Operation of monetary policy

This article covers the three months from April to June 1987.

Review

Developments during the first half of the period under review—until the announcement of the date of the general election—were dominated by continued market pressures for a rise in sterling and lower domestic interest rates, intensifying the dilemma for policy faced during the previous quarter. The authorities did not wish to see interest rates fall too sharply, with the economy already buoyant and monetary indicators suggesting prospective levels of demand which could put upward pressure on inflation in the near term. But, equally, they were reluctant to see a sharp and unsustainable exchange rate appreciation damage the re-emergence of industrial confidence and deter long-term decisions to expand capacity.

Table A
Growth rates of the monetary aggregates[a]
Percentages

	Unadjusted		Seasonally adjusted(b)	
Calendar months	12 months to Mar. 87	12 months to June 87	Jan. 87–Mar. 87	Apr. 87–June 87
M0(c)	+ 3.5	+ 4.2	−1.0	+1.1
Non-interest-bearing M1	+10.2	+13.5	+2.1	+7.2
M1	+22.6	+23.9	+7.6	+7.1
M2	+12.2	+12.1	+1.3	+4.0
M3	+19.0	+19.2	+6.8	+5.1
M3c	+21.5	+20.5	+5.7	+4.5
M4	+13.9	+13.8	+4.1	+4.0
M5	+13.4	+13.5	+3.9	+4.1

(a) See the May 1987 *Bulletin*, page 212, for definitions of the broad money aggregates.
(b) Seasonal adjustments constrained over the financial year.
(c) Weekly average.

Between end-November and end-March, sterling's effective exchange rate index (ERI) had risen from 68.1 to 71.4. This reflected a recognition in the markets that the preceding decline, in response to the fall in the oil price, had been exaggerated, together with some indication of improved long-term prospects—such as evidence of a better supply-side performance and fiscal outlook.

The pressures on sterling in April and May were in part a continuation of the earlier trend, but were also heavily influenced by short-term political developments and the timing of the general election. To the extent that the inflow to sterling seemed likely to be in part transient, the authorities sought to avoid a policy response which could prove difficult to reverse and which would have substantial long-term effects. If in that period the exchange rate had appreciated much further in response to short-run pressures, it might have deterred long-term business decisions to expand capacity and supply.

Reflecting these considerations, pressures on sterling in April and May were absorbed much more by intervention and less by exchange rate appreciation than had earlier been the case, although the ERI rose to 73.3 by end-June. This policy response by the authorities also had the merit of raising the reserves to levels above those last seen in 1981.

Despite increasingly heavy foreign exchange intervention, however, the strength and persistence of the demand for sterling was the main factor behind two further ½% cuts in interest rates, announced respectively on 28 April and on 8 May, even though the economy was already buoyant, and prospective demand levels ran the risk of putting upward pressure on inflation.

Market pressures on sterling abated once the date of the election had been announced, reinforcing the impression that some of the inflows had been speculative. Expectations widely held by commentators of further massive inflows after the general election proved to be unfounded. The reaction in the markets, as anticipatory positions were unwound, relieved the pressures on policy which were previously present.

The massive foreign exchange market intervention in April and May had important effects in the money market and on broad money. The additional supply of sterling as a result of intervention coincided with a seasonally large CGBR, which was not fully matched by net central government debt sales. Together with a bunching of gilt-edged maturities, this resulted in a very sharp, though temporary, reduction in the need for official money-market assistance, which was reflected in a decline in the Bank's holdings of commercial bills to a low point of £2½ billion on 28 May. In addition, the Treasury bill tender was raised from £100 million to £400 million per week, with the intention that it should decline again later in the year, thus helping to smooth out the sharp fluctuations in the Bank's commercial bill operations that might otherwise occur.

Intervention also boosted broad money growth. Taking the three months to end-May, the reserves increased by £5.9 billion and seasonally adjusted M3 rose by £11.6 billion (compared with a rise of £5.3 billion in the previous three months). This acceleration reflected the fact that the effects of intervention were not immediately offset by higher debt sales. Although the PSBR has been underfunded in this financial year so far, the monthly pace of debt sales has been above that necessary to achieve a full fund of the PSBR over the year as a whole, even allowing for the reserves increase recorded in the period under review.

The brisk increase in broad money over recent months continues to reflect in part the effects of liberalisation in financial markets. Moreover, buoyant asset markets helped to increase the size of financial institutions' total portfolios, along with their holdings of liquidity. As a result, their money holdings have expanded much more rapidly than those of other sectors. Additional demand for sterling during this period was generated by the hedging of currency asset portfolios. A further contributory factor to the rapid growth of M3 over the last year has been switching by building societies of their liquidity holdings from gilt-edged stocks into bank deposits. Personal sector deposits with banks and building societies meanwhile grew less rapidly than those of other sectors—by 10% in the year to June.

This recent pattern of monetary growth suggests that the implications for inflation may be more limited than the growth figures themselves would indicate. Nevertheless, the rate of increase of both money and credit over the past three months is bound to give cause for concern if continued.

Table B
Composition of changes in the money stock[(a)]
£ billions; *seasonally adjusted (financial year constrained)*

	Calendar months	Jan. 87– Mar. 87	Apr. 87– June 87	Level outstanding at end-June 87
1	Non-interest-bearing M1	+ 0.8	+ 3.0	43.9
2	Interest-bearing sight deposits	+ 4.8	+ 2.7	41.4
3	**M1 (= 1+2)**	**+ 5.7**	**+ 5.7**	**85.3**
4	Private sector holdings of time deposits with banks and bank CDs	+ 4.5	+ 2.5	83.1
5	**M3 (= 3+4)**	**+10.2**	**+ 8.1**	**168.4**
6	Building society holdings of M3 (increase–)	– 2.3	– 0.9	– 12.4
	Non-bank private sector holdings of:			
7	Building society shares and deposits(b)	+ 3.2	+ 3.5	123.0
8	Building society £CDs and time deposits(c)	– 0.3	+ 0.1	2.3
9	**M4 (= 5+6+7+8)**	**+10.8**	**+10.9**	**281.3**
10	Non-bank, non-building society private sector holdings of money-market instruments and national savings in M5	– 0.1	+ 0.6	+ 14.8
11	**M5 (= 9+10)**	**+10.7**	**+11.6**	**296.1**

(a) See the May 1987 *Bulletin*, page 212, for definitions of the broad money aggregates.

(b) Including term shares and interest credited.

(c) Excluding holdings by building societies themselves.

