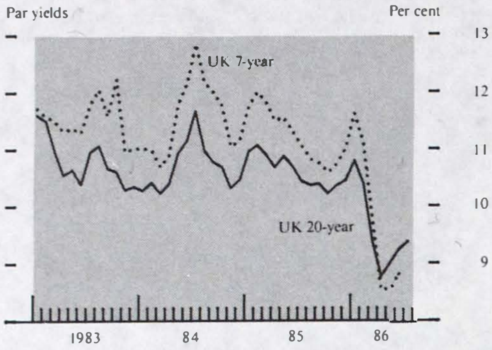
(d) Real yield, calculated on the basis of 5% annual rate of increase in the retail price index.

The authorities began the period having secured £0.8 billion through earlier sales of 9½% Conversion 2005 'A', 9% Conversion 2000 'A' and 8% Treasury 2009. Three stocks were due to be redeemed during the period—12% Treasury 1986, 8½% Treasury 1984/86 and 12¼% Treasury Convertible 1986 (which was the unconverted rump of a convertible stock, of which less than £½ million nominal remained in existence). Maturing stocks in market hands totalled £1 billion. Most of the 8% Treasury 2009 tap stock, issued on 23 April, was still available for sale from the authorities' portfolio at the start of the period, as was the tranchette of 2½% Index-Linked Treasury 2013 issued on 16 May.

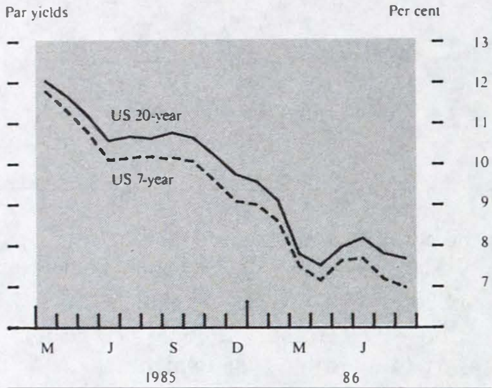
As mentioned in the June 1986 *Bulletin*, page 196, the Bank had rejected a number of bids for part of the residue of the 2009 tap stock, because it judged that the gilt-edged market had not yet settled at a level at which there would be substantial investor demand for stock. It was thought that this point may have been reached at the start of the period under review, and the Bank responded to bids for the stock on 23 May, in the wake of the base rate reductions, at a price of £21⅝ (the stock being £25-paid). On the same day the authorities announced the issue by tender on 29 May of £400 million of 3% Treasury 1991, their supplies of low-coupon stock having previously been exhausted on 14 April. With some interest being shown in index-linked after the Bank Holiday weekend, the authorities were able to sell out the tranchette of the index-linked 2013 stock on 28 May. All tenders for the low-coupon 1991 stock were allotted in full on the following day at the minimum tender price of £86.

The market drifted aimlessly over the following two weeks, reacting mainly to developments in the US bond market. Growing market optimism that an imminent base rate cut was in prospect lifted the market on 9 June, but the gains were largely reversed the next day by news of the banking May monetary data, itself reinforcing the depressing influence of US bonds.

Gross redemption yields on UK government securities



Gross redemption yields on US government securities



Helped by the fall in retail price inflation in May, published on 13 June, sentiment improved, enabling the authorities to sell out the remainder of the 2009 tap stock (which was by then £50-paid) at a price of £43. But the undertone was not firm and news on 17 June of the PSBR in May, which, at £1.0 billion, was lower than expected, was greeted by only a temporary rally.

Although the market drifted down during the rest of that week, there were tentative signs, at the then prevailing yields of close to 9½% at the long end, that outside investor demand was beginning to appear. In these circumstances, the authorities took the opportunity to replenish their supplies of full-coupon conventional stocks by announcing the issue on 20 June of tranchettes of £150 million each of 10% Treasury Convertible 1990, 9% Treasury 1994, 9¾% Exchequer 1998 and 9¾% Treasury 2002. The market reacted well and moved ahead in after-hours dealing. This buoyant tone continued into the following week, and facilitated the selling out of the 1998 and 2002 tranchettes on 24 June and the 1990 and 1994 tranchettes one day later.

A further series of tranchettes was announced on 27 June: £150 million each of 10% Treasury 1992, 8¾% Treasury 1997 and 9½% Conversion 2004. The next few days were marked by a substantial volume of intra-maturity switching, as investors sought to establish capital losses ahead of the lifting of capital gains tax on gilt-edged on 2 July. There was, however, little evidence of net selling on any scale, so that the market remained relatively firm, and the 2004 tranchette was sold out on 2 July. With encouragement being taken from US bonds, the authorities were able to sell out the 1997 tranchette on the following day.

