Operation of monetary policy

This article covers the three months from October to December 1987.

Review

During the period under review, monetary policy was conducted within the context of conflicting concerns created by domestic economic and monetary developments, the sharp fall in world equity prices in October and turbulent exchange markets associated with the global weakness of the dollar. Both interest rates and gilt-edged yields fell during the period, bank base rates by 1½%. However, sterling appreciated significantly, by 3¾% in effective terms, helping to offset the effect of lower interest rates on monetary conditions.

In early October, market concerns were beginning to emerge about the implications for both the external balance and domestic inflation of the strength of domestic demand, the growth of money and credit, and the rate of increase of asset prices. Sterling, however, was strengthening, in particular against the deutschemark. In the short term, this was met by official sales of sterling on the foreign exchange market.

The worldwide fall in equity prices which began in mid-October introduced an additional dimension to policy. Through its possible impact on demand, both in this country and abroad, it had a potentially dampening effect on the economy, although it was difficult to make an immediate assessment of the scale or timing of any such effect. Taken together with the continuing strength of sterling, which, despite softening in the interim against the deutschemark, reached 76.4 on the ERI by end-November (having been 73.0 at the beginning of October) as the dollar declined, this represented an overall tightening in monetary conditions.

For a time, policy needed to pay particular attention to events in the equity market and to try to help to restore financial confidence. Interest rates were reduced, in two ½% steps on 23 October and 4 November, and by a further ½% on 3 December. Moreover, despite a substantial funding requirement to reabsorb sterling liquidity created by exchange market intervention, in line with the Chancellor's Mansion House speech the authorities refrained from taking full advantage of funding opportunities and allowed yields on gilt-edged stocks to fall. The share purchase arrangements under which the Bank stood ready to buy back partly-paid BP shares were also designed to avoid further damage to confidence in world equity markets.

During December, it became clear from new data on output, retail sales and unemployment that the economy had been even more buoyant before the fall in equity prices than had previously been thought. Evidence was also emerging, from both surveys and retail sales figures, that events on the stock markets had had little immediate impact on domestic demand. Meanwhile, the

Table A
Growth rates of the monetary aggregates
Percentages

	Unadjusted		Seasonally adjusted(a)	
Calendar months	12 months to Sept. 87	12 months to Dec. 87	July 87–Sept. 87	Oct. 87–Dec. 87
M0(b)	+ 5.2	+ 4.2	+2.3	+1.8
Non-interest-bearing M1	+ 6.0	+10.5	+1.4	+1.0
M1	+20.3	+22.7	+4.6	+2.7
M2	+10.0	+10.4	+2.5	+2.2
M3	+19.5	+22.8	+5.1	+5.1
M3c	+18.3	+20.2	+5.1	+4.3
M4	+14.9	+16.3	+4.1	+3.9
M5	+14.3	+15.7	+3.9	+3.8

(a) Seasonal adjustments constrained over the financial year.
(b) Weekly average.

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

	Calendar months	July 87–Sept. 87	Oct. 87–Dec. 87	Level outstanding at end-Dec. 87
1	Non-interest-bearing M1	+ 0.6	+ 0.4	44.5
2	Interest-bearing sight deposits	+ 3.3	+ 2.0	46.5
3	**M1 (= 1+2)**	**+ 3.9**	**+ 2.4**	**91.0**
4	Private sector holdings of time deposits with banks and bank CDs	+ 4.6	+ 6.5	93.9
5	**M3 (= 3+4)**	**+ 8.5**	**+ 9.0**	**184.9**
6	Building society holdings of M3 (increase –)	– 0.4	– 1.7	– 13.8
	Non-bank private sector holdings of:			
7	Building society shares and deposits(a)	+ 2.7	+ 4.0	130.4
8	Building society £CDs and time deposits(b)	+ 0.7	—	2.7
9	**M4 (= 5+6+7+8)**	**+11.6**	**+11.3**	**304.2**
10	Non-bank, non-building-society private sector holdings of money-market instruments and national savings in M5	– 0.2	+ 0.3	15.1
11	**M5 (= 9+10)**	**+11.4**	**+11.6**	**319.3**

(a) Including term shares and interest credited.
(b) Excluding holdings by building societies themselves.