Table C
Counterparts to changes in M3, M4 and M5[(a)]
£ billions; *seasonally adjusted figures (financial year constrained) in italics*

		Counterparts to M3			Counterparts to M4	Counterparts to M5
		Jan.87– Mar.87	Apr. 87– June 87	July 86– June 87	July 86– June 87	July 86– June 87
1	PSBR	*+ 1.3*	*+ 0.4*	1.8	+ 1.8	+ 1.8
2	Net purchases (–) of central government debt by the 'private' sector(b)(c)	*+ 1.4*	*–2.5*	– 4.3	– 7.2	– 6.8
3	Net purchases (–) of other public sector net debt by the 'private' sector(b)(c)	*+ 0.7*	*+1.6*	+ 2.4	+ 0.7	+ 0.5
4	External and foreign currency finance of the public sector	*+ 0.8*	*+2.5*	+ 1.3	+ 1.3	+ 1.3
5	Public sector contribution (= 1+2+3+4)	*+ 4.2*	*+2.0*	+ 1.1	– 3.4	– 3.1
6	Sterling lending to the 'private' sector(b)(d)	*+ 6.7*	*+8.6*	+32.8	+49.8	+50.6
7	Other counterparts(e)	*– 0.7*	*–2.5*	– 7.0	–12.4	–12.4
8	**Total** (= 5+6+7) = change in the aggregate	***+10.2***	***+8.1***	**+27.0**	**+34.1**	**+35.1**

(a) See 'Measures of broad money' in the May 1987 *Bulletin* page 217.

(b) For M3 counterparts, the 'private' sector excludes banks; for M4 and M5 counterparts it also excludes building societies.

(c) Transactions in public sector debt instruments included in M5 are necessarily excluded from the M5 counterparts.

(d) Includes changes in Issue Department's holdings of commercial bills and of promissory notes relating to shipbuilding paper guaranteed by the Department of Industry. The M5 counterpart includes 'private' sector holdings of commercial bills.

(e) External and foreign currency transactions and changes (–) in net non-deposit liabilities.

Monetary aggregates and credit

The figures in this section are seasonally adjusted except for twelve-month growth rates or as otherwise stated.

Following slightly erratic movements over the previous six months, M0 growth during the second quarter was close to the trend of the past year. Its twelve-month growth in June was around the middle of the 2%–6% target range. Broad money growth remained high, with M4 and M5 growth in the second

Table D
Sectoral contributions to the growth of the broad aggregates and credit in the twelve months to June 1987[(a)]

	Persons	ICCs	Building societies	Other OFIs
M3 components				
Percentage growth	8.8	25.0	69.0	32.1
Contribution to M3 growth(b)	5.0	6.0	3.7	4.5
M4 components				
Percentage growth	9.8	25.3	—	32.1
Contribution to M4 growth(b)	7.6	3.7	—	2.5
M3 credit counterpart				
Percentage growth	19.5	12.6	36.1	45.1
Contribution to M3 credit growth(b)	8.4	4.8	0.6	7.7
M4 credit counterpart				
Percentage growth	17.7	13.3	—	45.1
Contribution to M4 credit growth(b)	11.8	3.0	—	4.6

(a) Rows may not add to growth rates of the aggregates given in other tables because of rounding.
(b) Percentage points.

Table E
UK monetary sector: sterling and foreign currency deposits of, and lending to, the non-bank private sector
£ billions; *seasonally adjusted*(a)

	1986 Year	1986 Q3	1986 Q4	1987 Q1	1987 Q2
Sterling deposits					
Other financial institutions	5.6	1.5	2.1	6.5	1.0
Industrial and commercial companies	8.4	3.3	−0.3	1.6	3.6
Persons	8.4	1.4	0.4	2.1	2.8
Total	22.4	6.1	+2.2	10.1	7.3
of which, transit items allocated to ICCs	—	*1.2*	*−1.0*	*− 0.5*	*1.4*
Sterling lending					
Other financial institutions	10.9	3.5	3.3	3.0	2.9
Industrial and commercial companies(b)	9.1	0.8	5.0	0.1	1.5
Persons	10.1	2.6	2.2	3.7	4.3
Total	30.2	6.9	10.5	6.7	8.7
of which, transit items allocated to ICCs	—	*−0.8*	*0.7*	*0.4*	*−1.0*
Foreign currency deposits					
Other financial institutions	4.4	0.5	2.2	0.4	2.0
Industrial and commercial companies	3.0	2.1	−0.2	0.9	−1.1
Persons	—	0.1	—	0.2	−0.2
Total	7.5	2.7	1.9	1.4	0.7
Foreign currency lending					
Other financial institutions	10.7	4.9	0.6	5.2	3.8
Industrial and commercial companies	−3.1	−1.1	−0.1	2.1	0.8
Persons	0.7	−0.1	—	0.1	0.1
Total	8.2	+3.7	0.6	7.4	4.7

(a) Seasonal adjustments constrained over the calendar year.
(b) Includes Issue Department take up of commercial bills and guaranteed shipbuilding paper.

quarter similar to that in the first, while that of M3 fell back a little. The public sector counterparts were boosted by intervention in the foreign exchange market during April and May and by the bunching of debt maturities. The lending counterparts to broad money, which had slowed a little since the end of 1986, mainly owing to weaker lending to companies, accelerated during the second quarter. Lending to persons has been particularly buoyant, with the banks continuing to gain market share at the expense of the building societies.

M3 continued to grow more rapidly than other measures of broad money during the period under review. Balances included in M1 accounted for about 70% of the total increase in M3 over the quarter. This may reflect the use of sight deposits as a temporary resting place for part of the inflow into sterling during the quarter. Some of this increase in M1 may also represent the emergence of a fund of liquidity held in connection with applications for successive oversubscribed share sales. The potential for distortion to the broad money figures and, particularly, to their composition is illustrated by the growth of the amount held in suspense accounts,[(1)] which has doubled since the beginning of the year. In addition, changes in transit items[(2)] have become more volatile, and, within the recorded statistics, this has increased the uncertainty surrounding the sectoral split of deposits and lending.

Two additional features of the figures are worth remarking. The first is that building society bank deposits have continued to grow. The second is that companies and financial institutions, both sectors which hold deposits predominantly with banks, have been building up liquidity more rapidly than persons. Both of these factors help to explain why M3 growth exceeded that of M4 and M5 over the past year.

The strength of industrial and commercial companies' income and profits, combined with the absence of any significant investment response to higher output growth, has meant that companies have built up their liquid assets particularly rapidly. Growth has been concentrated in their sterling bank deposits, which have gone up about 25% over the last year. This build-up slowed somewhat at the end of last year, possibly reflecting stockbuilding and the pause in growth of consumer demand, but has resumed this year.