The market strengthened further in the following days, with long yields falling to around 9⅛% on 4 July. By this time, however, expectations of an early cut in domestic interest rates were weakening, and the banking June money figures, released on 8 July, prompted the market to fall. Expectations were now focussed on the possibility of interest cuts abroad, particularly in the United States, and an upward movement in US bonds facilitated the selling out of the 1992 tranchette (the last of the three issued on 27 June) on 10 July. In the event, the ½% US discount rate cut on 10 July had little impact on the market. In the light of the firming undertone, however, the authorities announced the issue by tender of £800 million of 8½% Treasury 2007,(1) free of tax to non-residents, at a minimum tender price of £94½, implying a yield of 9.09%. The stock was £25-paid with the balance payable in banking August.

Sentiment was affected over the weekend, however, by the continuing fall in oil prices and the consequent effects on the exchange rate. Very little of the stock was taken up at the tender on 16 July, with all applications being allotted in full at the minimum tender price. The easier tone continued for the rest of the week, reflecting political factors as well as exchange rate concerns. In the following week, the market moved ahead somewhat, despite a series of factors—publication of figures showing US GNP growth at 1.1% per annum in the second quarter and a rise in US durable goods orders in June, and Congressional testimony by the Chairman of the Federal

(1) A further £100 million was reserved for the National Debt Commissioners.

Reserve Board—which caused the US bond market to fall away as the prospects for another discount rate cut seemed to recede.

Against the background of a reasonably firm market in index-linked, the Bank announced, on 25 July, the issue of a £400 million tranche of $2\frac{1}{2}$% Index-Linked Treasury 2016 'A' for tender on 30 July. This stock was £40-paid, with the remaining call coming in banking September. It was made clear at the time that the authorities were aware of specific investment demand for stock of this type. The stock was allotted at £97 (a real yield of 3.40%, assuming 5% inflation) with insufficient remaining in official hands for it to be operated as a tap stock.

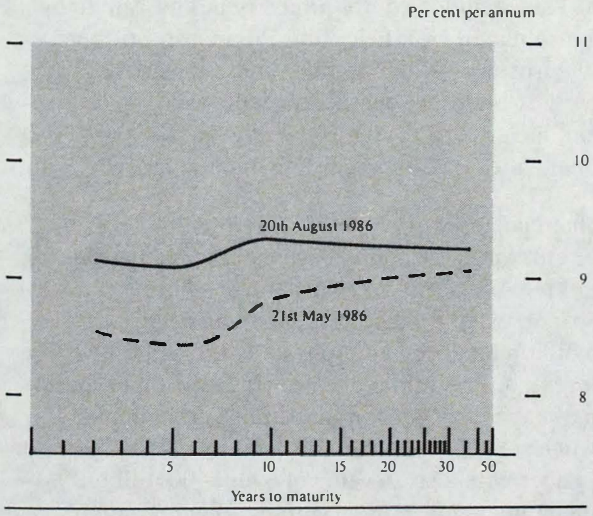
The fall in the exchange rate at the beginning of the following week set the market back, but news of the OPEC production agreement stimulated a recovery on 5 August, although the banking July money numbers, published the same day, caused prices to close off their best. By the end of the week the market had recovered sufficiently for the authorities to replenish their supplies of index-linked stock, which were once again depleted. Accordingly, the issue was announced on 8 August of a £200 million tranchette of $2\frac{1}{2}$% Index-Linked Treasury 2013 and a £100 million tranchette of $2\frac{1}{2}$% Index-Linked Treasury 2020.

Developments in the oil market encouraged the market further at the beginning of the following week, and the 2007 tap stock was reactivated after hours at a price of £$23\frac{1}{2}$, the first time that sales had been made since its issue on 11 July. By the end of that week, reawakening interest rate optimism, this time centred on possible moves abroad, was being reflected in strong US bond prices and a more buoyant gilt-edged market. A firmer oil price and exchange rate also contributed. In this atmosphere the 2020 index-linked tranchette was sold out on 14 August.

The market continued to advance strongly in the final week of the period under review, mainly on growing hopes of an international round of interest rate cuts. Official sales of the low-coupon tap stock, 3% Treasury 1991, were made on 15 August. Assisted by the good PSBR figures for July (a surplus of £0.2 billion) published on 18 August, the market moved ahead strongly the following day. News of the slowdown in US growth in the second quarter fuelled interest rate expectations. This enthusiasm enabled the authorities to exhaust both the 2007 tap stock and the 2013 index-linked tranchette on 19 August, the last dealing day for banking August. The cut in the US discount rate, when it came on 20 August, had been largely discounted in the gilt-edged market, and did not give rise to significant gains.

Over the three months to mid-August, yields on conventional 5-year stocks rose by $\frac{7}{16}$% to $9\frac{5}{16}$%, on 10-year stocks by $\frac{3}{8}$% to $9\frac{9}{16}$%, and on 20-year stocks by $\frac{3}{16}$% to $9\frac{3}{8}$%. Real yields on index-linked stocks were little changed: that on the 1988 maturity fell by $\frac{1}{16}$% to $3\frac{1}{2}$% while that on the 2020 maturity rose by $\frac{1}{8}$% to $3\frac{1}{4}$% (both assuming inflation of 5%).