Table C
Counterparts to changes in M3, M4 and M5

£ billions; *seasonally adjusted figures (financial year constrained) in italics*

	Counterparts to M3			Counterparts to M4	Counterparts to M5
	July 87– Sept. 87	Oct. 87– Dec. 87	Jan. 87– Dec. 87	Jan. 87– Dec. 87	Jan. 87– Dec. 87
1 PSBR	*+0.1*	*− 2.3*	− 1.4	− 1.4	− 1.4
2 Net purchases (−) of central government debt by the 'private' sector(a)(b)	*+ 1.1*	*− 2.1*	− 2.2	− 3.8	− 2.6
3 Net purchases (−) of other public sector net debt by the 'private' sector(a)(b)	*+ 0.1*	*− 0.1*	+ 1.7	+ 0.6	+ 0.3
4 External and foreign currency finance of the public sector	*− 2.0*	*+ 5.0*	+ 6.2	+ 6.2	+ 6.2
5 Public sector contribution (= 1+2+3+4)	*− 0.8*	*+ 0.6*	+ 4.3	+ 1.8	+ 2.6
6 Sterling lending to the 'private' sector(a)(c)	*+11.5*	*+11.2*	+38.6	+53.0	+53.2
7 Other counterparts(d)	*− 2.2*	*− 2.8*	− 8.3	−12.2	−12.2
8 Total (= 5+6+7) = change in the aggregate	***+ 8.5***	***+ 9.0***	**+34.6**	**+42.6**	**+43.6**

(a) For M3 counterparts, the 'private' sector excludes banks; for M4 and M5 counterparts it also excludes building societies.
(b) Transactions in public sector debt instruments included in M5 are necessarily excluded from the M5 counterparts.
(c) 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.
(d) External and foreign currency transactions and changes (−) in net non-deposit liabilities.

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

	Persons	ICCs	Building societies	Other OFIs
M3 components				
Percentage growth	10.6	29.7	63.2	37.3
Contribution to M3 growth(b)	5.6	7.6	4.0	5.6
M4 components				
Percentage growth	11.3	28.5		35.9
Contribution to M4 growth(b)	8.5	4.5		3.3
M3 credit counterparts				
Percentage growth	26.3	16.5	15.6	28.9
Contribution to M3 credit growth(b)	10.7	6.1	0.6	5.3
M4 credit counterparts				
Percentage growth	17.9	16.9		28.9
Contribution to M4 credit growth(b)	11.9	3.8		3.2

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

rapid growth of broad money and credit continued, with little evidence of any effect of stock market events other than increased retail inflows to building societies. M0 growth, however, moderated a little after its acceleration in the previous quarter, and remained within its target band. Market concerns about a possible rise in interest rates developed late in the year when published figures showed a deteriorating trade balance, and were reflected by a steepening interbank yield curve at the end of December.

Upward pressure on sterling against the deutschemark, which re-emerged at the end of November, eased after mid-December, in part because of softer oil prices. However, the announcement on 10 December of the record US trade deficit in October pushed sterling yet higher against the dollar. By the end of the year, the sterling/dollar rate was at its highest level for five years and the effective exchange rate was 75.8, representing some tightening of monetary conditions. Against this background, base rates remained unchanged after 3 December for the rest of the period.