The growth of personal sector holdings of broad money accelerated in the first half of the year, and thus continued to grow more rapidly than disposable income. The first quarter increase in deposits may have been associated with the pause in consumption growth; but the build-up continued in the second quarter, at a time when consumption expenditure was buoyant, perhaps reflecting the increase in consumer credit and mortgage lending, the latter probably resulting in increased cash extraction from the housing market.

Building societies have tended to lose share in the retail savings market to the banks over the past year. The change is difficult to explain in terms of short-term interest rate competitiveness and may reflect a tendency for the societies' inflows to be more affected than banks by the recent series of privatisations and by competition from unit trusts. Over the most recent quarter, the

(1) These include bank accounts in which unsuccessful subscribers' funds are temporarily held.
(2) Principally cheques in course of collection.

Table F
Industrial and commercial companies: some sources of finance
£ billions, *not seasonally adjusted*

	1985 Year	1986 Year	1986 Q3	1986 Q4	1987 Q1	1987 Q2
Net equity issues:						
Listed companies	4.1	5.9	1.6	2.0	0.6	2.3
Unlisted market	0.2	0.2	0.1	0.1	0.1	0.2
Gross international bond issues:						
Sterling	0.5	1.2	0.2	0.1	0.8	1.2
Foreign currency	1.1	2.2	0.3	0.6	0.3	0.2
Net commercial paper issues:						
Sterling	—	0.4	0.2	0.1	0.4	0.7
US dollar(a)	..	..	0.4	0.3	..	..
Borrowing from UK banks:						
Sterling(b)(c)(d)	5.3	9.4	0.3	5.4	1.1	0.5(e)
Foreign currency(d)	2.4	-3.3	-1.1	—	2.1	0.8(e)

— less than £50 million.
.. not available.

(a) Outstanding US commercial paper issued by ICCs increased from $1.7 billion at end-June 1984 to $2.2 billion at end-June 1985 and $3.6 billion at end-June 1986. These figures do not include euronotes or eurocommercial paper.
(b) Includes Issue Department take-up of commercial bills and guaranteed shipbuilding paper.
(c) Includes changes in borrowing by some securities dealers up to 1986 Q3 (see the December 1986 *Bulletin*, page 478).
(d) Includes banks' investments in ICCs' equity and bonds.
(e) Provisional.

Table G
Non-bank financial institutions: some sources of finance
£ billions, *not seasonally adjusted*

	1985 Year	1986 Year	1986 Q3	1986 Q4	1987 Q1	1987 Q2
Net equity issues:						
Listed companies(a)	0.3	2.2	1.0	0.2	0.1	0.1
Unlisted market	—	—	—	—	—	—
Gross international bond issues:						
Sterling	1.0	3.5	2.1	0.3	0.4	0.4
Foreign currency	0.2	0.1	—	—	0.4	0.2
Net commercial paper issues:						
Sterling	—	0.1	0.1	—	—	0.1
US dollar	..	..	—	—	..	..
Borrowing from UK banks:						
Sterling(b)	5.6	9.8	3.5	3.2	3.0	2.9(c)
Foreign currency	1.5	10.7	4.9	0.6	5.2	3.8(c)

— less than £50 million.
.. not available.

(a) UK public companies only.
(b) Excludes changes in borrowing by some securities dealers prior to 1986 Q4 (see the December 1986 *Bulletin*, page 478).
(c) Provisional.

Table H
Comparison of inflows to banks and building societies
£ billions; *seasonally adjusted (calendar year constrained)*

	1985 Year	1986 Year	1986 Q3	1986 Q4	1987 Q1	1987 Q2
Building society retail inflows (net, including interest credited)	13.4	12.3	1.4	3.5	3.1	3.5
Change in personal sector sterling deposits with banks(a)	4.9	8.4	1.4	0.4	2.1	2.8

(a) Includes changes in the deposits of some securities dealers up to 1986 Q3 (see the December 1986 *Bulletin*, page 478).

building societies have been slower than the banks to reduce interest rates, and so their competitive position for deposits has strengthened.

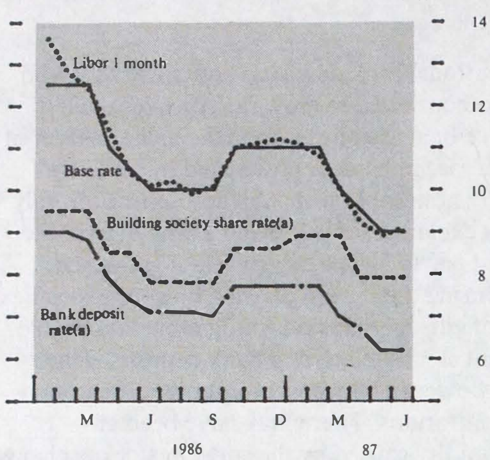
Other financial institutions' bank deposits (both in sterling and other currencies) have continued to grow rapidly over the last year; indeed, they have increased faster than the balance sheet of these institutions. The rise in bank deposits held by building societies is particularly noticeable; although accounting for only about 7% of M3, they explain nearly 20% of its growth over the last year. This resulted partly from a switch out of gilt-edged stock into deposits; during the second quarter, however, societies were net purchasers of gilts, perhaps reflecting more favourable returns on government stocks relative to bank deposits. The build-up in deposits, however, appears common to different groups of financial institutions. There may have been an increased need for liquidity caused by the surge in stock exchange turnover since Big Bang. There was a massive build-up of sterling deposits by financial institutions in the first quarter and an almost equivalent amount of foreign currency borrowing by them from the banks. It seems certain that some of this was due to institutions hedging their existing foreign currency investments by borrowing in foreign currency and switching the proceeds into sterling deposits. In the latest quarter, the increase in the institutions' bank deposits was more modest.

Among the counterparts to broad money growth, the public sector was an expansionary influence, partly owing to heavy intervention in the foreign exchange market—equivalent to a fall in external and foreign currency finance of the public sector. In the last quarter the PSBR was underfunded by the equivalent of $1\frac{1}{4}$% of the stock of M3, taking together public sector debt sales to the non-bank private sector and external finance of the public sector. This outturn reflected in part the large amount of intervention. The underfund also reflected the activities of the local authorities, which reduced their net borrowing from the non-bank private sector over the quarter. The policy objective remained a full fund of the PSBR over the financial year as a whole.

Evidence from the first five months of the year provided some indication of a slowdown in credit growth; lending in June, however, was sufficient to suggest a possible reversal of that trend. The twelve-month growth of lending by banks and building societies remained around $19\frac{1}{2}$%. Lending to financial institutions over the past year has grown far more than that to other sectors, although some of this may have resulted in on-lending to those other sectors.