Time/yield curves of British government stocks



Other capital markets

The *equity market* was unsettled for most of the period. The FT-Actuaries all-share index, which stood at 783.64 in mid-May, drifted lower through early June. There was modest recovery in late June, encouraged by a number of special factors, including Lloyds Bank's bid for Standard Chartered and the oversubscription of the Thames TV offer for sale, and the all-share index advanced to a high point for the period of 820.24 on 1 July. A sharp fall on Wall Street on 7 July, combined with worries over the sterling exchange rate and falling oil prices, quickly reversed the upward trend and the index fell back to a low point of 757.22 on 8 August. Thereafter, however, improved prospects for lower international interest rates and firmer oil prices brought about a rally in prices and the index closed the period at 792.74, up 1.2% overall. The all-share yield rose by 0.08% to 4.0% over the same period.

Equity issues continued at a record rate. A total of £1.9 billion of issues were announced over the three months to August, bringing the total for the year to date to £4.8 billion. Interest centred on three offers for sale by independent television companies—Thames Television (£32 million), Yorkshire Television (£10 million) and TV AM (£16 million)—all of which were heavily oversubscribed, and a £131 million offer for sale by Morgan Grenfell Group. A number of companies announced sizable rights issues including Costain (£62 million), International Signal (£71 million), de la Rue (£65 million) Barker and Dobson (£70 million), Rowntree Mackintosh (£144 million), BBA (£69 million) and Sedgwick Group (£135 million). In addition, Dee Corporation (£350 million) and Boots (£377 million) raised substantial sums by means of vendor placings to finance acquisitions .

In the *domestic fixed-interest market*, eleven UK borrowers raised a total of £427 million. This included a £125 million deep-discount issue by Tesco Stores, a £96 million placing of loan stock by Globe Investment Trust, and a £30 million index-linked issue by Nationwide Building Society. In addition, Billingsgate City Securities, a single-asset property company, raised £35 million by means of a deep-discount mortgage stock listed in Luxembourg. Two overseas borrowers raised a total of £200 million.

The fixed-rate *eurosterling market* was less active than in the previous two quarters. Twelve borrowers raised a total of £686 million. This included equity-linked issues by Yamaichi Securities, Consolidated Goldfields and Pilkington Brothers. New issues of eurosterling floating-rate notes increased again. Seven issues, all by building societies, raised a total of £1,475 million, including a £500 million ten-year issue for Abbey National—the largest eurosterling issue so far.

Sterling commercial paper

Following the entry into effect on 20 May of the regulation under the Banking Act permitting the issue of sterling commercial paper, twenty programmes with an aggregate size of some £1.5 billion had been announced by the end of the period under review. Preliminary returns indicate that around £250 million of paper was outstanding at the end of banking August, of which some £50 million was held by monetary sector institutions. Paper with a gross value of over £400 million had been issued under eleven programmes, of which some £150 million had been redeemed.

Table J
Amounts raised in the capital market

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

Banking months	Sept. 85– Nov. 85	Dec. 85– Feb. 86	Mar. 86– May 86	June 86– Aug. 86
UK private sector				
Loan capital and preference shares	+ 147	+218	+ 385	+ 429
Equity capital(a)	+ 443	+598	+ 675	+2,725
Unit trusts(b)	+1,030	+835	+1,200	+1,038(c)
Issues on the unlisted securities market	+ 28	+ 45	+ 33	+ 83
Local authorities				
Stocks	– 90	—	+ 3	– 7
Negotiable bonds	– 108	– 68	– 9	– 54
Overseas	+ 134	+245	+ 189	+ 37

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

Table K
Debt issues announced on the London capital market, mid-May to mid-August 1986

Date of Announcement	Issuer	Nominal amount (£ millions)	Coupon (per cent)	Maturity
Domestic borrowers				
27 May	Scottish National Trust	25	10	2011
2 June	Bristol Waterworks Co.	5	9.8	1996
3 June	Brixton Estates	30	$9\frac{1}{2}$	2026
9 June	Tesco Stores(a)	125	4	2006
17 June	Smith New Court(b)	15	12	1998
18 June	Bankers Investment Trust	10	$10\frac{1}{2}$	2016
24 June	Govett Strategic Investment Trust	30	$10\frac{3}{8}$	2016
25 June	Scottish Mortgage & Trust(c)	50	6-12	2026
1 July	Globe Investment Trust	100	10	2016
9 July	Nationwide Building Society(d)	30	$3\frac{7}{8}$	2021
12 August	Electric & General Investments	7	$10\frac{3}{4}$	2011
Overseas borrowers				
11 June	Paribas Concorde Trust	100	9.364	1991
17 June	EIB	100	9	2001

(a) Deep discount issue to raise £61 million.
(b) Issue with equity warrants.
(c) Stepped-coupon issue.
(d) Index-linked issue.