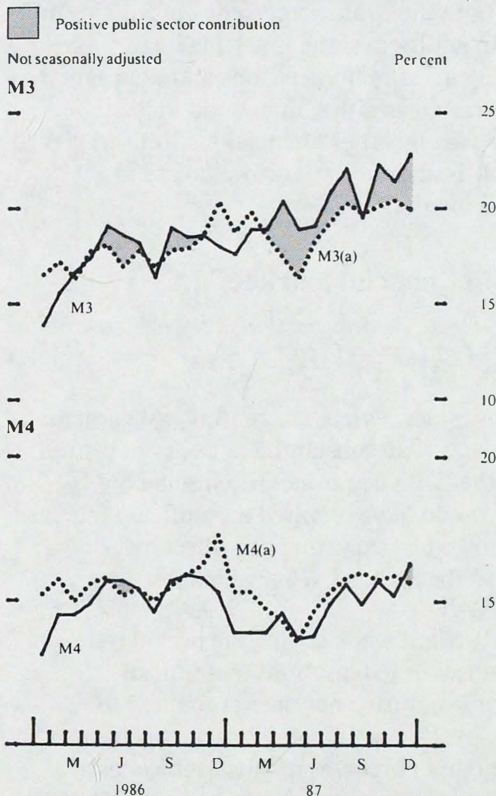
Monetary aggregates and credit

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

Over the three months to December, M0 growth, although slower than in the third quarter, was again high at 1.8%, but the twelve-month growth rate fell from 5.2% to 4.2%: in part this fall reflected erratic fluctuations in bankers' balances, and the growth rate of notes and coin showed a more modest fall. The growth of broad money within the quarter was little changed from the previous three months, although the twelve-month growth rates of M3 and M4 increased to 22.8% and 16.3% respectively from 19.5% and 14.9%. The falls in equity prices had some impact on broad money by provoking increased retail inflows into building societies but it is, as yet, difficult to gauge the impact of these price movements on growth of broad money as a whole. M4 continued to grow more slowly than M3 despite the strong inflows into building societies from persons, the effect of which on M4 was offset by an increase in the societies' holdings of bank deposits.

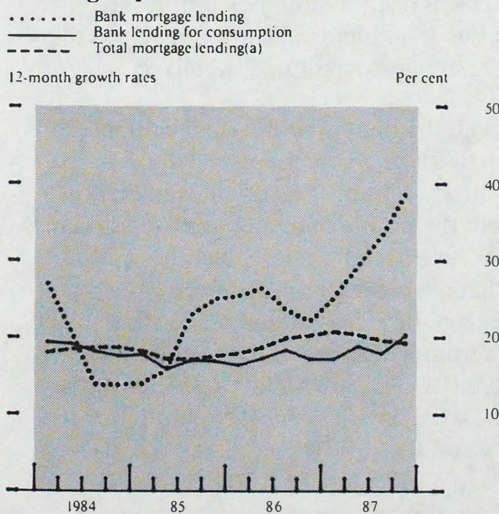
Among the counterparts to broad money, credit growth remained strong, although a little less so than in the third quarter. The public sector's influence on broad money was expansionary. Buoyant revenues, together with receipts from the BP share sale, resulted in a PSBR surplus in the fourth quarter and there were also substantial sales of government debt to the non-bank private sector. But these influences were more than offset by external and foreign currency finance of the public sector, which was dominated by an increase in the reserves of £5.8 billion (of which £0.9 billion represented the foreign currency proceeds of the BP share sale). However, a rise in the reserves does not necessarily feed through into the money stock. It will do so only if the sterling with which the authorities purchase the foreign currency ends up in private sector bank or building society deposits. Sterling sold by the authorities may be taken up by overseas residents, for example. There may also be offsetting factors within the other external counterparts if, for example, the non-bank private sector repays foreign currency borrowing by running down sterling deposits. This may have happened in the

Contribution of public sector counterparts to annual growth rates



(a) M3(a) and M4(a) exclude contributions of public sector counterparts to each aggregate. M4(a) partly estimated.

Lending to personal sector



(a) Partly estimated.

latest quarter as equity price falls overseas led to a smaller requirement for hedging finance. Over the three months to December the public sector counterparts were expansionary by £½ billion on an M3 basis, and by £¼ billion on an M4 basis, bringing the twelve-month totals to £4.3 billion and £1.8 billion respectively (see chart).

A sectoral breakdown of broad money reveals that both persons and industrial and commercial companies continued to increase substantially both their sterling deposits and their sterling borrowing. Building societies' borrowing from and deposits with the monetary sector showed a large rise, but the remaining financial institutions' borrowing and deposits increased more modestly.

The growth of personal sector deposits, particularly with building societies, increased compared with the third quarter. This reflected both the perceived additional attractiveness of building societies, rather than banks, relative to unit trusts after the fall in equity prices and the fact that societies reacted more slowly to the cuts in interest rates than did the banks, so that their competitive position in the retail deposit market strengthened in November. Bank and building society lending to persons remained buoyant in the fourth quarter, but there is little to suggest any acceleration in the twelve-month growth rate over the last six months. Of the total increase in lending to persons of £8.2 billion in the fourth quarter, mortgage lending accounted for £6.9 billion (84%), much in line with its proportion of total lending to persons in the rest of 1987. Mortgage lending by banks accelerated during 1987, but this largely represented a gain in market share, and was offset in total mortgage lending by a decline in the rate of growth of building societies' lending (see chart). There are, though, signs of a pick-up in the societies' new mortgage commitments in the three months to December. The twelve-month growth rate of lending for consumption increased a little compared with the third quarter but remained close to its average rate of growth since 1982, around 18%, considerably above the growth rate of nominal spending.