The sectoral composition of bank lending in sterling during the second quarter shows that lending to the personal sector was particularly strong, accounting for almost 50% of the total. Within this, lending to unincorporated businesses fell back but lending to households, for house purchase and other purposes, accelerated. Building societies continued to lose ground to the banks in the mortgage market. If the new mortgage lenders' business has continued to expand, total mortgage lending will have picked up substantially in the second quarter to a rate above that seen in the same period last year. Some of this no doubt reflected the promotion by banks of fixed-interest mortgages, and may be temporary, but it may also reflect lower interest rates.

Bank/building society competitiveness



(a) Building society share rate and bank deposit rate are net of composite rate tax. Building society share rate is an average of the best rates from five top building societies. Bank deposit rate is an average of the best rates from seven major banks.

Table J
Financing of the public sector

£ billions; *seasonally adjusted (financial year constrained)*

Calendar months	Oct. 86– Dec. 86	Jan. 87– Mar. 87	Apr. 87– June 87	July 86– June 87
Central government borrowing on own account	-2.1	+1.3	+0.9	+2.9
Other public sector borrowing(a)	-0.4	—	-0.5	-1.3
PSBR	**-2.5**	**+1.3**	**+0.4**	**+1.7**
Net sales of central government debt to the non-bank private sector	-1.8	+1.4	-2.5	-4.3
of which:				
Gilt-edged stocks	*-1.6*	*+1.7*	*-1.3*	*-2.0*
National savings	*-0.8*	*-1.0*	*-0.7*	*-3.3*
CTDs	*+0.8*	*+0.8*	*-0.4*	*+1.2*
Net sales of local authorities' and public corporations' debt to the non-bank private sector	-0.2	+0.7	+1.6	+2.4
External and foreign currency finance of the public sector	-0.9	+0.8	+2.5	+1.3
of which, gilt-edged stocks	*-0.7*	*-0.8*	*-1.6*	*-3.7*
Total financing of the public sector from the non-bank private and overseas sectors	**-2.8**	**+2.9**	**+1.6**	**-0.7**

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

Table K
Official transactions in gilt-edged stocks

£ billions; *not seasonally adjusted*

Calendar months	Apr. 86– June 86	July 86– Sept. 86	Oct. 86– Dec. 86	Jan. 87– Mar. 87	Apr. 87– June 87
Gross official sales(a)	+4.6	+3.0	+4.5	+2.7	+4.0
less					
Redemptions and net official purchases of stock within a year of maturity	-2.7	-0.9	-1.8	-3.3	-2.6
Equals net official sales(b)	+1.9	+2.0	+2.7	-0.7	+1.4
of which, net purchases by:					
Monetary sector(b)	*+0.2*	*+0.7*	*+0.2*	*+0.3*	*-1.5*
Overseas sector	*+0.8*	*+0.5*	*+0.7*	*+0.8*	*+1.6*
Non-bank private sector	*+0.8*	*+0.8*	*+1.6*	*-1.7*	*+1.3*

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.

In contrast to the acceleration in persons' bank borrowing, sterling lending by the banks to companies slowed during the first half of the year. The evidence suggests a shift in ICCs' financing towards equity and more marketable forms of debt as a result of the strength of the equity market, lower long-term nominal interest rates, a firming of interest rate expectations and a widespread move towards securitisation.[1]

Sterling lending by the monetary sector to financial institutions continued to grow rapidly in the second quarter, bringing its increase over the past year to around 45%. The growth of lending over the year appears widely spread, with lending to building societies, insurance companies and pension funds, investment and unit trusts, property companies and securities dealers growing rapidly. Some of the lending (for example, that to consumer credit companies and mortgage finance vehicles) may reflect an increase in lending to persons by these financial institutions. The trend over the past year will have been inflated by borrowing in connection with Big Bang and in recent quarters possibly by settlement delays in the equity market. The growth of foreign currency lending to financial institutions and to a lesser extent companies is also noticeable. It is likely that some of this borrowing reflects hedging in the foreign exchange markets.

Official operations in financial markets

This and the succeeding section include commentary on both the money market and the foreign exchange market. The figures are not seasonally adjusted unless stated.

The most striking development in the money market during the second quarter was the continued sharp fall in market assistance, with the Bank's holdings of commercial bills falling to their lowest level since late 1981. In part this reflected a large CGBR only partly offset by debt sales, but it was mainly the result of foreign exchange market intervention. A further factor was the heavy weight of gilt-edged maturities during the period. In response to these developments, the authorities increased the weekly Treasury bill tender.

Central government own-account borrowing in the first quarter of the current financial year was £1.7 billion. Local authorities borrowed very large amounts from the Public Works Loan Board in order to repay other sterling borrowing and to bolster liquidity in anticipation of future needs. This raised the CGBR, without affecting the PSBR, and produced a flow of cash to the banking system which was only partly offset by net sales of central government debt, mainly gilt-edged stock.

Gross official sales of gilt-edged stock increased to £4.0 billion while redemptions and official purchases of near maturities fell back slightly, resulting in net official sales of £1.4 billion, as against the exceptional net official purchases of gilts in the previous period. In the latest quarter, the overseas sector made their largest ever quarterly net purchases of gilts, which more than accounted for the total take-up. Their purchases were concentrated in June. In the latest quarter, also, the non-bank private sector returned to being net purchasers of gilts, while the monetary sector sold a record £1.5 billion, reversing virtually all of the increase in their holdings during 1986/87.

(1) For a further discussion see the article on company profitability and finance on page 386.

Table L
Influences on the cash position of the money market

£ billions; *not seasonally adjusted*
Increases in the market's cash (+)

Calendar months	Apr.– June 86	Jan.– Mar. 87	Apr.– June 87	July 1986– June 1987
Factors affecting the market's cash position				
CGBR (+)	+6.4	+1.3	+4.1	+8.2
of which, on-lending to local authorities and public corporations	*+3.3*	*+2.4*	*+2.4*	*+5.1*
Net sales (–) of central government debt(a)	-3.1	+0.7	-2.2	-7.7
of which:				
Gilt-edged	*-1.9*	*+0.7*	*-1.4*	*-5.4*
National savings	*-0.6*	*-1.1*	*-0.6*	*-3.3*
CTDs	*-0.6*	*+1.1*	*-0.2*	*+1.0*
Currency circulation (increase –)	+0.5	+1.0	-0.4	-0.6
Reserves etc	+0.4	+1.6	+4.6	+5.6
Other	+0.7	-0.9	-0.3	-0.2
Total (A)	**+4.9**	**+3.7**	**+5.8**	**+5.3**
Official offsetting operations				
Net increase (+) in Bank's holdings of commercial bills(b)	-2.0	-5.7	-2.3	-3.6
Net increase (–) in Treasury bills in market	-0.2	-0.4	-1.3	-1.8
Securities(c) acquired (+) under sale and repurchase agreements with banks	-2.3	+1.1	-1.1	—
Other	-0.3	+1.4	-1.2	—
Total (B)	**-4.8**	**-3.6**	**-5.9**	**-5.4**
Change in bankers' operational balances at the Bank (= A + B)	+0.1	+0.1	-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.