Industrial and commercial companies continued to build up sterling bank deposits, reflecting in part the strength of their profits but also the proceeds of £4½ billion of capital issues, which remained high compared with the first two quarters of the year despite the fall in equity prices. This increase in company deposits contributed to the more rapid growth of M3 relative to M4, since companies typically hold their liquidity with banks rather than building societies. Companies' sterling borrowing from the banks increased rapidly in the fourth quarter, although a little less than in the previous period. This may have reflected both accumulation of stocks and continuing takeover and merger activity, which probably also accounts for some of their foreign currency borrowing. Some borrowings may have taken the place of equity issues cancelled in the wake of stock market events. A feature of the industrial analysis of lending for the three months to end-November is a further large rise of £1.3 billion in lending to property companies.

Changes in the sterling bank deposits of financial institutions were dominated by the activities of the building societies, which accounted for over half of the rise in such deposits. The more modest increase in the sterling deposits of the remaining financial

Table E
UK monetary sector: sterling and foreign currency deposits of, and lending to, the non-bank private sector

£ billions; *seasonally adjusted*(a)

	1987				
	Year	Q1	Q2	Q3	Q4
Sterling deposits					
Other financial institutions	+14.5	+6.4	+2.3	+ 2.9	+ 2.9
ICCs	+11.2	+1.4	+3.7	+ 3.0	+ 3.1
Persons	+ 8.1	+1.3	+1.9	+ 2.2	+ 2.7
Total	+33.8	+9.1	+7.9	+ 8.1	+ 8.7
of which, transit items allocated to ICCs	*+ 0.2*	*−0.5*	*+1.4*	*− 0.8*	*+ 0.1*
Sterling lending					
Other financial institutions	+10.0	+3.0	+2.8	+ 2.3	+ 1.9
ICCs(b)	+10.1	−0.3	+1.6	+ 4.6	+ 4.2
Persons	+18.2	+3.9	+4.3	+ 4.5	+ 5.5
Total	+38.3	+6.6	+8.7	+11.4	+11.6
of which, transit items allocated to ICCs	*− 0.1*	*+0.3*	*−0.9*	*+ 0.5*	—
Foreign currency deposits					
Other financial institutions	+ 6.8	+0.4	+1.9	+ 2.6	+ 1.9
ICCs	− 0.5	+0.9	−1.4	− 0.5	+ 0.5
Persons	+ 0.2	+0.2	−0.2	—	+ 0.2
Total	+ 6.4	+1.4	+0.4	+ 2.1	+ 2.5
Foreign currency lending					
Other financial institutions	+ 7.1	+5.1	+3.8	− 1.2	− 0.6
ICCs	+ 3.5	+2.1	+0.7	− 0.1	+ 0.8
Persons	+ 0.1	+0.1	+0.1	+ 0.1	− 0.2
Total	+10.8	+7.4	+4.7	− 1.2	− 0.1

(a) Seasonal adjustments constrained over the calendar year.

(b) Includes Issue Department take-up of commercial bills and guaranteed shipbuilding paper.

Table F
Financing of the public sector

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

Calendar months	Apr. 87– June 87	July 87– Sept. 87	Oct. 87– Dec. 87	Jan. 87– Dec. 87
Central government borrowing on own account	−0.2	+0.3	−1.7	−1.2
Other public sector borrowing(a)	+0.6	−0.2	−0.6	−0.2
PSBR	**+0.4**	**+0.1**	**−2.3**	**−1.4**
Net sales of central government debt to the non-bank private sector	−2.2	+1.1	−2.1	−1.9
of which: Gilt-edged stocks	*−1.1*	*+1.2*	*−1.8*	*−0.1*
National savings	*−0.7*	*−0.4*	*−0.3*	*−2.4*
CTDs	*−0.2*	*+0.3*	*+0.2*	*+1.1*
Net sales of local authorities' and public corporations' debt to the non-bank private sector	+0.9	+0.1	−0.1	+1.7
External and foreign currency finance of the public sector	+2.4	−2.0	+5.0	+6.2
of which, gilt-edged stocks	*−1.7*	*−2.3*	*−0.8*	*−5.5*
Total financing of the public sector from the non-bank private and overseas sectors	**+1.1**	**−0.9**	**+2.8**	**+6.0**

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

Table G
Official transactions in gilt-edged stocks

£ billions; *not seasonally adjusted*

Calendar months	Oct. 86– Dec. 86	Jan. 87– Mar. 87	Apr. 87– June 87	July 87– Sept. 87	Oct. 87– Dec. 87
Gross official sales(a)	+4.5	+2.7	+4.0	+2.6	+3.8
less					
Redemptions and net official purchases of stock within a year of maturity	−1.8	−3.3	−2.6	−1.2	−1.3
Equals net official sales(b)	+2.7	−0.7	+1.4	+1.4	+2.5
of which, net purchases by:					
Monetary sector(b)	*+0.2*	*+0.3*	*−1.4*	*+0.2*	—
Overseas sector	*+0.7*	*+0.8*	*+1.7*	*+2.3*	*+0.8*
Non-bank private sector	*+1.6*	*−1.7*	*+1.1*	*−1.2*	*+1.8*

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.

institutions may be linked to the falls in equity prices overseas: some institutions which had hedged their foreign currency investments earlier in the year (by borrowing in foreign currency and switching the proceeds into sterling deposits) may have found themselves over-hedged after these falls and have responded by reducing both their foreign currency borrowing and their sterling deposits. In addition, some investing institutions may have chosen to delay investment decisions and to use their cash inflows to repay borrowings rather than build up bank deposits: total net borrowing by other financial institutions was modest by recent standards, despite a marked increase in borrowing by leasing companies.

Official operations in financial markets

The figures in this and the succeeding sections are not seasonally adjusted unless otherwise stated.

During the three months under review, the central government had a cash surplus but there were substantial net sales of central government debt. Together with a seasonal rise in the note circulation, these flows would have required a significant increase in money-market assistance had they not been offset by heavy official sales of sterling in the foreign exchange market.

Gross official sales of gilt-edged stock during the period were £3.8 billion; after allowance for redemptions and official purchases of stock nearing maturity, net sales amounted to £2.5 billion, the highest level since the same quarter last year. The monetary sector made no net purchases of gilts in the latest quarter and net acquisitions by the overseas sector of £0.8 billion were modest compared with the previous three months, though large by the standard of previous years. The non-bank private sector had made net disposals of £1.2 billion of gilts in the previous quarter, but in the period under review it reversed this behaviour and made net purchases totalling £1.8 billion.

There was an overall rise in the Bank's holdings of commercial bills, of £2 billion. Much of this increase represented the counterpart of a rise in the amount of Treasury bills in market hands. In order to smooth the profile of money-market assistance between the expected low levels required in November and December and the much higher levels required during the tax-paying season in January, the Treasury bill tender was increased for four weeks from 23 October. In addition to the usual £100 million of 91-day bills, £500 million of 63-day bills, maturing during January, were on offer each week, and over the period as a whole there was a £1.4 billion net increase in the amount of Treasury bills in market hands. At the end of December, total official assistance outstanding to the money market was £7.2 billion, almost entirely accounted for by eligible bills held either outright or under sale and repurchase agreements, compared with £5.4 billion three months earlier. The level fluctuated over the quarter with a low point of £4.4 billion on 14 October and a peak of £8.1 billion on 4 December.

Average daily shortages in the money market increased progressively from £530 million in October to £710 million in November and £820 million in December. The average for the quarter was £690 million, compared with £470 million in the previous quarter. This rise mainly reflected the development of

Table H
Influences on the cash position of the money market
£ billions: *not seasonally adjusted*
Increases in the market's cash (+)

Calendar months	Oct.– Dec. 86	July– Sept. 87	Oct.– Dec. 87	Jan.– Dec. 87
Factors affecting the market's cash position				
CGBR (+)	–1.1	+0.4	–1.6	+ 4.0
of which, on-lending to local authorities and public corporations	—	—	*+0.4*	*+ 5.1*
Net sales (–) of central government debt(a)	–3.0	–2.0	–3.0	– 6.5
of which: Gilt-edged	*–2.6*	*–1.4*	*–2.5*	*– 4.6*
National savings	*–0.8*	*–0.6*	*–0.2*	*– 2.5*
CTDs	*+0.4*	—	*–0.3*	*+ 0.6*
Currency circulation (increase –)	–1.0	–0.3	–1.4	– 1.1
Reserves etc	–0.1	+0.3	+5.9	+12.4
Other	+0.9	+0.3	–0.4	– 1.0
Total (A)	**–4.3**	**–1.3**	**–0.3**	**+ 7.8**
Official offsetting operations				
Net increase (+) in Bank's commercial bills(b)	+5.0	+0.4	+2.0	– 5.6
Net increase (–) in Treasury bills in market	–0.4	+0.9	–1.4	– 2.2
Securities(c) acquired (+) under sale and repurchase agreements with banks	—	—	—	—
Other	–0.4	–0.1	–0.2	– 0.1
Total (B)	**+4.2**	**+1.2**	**+0.4**	**– 7.9**
Changes 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 J
Changes in UK official reserves
$ millions