Table M
Changes in UK official reserves

$ millions

	1987 Apr.	May	June
Change in reserves	**+2,768**	**+4,872**	**–315**
of which:			
Net borrowing (+)/payment (–) of public debt	– 45	+ 112	– 85
Valuation change on roll-over of EMCF swap	– 99	—	—
Underlying change in reserves	+2,912	+4,760	–230
Level of reserves (end of period)	**29,807**	**34,679**	**34,364**

Intervention to stabilise the pound dominated other money-market influences, with the additional sterling used to purchase foreign currency flowing into the banking system and improving the money market's cash position. The net result was a continued sharp reduction in the need for market assistance, manifested over the period as a whole largely in a fall in the Bank's holdings of commercial bills. With the need for assistance being generally low in late May and June, and with occasional cash surpluses, the authorities increased the size of the weekly Treasury bill tender—from £100 million to £250 million on 22 May and to £400 million from 29 May. Most of the additional Treasury bills were taken up by the banking system, though overseas residents made large purchases, mainly in June.

The amount of official assistance to the money market outstanding (other than that provided through dealings in Treasury bills) fell on balance over the quarter by £4.6 billion to £5.1 billion, of which £4.7 billion was in the form of eligible commercial bills held outright by the Bank. The low point of £2½ billion was reached on 28 May. The amount of Treasury bills in the market rose by £1.3 billion to £2.6 billion over the three months.

Average daily shortages in the money market were about £530 million in the latest quarter, below the £660 million or so recorded in the previous three months. However, on 23 April a record shortage of £2,210 million was recorded as a result of the clearing of large volumes of delayed VAT payments.

Official reserves

Over the three months to end-June there was an underlying increase in the official reserves of $7,442 million, of which $4,760 million occurred in May (a record monthly increase). There was a small fall in the reserves in June. Net official foreign currency debt repayments amounted to $18 million. The reserves were reduced by $99 million on account of the valuation adjustment arising from the quarterly roll-over of the European Monetary Co-operation Fund swap. At the end of June the reserves stood at the level of $34,364 million.

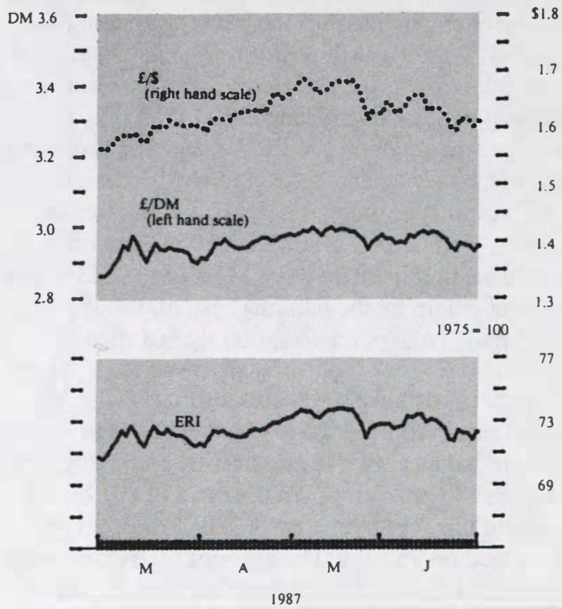
The money and foreign exchange markets

As in the previous three months, developments in the second quarter of 1987 were dominated by periods of intense upward pressure on sterling. These pressures, concentrated in late April and early May, were met by heavy foreign exchange market intervention to a much greater extent than earlier in the year and by two further ½% cuts in domestic interest rates. The intervention was also consistent with the outcome of the Louvre meeting of Finance Ministers in February. This policy responded to pre-election uncertainty and the continuing concern of the authorities that a sharp appreciation of the exchange rate would damage re-emerging industrial confidence. After the general election, sterling drifted lower, ending the quarter on a quiet note, and money-market interest rates edged up.

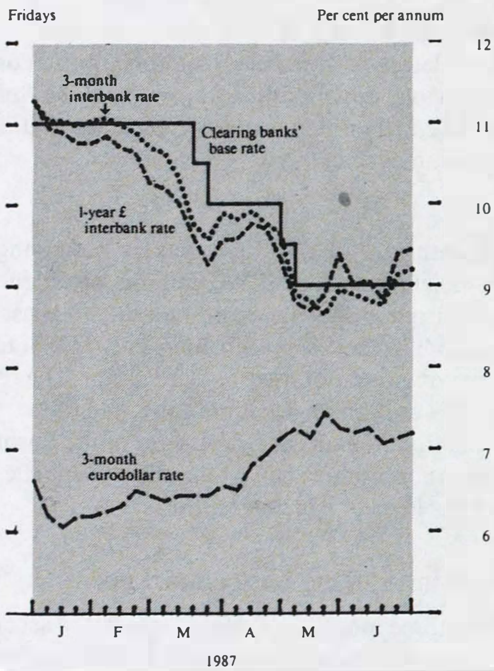
The period opened with a downward-sloping money-market yield curve, with the one-month rate at $10\frac{1}{32}$%, the three-month rate at $9\frac{29}{32}$% and the twelve-month rate at $9\frac{11}{16}$%. Banks' base rates were 10% and the effective exchange rate index (ERI) was 71.6 ($1.6025 and DM2.9149). In the first three weeks of April,

Sterling exchange rates

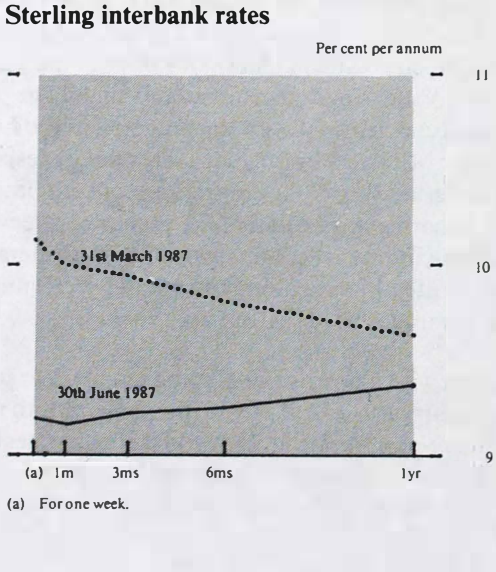
At the close of business in London each day



Short-term interest rates in London



Sterling interbank rates



(a) For one week.

conditions in the money market were generally quiet, with rates fluctuating within a narrow range. Sterling also began the period quietly, but the pound came into demand as opinion polls favourable to the government increased expectations of an early general election. By 6 April the pound had reached $1.6187 and DM2.9541 and, although it eased in a pre-Easter lull, it rallied further to $1.6352 by the close on 21 April and to DM2.9685 (and to 72.4 on the ERI) on the following day. The effect of sterling's strength on sentiment in the money market was, however, counterbalanced by worries about rising interest rates abroad.