	1987		
	Oct.	Nov.	Dec.
Change in reserves	**+6,591**	**– 118**	**+3,045**
of which:			
Net borrowing (+)/payment (–) of public debt	– 236	– 149	– 692
Valuation change on roll-over of EMCF swap	+ 128	—	—
Underlying change in reserves	+6.699	+ 31	+3.737
Level of reserves (end of period)	**41,399**	**41,281**	**44,326**

market expectations of falling interest rates and the consequent increase in the proportion of shorter bills offered by the market, the increased use of short-dated sale and repurchase facilities by the Bank, and the greater use made of borrowing facilities. These factors all had the effect of increasing the daily amounts of maturing assistance.

Official reserves

Over the three months to end-December there was an underlying rise in the reserves of $10,467 million, with increases of $6.7 billion in October and $3.7 billion in December but virtually no change in November. At the end of December, the reserves stood at $44,326 million, compared with $21,923 million a year earlier.

The money and foreign exchange markets

At the beginning of the period, participants in the foreign exchange market appeared to be taking a different view about the monetary and economic outlook for the United Kingdom from that taken by participants in the domestic money market. There was heavy demand for sterling at an exchange rate just below DM 3 (the dollar rate at the beginning of the period was $1.6215 and the ERI 73.0), but the money-market yield curve was upward-sloping with interbank rates of 10 1/16%, 10 1/4% and 10 9/16% at the one, three and twelve months' maturities respectively, indicating a market expectation of a rise in base rates from 10%, in part influenced by a view that rates overseas were on an upward trend.

Sterling remained under upward pressure for most of the early part of October, despite official intervention on the exchanges. By 16 October, sterling had been kept little changed against the deutschemark at DM 2.9969, but had gained against the dollar to stand at $1.6645, with an ERI of 73.6.

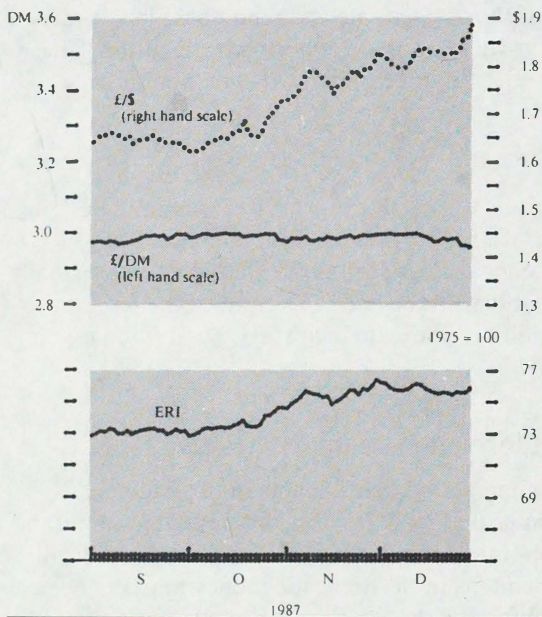
In the money market, the yield curve steepened further during early October. Easy day-to-day money conditions kept very short rates soft but by the close on 15 October the three months' rate had risen to 10 5/16% and the twelve months' rate had risen to 10 3/4%, reflecting market concern about the dangers of 'overheating' of the economy.(1)

The worldwide fall in equity prices, which in the United Kingdom began on 19 October, created an entirely new situation in the markets, in which a reduction in interest rates was appropriate. In particular, it was deemed necessary to impart a calming influence to the markets in order to help restore financial confidence, and on 23 October the Bank announced that it would accept offers of bills in all bands at a discount rate of 9 3/8%, 1/2% down from its earlier buying rates. The commercial banks quickly followed by announcing 1/2% reductions in their base rates, to 9 1/2%. This officially sanctioned fall in rates had not been fully anticipated in the money market, although by the close on 22 October the three months' interbank rate had fallen to 10 1/16% and the twelve-month rate to 10 1/8%, reflecting softer US rates.