As the local elections approached, upward pressure on sterling intensified and was met by increasingly heavy official sales of sterling. In the money market on 24 April the Bank refused offers of bills at $\frac{1}{2}$% below its established dealing rates but, with strong upward pressure on sterling persisting, accepted similar offers on 28 April, signalling a cut of $\frac{1}{2}$% in interest rates. This brought little relief, however, and sterling continued under strong upward pressure, which became particularly intense on 8 May, following the local election results, when sterling reached $1.6735 and DM 2.9972, and an ERI of 73.6. These pressures were met by heavy official intervention and by a further $\frac{1}{2}$% cut in interest rates: the Bank announced that it would buy eligible bills in all four maturity bands (out to 3 months) at a common discount rate of $8\frac{7}{8}$% ($\frac{1}{2}$% down from its earlier buying rate in band 1, but only $\frac{5}{16}$% down in band 4). This implied an upward-sloping money-market yield curve and clearly signalled caution about any further fall in rates. Sterling remained strong until the date for the election was announced and then eased back on profit-taking, with money-market rates edging up.

The election announcement heralded a much quieter period in the money and foreign exchange markets. The size of the earlier intervention, and the implications of this for the authorities' willingness to resist further appreciation, restrained the market, so that bouts of upward pressure on sterling were much less intense than they had been in late April and early May. Nonetheless, the pound reached a high point for the quarter against the dollar of $1.6895 on 20 May, before falling back as the dollar began to recover later in the month. The strength of the dollar's rise was notably pronounced against the pound as sterling positions acquired in previous weeks were quickly unwound, and the pound fell to $1.6140 and DM2.9354 (71.9 on the ERI) on 27 May. The consequent poorer tone in the money market pushed up the three-month interbank rate to $9\frac{1}{16}$% and the twelve-month rate to $9\frac{7}{16}$% on the same day. However, better-than-expected trade figures and strengthening expectations that the government would be re-elected helped a quick recovery, and on 10 June the pound opened at $1.6655, with money-market rates back inside 9%.

Sterling staged only a modest rally on the election result, which had largely been already discounted. Furthermore, the market expected official intervention if sterling resumed its upward movement. Disappointment that inflows had not followed the election result triggered a sharp wave of selling on 22 June and during the following day the pound touched lows of $1.5890 and DM2.9313 before rallying again. Sentiment in the money market was affected by sterling's weakness, and the three-month interbank rate had risen to 9$\frac{5}{32}$% by 22 June. Although sterling suffered a further brief fall on 29 June, it ended the quarter on a steadier note with the market apparently believing that post-election profit-taking sales had been completed. The pound finished June at \$1.6135 (up $\frac{1}{2}$% on the quarter), DM2.9452 (up 1$\frac{5}{8}$%) and an ERI of 72.3 (up 0.7). Money-market rates had eased back to 9$\frac{3}{16}$% and 9$\frac{3}{8}$% at three and twelve months' maturity, respectively. The money-market yield curve pivoted during the period, influenced by the Bank's action on 8 May, and ended with an upward slope.

The gilt-edged market

In contrast to the money market, there was no definite trend in yields in the gilt market between end-March and end-June: the fall in money-market rates that occurred during the quarter was no more than had been previously discounted by the gilt-edged market. Gilt yields were far from stable, however, and fluctuated between about 8$\frac{1}{2}$% and over 9$\frac{1}{4}$%. This was in contrast to previous months, when yields had been tending to fall. The more uncertain tone of the market reflected a number of factors which had broadly offsetting influences over the period as a whole, though one or other of them held sway at different times. Two episodes of bullish sentiment carried yields below 9% in late April/early May and again in early June, but each time the market's gains were pegged back.

The objective of the authorities remained 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. As the period progressed, the extent of official intervention in the foreign exchange market became apparent to the market. Increases in the reserves count as negative external finance of the public sector and imply a greater need for other forms of funding over the financial year as a whole. Thus commentators saw the increase of £4.7 billion in the reserves in April and May—more than the forecast PSBR—as adding considerably to the likely total of gilt sales. This dampened the market and more than outweighed the bullish implications which strong demand for sterling might otherwise have had.

The authorities began the period with calls totalling some £1.8 billion secured on 9% Treasury 2008, 8$\frac{3}{4}$% Treasury 1997 and 9% Treasury 2002, all of which had been issued before the end of the 1986/87 financial year. Three stocks were scheduled to mature during the period: 10$\frac{1}{2}$% Exchequer 1987, of which £0.9 billion was in market hands; 6$\frac{1}{2}$% Funding 1985/87, of which £0.6 billion was in market hands; and 10% Treasury 1987, of which £1.1 billion was in market hands. The authorities had available for sale supplies of 2$\frac{1}{2}$% Index-Linked Treasury 2011 and 2$\frac{1}{2}$% Index-Linked Treasury 2024 which had been issued at the end of March, and quantities of other stocks.