(1) On the morning of Friday 16 October, in the aftermath of a hurricane which struck south-east England the previous night, there were very few staff present for work in the City and communications were severely disrupted. The Bank therefore announced that in its view effective clearing settlements could not be conducted and that there seemed to be no alternative to postponing settlement until Monday 19 October. The clearing banks subsequently announced their agreement that they would take no part in clearing sterling cheques or bankers' payments on 16 October. Accordingly, there were no official money-market operations, although the Treasury bill tender took place as scheduled.

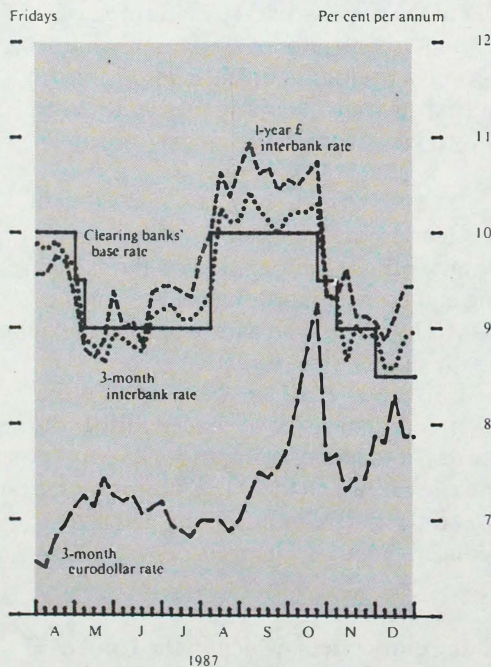
Sterling exchange rates

At the close of business in London each day



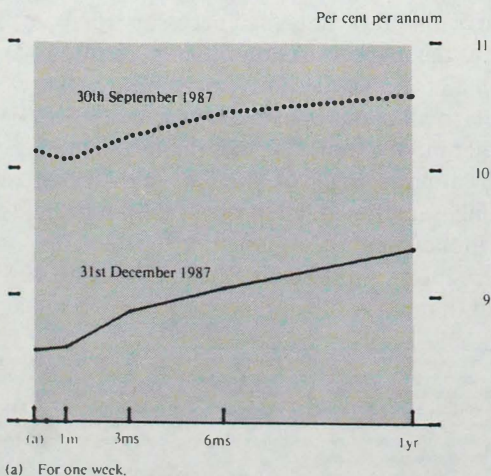
Short-term interest rates in London

Fridays Per cent per annum



Sterling interbank rates

Per cent per annum



(a) For one week.

The markets immediately began to look for a further ½% cut: increasingly, market sentiment was ruled by equity market developments, and other economic data came to be largely ignored. World stock markets, including London, continued to fall. Initially, the foreign exchange markets were calm, but sterling began to appreciate rapidly against the dollar as funds moved out of the dollar on concern about the US budget and trade deficits, although pressure on the cross-rates had dissipated. By close of business on 3 November, sterling had appreciated to \$1.7380 and an ERI of 74.9, although it had fallen to DM 2.9850. Meanwhile, the markets had been waiting for hard information about the sale of BP shares by the Government and the company scheduled for the end of October. Although there were some expectations that the sale might be cancelled in order to help stabilise the equity market, market rates reflected the view that it would proceed, but that it would be accompanied by a further ½% reduction in interest rates. By the close on 29 October, the three-month interbank rate had fallen to 9 1/16% (nearly ½% below the level of base rates), with the twelve-month rate at 9⅛%. Following the Chancellor's statement that evening that the issue would go ahead, but that the Bank would stand ready to purchase partly-paid BP shares at a price of 70p per share, interbank rates moved up a little, although they remained firmly below 9½% as the equity market continued to show weakness, and showed no response to the Chancellor's Autumn Statement and the announcement on 3 November of October's official reserves increase of \$6.7 billion.

The equity market had by this time shown little sign of any end to its fall and, together with sterling's continuing appreciation against the weak dollar bearing down on inflation through traded goods prices, represented a tightening of monetary conditions. In these circumstances the authorities considered it appropriate that interest rates should fall a further ½%. On 4 November, the Bank invited the discount houses to borrow at 2.30 pm at a rate of 9%, signalling its view that rates should fall ½%, and subsequently purchased bills at discount rates of 8⅞%, ½% down from its earlier buying rates. The commercial banks followed by reducing their base rates to 9%.