The market began the new financial year in modest retreat, reflecting profit-taking following the Budget, uncertainties in the opinion polls, and rumours of Japanese selling. The uncertain tone continued past the middle of April amid market worries about the apparently worsening mood in international trade relations, the continued weakness of the dollar and the lack of visible progress at the G7 meeting. Sentiment became more

Table N
Issues of gilt-edged stock

Stock	Amount issued (£ millions)	Date announced	Method of issue	Date issued	Price per £100 stock	Payable per £100 stock(a): Initial payments (£)	Payable per £100 stock(a): Further instalments (£)	Redemption yield (per cent)	Date exhausted
8½% Treasury 2000(b)	1200(c)	28/4	Direct to Bank	28/4	97.50	30.00	67.50 (22/6)	8.82	5/5
8% Treasury 1992(b)	1000	5/5	Bid price auction	13/5	98.25(d)	48.25	50.00 (29/6)	8.45(e)	13/5
8% Treasury 2002/06 'A'(b)	1100(f)	8/5	Minimum price tender	14/5	94.75	30.00	64.75 (6/7)	8.56	24/6
10% Treasury 1993	200	26/6	Direct to Bank	26/6	103.8125			9.12	7/7
10% Conversion 1996	200	26/6	Direct to Bank	26/6	104.25			9.30	7/7
9% Exchequer 2002	100	26/6	Direct to Bank	26/6	99			9.11	1/7
10½% Treasury Convertible 1992	150	26/6	To National Debt Commissioners	26/6					..
10½% Exchequer 1997	150	26/6	To National Debt Commissioners	26/6					..
3% Treasury 1992	500	10/7	Minimum price tender	15/7	85.50	Fully paid		6.49	—
8% Treasury 1991	1200(g)	17/7	Minimum price tender	22/7	97.25	20.00	77.25 (24/8)	8.78	—

(a) If not fully paid at time of issue.

(b) 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.

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

(d) The lowest accepted price for competitive bids. The non-competitive allotment price was £98.30. The highest accepted price for competitive bids was £98.75 (yield 8.32%).

(e) Yield at the lowest accepted price.

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

(g) The prospectus includes provision for exemption from UK taxation in favour of non-resident holders.

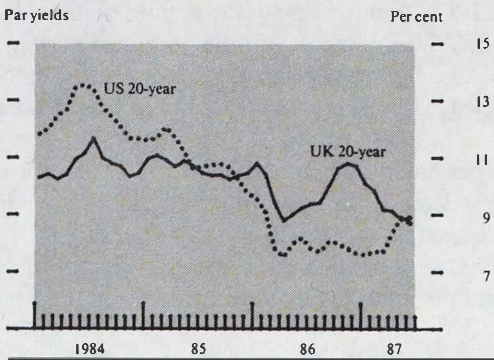
optimistic towards the end of the month in response to developments in the opinion polls and a better-than-expected outturn for the PSBR in 1986/87.

In the last week of April and early May, the market became increasingly buoyant as sterling strengthened and the likelihood of a June election increased. The cuts in base rates announced on 28 April and 8 May, together with a favourable reaction to the outcome of the local elections, resulted in yields on short-dated stocks falling to 8½%. During this period the 8½% Treasury 2000 tap, issued on 28 April, was exhausted. The authorities took further advantage of the bullish tone of the market to announce two additional issues of stock, including the first gilt-edged auction, of £1,000 million of 8% Treasury 1992, to be held on 13 May; this was followed on the next day by an offer by tender of £1,000 million of 8% Treasury 2002/06 'A'. The weight of stock brought to the market helped to steady it, and the calmer mood was reinforced on 11 May when the date of the general election was announced. The auction stock was oversubscribed but, as expected and against a background of profit-taking, the 2002/06 stock was undersubscribed at tender.

As mentioned above, the first in an experimental series of auctions of gilt-edged stock was held on 13 May. This was covered some two-and-a-quarter times by bids received: except for non-competitive bids, which totalled less than 0.1% of the amount offered, stock was allocated competitively at prices bid. This may in part explain the much narrower distribution of bids than is customary at tender when allocation is at a common price. The narrow spread of bids—the lowest of the accepted bids was only 6½p below the average—may also have reflected the guide price established during 'when issued' trading, which in the event was close to the average allotment price. About 90% of allocated competitive bids were received from gilt-edged market makers bidding both on their own account and on behalf of customers. The result of the auction was sufficiently encouraging to justify a continuation of the experiment.(1)

(1) It was subsequently announced that the next gilt-edged auction, for up to £1 billion of a long-dated stock (over 15 years) will be held around the middle of September 1987. It is envisaged that a further auction, this time of a medium-dated stock (7–15 years), may be held in January 1988.

Gross redemption yield on UK and US 20-year government securities

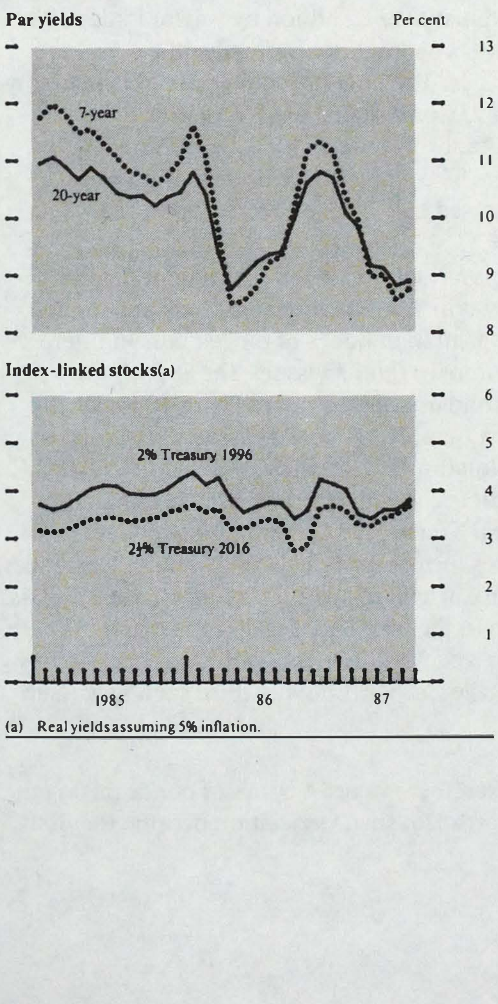


The market retreated to yields above 9% in the first two weeks of the election campaign and reacted nervously to news on the political and economic fronts. The market responded badly to the April retail prices figures, which were above expectations, and was worried about the wider implications of Citicorp's large increased provisions against sovereign debts. The announcement of these provisions had weakened the US bond market, supporting the trend towards higher US bond yields which had become established since end-March. By the middle of May, rising US bond yields had converged with yields on gilts and the market had become wary about the room for 'decoupling' gilt yields from those on US bonds.

The market began to rally again in early June as US bond yields began to move lower and as confidence increased about the result of the election. The market was lifted by professional buying in anticipation of large foreign inflows once the election was past and by news of the current account surplus in April, which was a better outturn than the market had expected. Yields on short gilts fell to close to $8\frac{1}{2}$% and, for the first time since 14 May, sales of the long tap were made on 8 June.

On election night the market continued trading through the night for the first time, with a good volume of business, orders coming both from domestic and overseas investors. The reaction to the election result on the following day was subdued, it having been largely discounted by the market, though further sales of the tap stock were made. With the expected foreign demand failing to materialise, the market felt itself overloaded with stock and lost direction. A reassessment of the volume of sales likely during the year, consequent upon the reserves figures, also acted to raise yields. With sterling easing against a firming dollar, and worries increasing about pressures on capacity and wages, yields rose to around $9\frac{1}{4}$% by the end of June. After the long tap stock was exhausted on 24 June, the authorities announced a £500 million package of tranchettes designed to continue the funding programme in the uneasy prevailing market conditions.

Gross redemption yields on UK government securities



(a) Real yields assuming 5% inflation.

The period began with yields on 5-year gilts at $9\frac{1}{8}$% and those on 20-year stocks marginally higher at $9\frac{5}{32}$%. The gentle upward slope to the curve was in contrast to experience during much of the 1980s when the curve had sloped downwards, reflecting expectations of falling interest rates. The slope of the yield curve over the maturity range as a whole remained positive during the period, steepening in the two episodes when yields were falling and flattening when they were rising, reflecting the greater variability of yields on short gilts than on longs. At the end of the period under review, yields were much the same as at the start of it, with 5-year yields at $9\frac{1}{8}$% and those at 20 years around $9\frac{3}{16}$%. Gilt yields were by then above interest rates in the money market, rather than below them as at the start of April.

It was a rather different story in the index-linked sector, where the reduction in the larger uncertainties about inflation following the election result reduced the attraction of index-linked stock. The notable strength of equities during the second quarter may have had the same effect. The net result was a persistent upward drift in yields on medium and long-dated index-linked stock, with the real rate of return on Treasury $2\frac{1}{2}$% Index-Linked 2006 rising from $3\frac{3}{16}$% at the end of March to $3\frac{31}{32}$% three months later (both calculated assuming 5% inflation and before tax).

During the period under review, turnover in the gilt-edged market continued at a high level. Turnover with outside-market customers averaged £2.5 billion per day in the second quarter, a little higher than the £2.3 billion per day in the previous quarter but below the peak of £3.0 billion per day in March. Additionally, turnover between gilt-edged market makers, many of whom were classified in the outside-market prior to 27 October 1986, averaged £2.4 billion per day in the second quarter. Turnover in long gilt futures contracts on the London International Financial Futures Exchange averaged about 30,000 contracts per day in April to June, 5,000 contracts per day more than in January to March and more than four times the average turnover in the first ten months of 1986.

Other capital markets

The bull market in equities continued during the second quarter, with the FT-Actuaries all-share index rising by 17% from 989 to 1,153 in the three months to end-June. The market was, however, weak in the first half of April, when prices fell by 3% because of worries about continuing tensions between the United States and Japan on trade issues. But for most of the period under review equity prices were buoyed by rising markets in New York and Tokyo, the general strength of sterling on the foreign exchanges, cuts in base rates in late April and early May and, more generally, by optimistic forecasts for the British economy. The market was affected by the ebb and flow of the general election campaign, and prices rose sharply immediately before and after the election as the political uncertainty was resolved. The upward trend was not sustained, however, and prices moved erratically during the final two weeks of June with no discernible trend, reflecting re-emerging worries about an increase in wage inflation and about the sustainability of the bull market.

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

	1986 Q3	1986 Q4	1987 Q1	1987 Q2
UK private sector				
Loan capital and preference shares	+ 447	+ 40	− 820	+ 404
Equity capital	+2,275	+2,301	+1,571	+2,079
Unit trusts	+1,033	+1,743	+1,726	+1,234
Issues on the unlisted securities market	+ 82	+ 145	+ 110	+ 166
Local authorities				
Stocks	—	− 25	—	− 14
Bonds	− 68	− 49	− 25	− 56
Overseas	+ 39	+ 104	—	+ 11

UK companies raised just over £2 billion by way of issues of ordinary shares in the second quarter, virtually all by non-financial companies. The largest issues were rights issues by the British Printing and Communication Corporation for £645 million, by the Ladbroke Group for £306 million and by Valor for £265 million. The Rolls Royce privatisation was oversubscribed and raised £681 million from the first call.

Table Q
Amounts raised by sterling bond issues
£ millions

	Eurosterling: Fixed-rate(a): UK borrowers	Eurosterling: Fixed-rate(a): Overseas borrowers	Eurosterling: FRNs	Domestic issues: UK borrowers	Domestic issues: Overseas borrowers
1985	522	2,160	2,275	4,500	675
1986	1,787	1,814	3,700	8,613	535
1987					
Q1	1,403	1,775	250	58	—
April	655	356	—	119	—
May	385	235	—	129	—
June	134	640	150	89	—
Q2	1,174	1,231	150	337	—

(a) Of which, £780 million were equity-related in the second quarter of 1987.

The high rate of new issue activity in eurosterling in the first quarter was maintained in April, but faded in May and, to a lesser extent, in June as market hopes of further cuts in interest rates receded. There were in total 34 issues, for £2.5 billion, announced in the second quarter, compared with 50 issues for £3.4 billion in the first quarter. All but one issue were at fixed rates, and ten issues totalling £780 million were equity-related bonds, either convertibles or with warrants attached. Notable issues were by General Cinema, a US company, which was convertible into shares the company held in Cadbury Schweppes, and by the World Bank, which raised £200 million over 20 years, thereby giving a fillip to the long-dated end of the market. There was a further mortgage-backed FRN issued, on this occasion by the Household Mortgage Corporation, the third such new issue this year.

In the domestic market, there were 14 issues of bonds raising £337 million. The North Housing Association became the first housing association to tap this market, raising about £65 million by the issue of three different stocks including two long-dated zero-coupon issues.

UK borrowing in the international bond markets in currencies other than sterling amounted to £530 million in the second quarter. This was only half as much as in the previous quarter and reflected a sharp fall in issues by building societies. In the first quarter the societies had been major issuers following the enactment of legislation which enabled them to make non-sterling bond issues (providing the proceeds were swapped immediately into sterling). In the second quarter there were no such bond issues by UK building societies, but there was a dollar-denominated issue of $100 million by National Home Loans which, unlike an earlier sterling issue by the same borrower, was not secured upon mortgages. The Swiss franc was the most popular currency of issue with five bond issues for Sw. Fc. 420 million (£173 million).

Sterling commercial paper

The sterling commercial paper market grew further in the second quarter of 1987. Over the period, gross issues totalled £3,326 million, compared with £2,027 million in the previous quarter. Redemptions amounted to £2,617 million and the total value of paper outstanding increased by £709 million to £1,655 million. By the end of June, seventy-three programmes had been notified to the Bank. Paper had actually been issued under forty-nine of these programmes.