Initially the money market expected a further cut in interest rates, based largely on a view that a G7 meeting would lead to concerted cuts worldwide. On 9 November, when the equity market showed renewed weakness, interbank rates at three months and beyond fell to 8⅝%, but they subsequently backed up to straddle the 9% level, failing to react to either the publication of money and manufacturing output figures or the co-ordinated reduction in continental European interest rates on 24 November. There was far more activity in the foreign exchange market, where sterling continued to appreciate against the weaker dollar, touching \$1.8010 on 10 November and reaching an ERI of 75.6 at the previous day's close, before enthusiasm was tempered by October's rise in the twelve-month rate of growth of the RPI to 4.5%, announced on 13 November. The upward movement of sterling then resumed, first against the dollar as market doubts emerged about the outcome of the negotiations on reducing the US budget deficit, and second against the continental currencies as the pound benefited from the dollar's temporary rally after the announcement on 20 November of a deficit reduction package in the United States.

This upward pressure against both the dollar and the continental currencies was sustained by the announcement on 24 November of a smaller UK trade deficit than expected for October and the concerted continental interest rate cuts on the same day. Sterling ended November at $1.8320, DM 2.9957 and an ERI of 76.4.

December opened with the authorities again intervening on the foreign exchanges in the face of heavy demand for sterling and upward pressure on the sterling/deutschemark rate. In these circumstances the authorities considered it appropriate to reduce interest rates in parallel with reductions in Germany and other continental countries. On 3 December the Bank accepted offers of bills at a discount rate of 8⅜%, ½% down from the previous day: the commercial banks followed with reductions of ½% in their base rates, to 8½%. Upward pressure on sterling continued, however, and sterling jumped nearly 3 cents against the dollar on 10 December following the announcement of the record US trade deficit of $17.6 billion in October, and on the morning of 11 December sterling stood at $1.8370, DM 2.9971 and an ERI of 76.2.

The pound continued to gain against the dollar for the rest of the year, helped not only by the record US trade deficit but also by nervousness about the prospects for resolving either of the US deficits, and the foreign exchange markets appeared to take little immediate comfort from the G7 statement on 23 December regarding stabilisation of the dollar. However, from 11 December, upward pressure on the sterling/deutschemark rate subsided as the oil price weakened; although there was some sign of a resurgence of upward pressure in thin pre-Christmas markets, this was not sustained. Sterling ended the period with a 16¼% gain overall against the dollar at $1.8870, its highest level since January 1982, but 1% lower against the deutschemark at DM 2.9607. The ERI gained 3¾%, to stand at 75.8.

The abatement of upward pressure on sterling against the deutschemark, and the growing signs of stability at a lower level of prices achieved by the equity market, refocused the domestic money market's thoughts on the domestic economy, which had been largely overshadowed since mid-October. The accumulating evidence appeared to point to an economy which before the fall in equity prices had been even more buoyant than had previously been thought. Together with surveys which showed the crash to have had little immediate impact on investment intentions and later figures which suggested no short-term slowdown in overall domestic demand, this served to reawaken market fears of 'overheating'. Accordingly, from about 11 December, the money-market yield curve steepened as the markets began to consider that the next move in rates would be upwards. By 17 December the twelve-month interbank rate had reached 9½%. Despite some subsequent softening, possibly encouraged by some decline in equity prices at the very end of the year, interbank rates closed the year at 8⅝%, 8⅞% and 9⅜% at the one, three and twelve months' maturities, respectively, having fallen over the period as a whole by 1 7/16%, 1⅜% and 1 3/16%, respectively. Banks' base rates were 8½%, down 1½%.

The gilt-edged market

The three months under review were almost entirely dominated by the reaction in the gilt market to events in the equity markets

Table K
Issues of gilt-edged stock

Stock	Amount issued (£ millions)	Date announced	Method of issue	Date issued	Price paid per £100 stock (£)	Payable per £100 stock: Initial payment(a) (£)	Payable per £100 stock: Further instalments (£)	Redemption yield at issue (per cent)	Date exhausted
11% Exchequer 1991	150	22/10	To National Debt Commissioners	22/10					
10% Treasury 1993	200	22/10	Direct to Bank	22/10	99.6250			10.08	23/10
10% Conversion 1996	200	22/10	Direct to Bank	22/10	98.6875			10.22	23/10
9¾% Exchequer 1998	100	22/10	To National Debt Commissioners	22/10					
9% Conversion 2000	100	22/10	Direct to Bank	22/10	92.8125			10.02	23/10
10% Treasury 1993	150	30/10	To National Debt Commissioners	30/10					
9% Treasury 1994	200	30/10	Direct to Bank	30/10	98.9375			9.21	3/11
10¼% Conversion 1999	100	30/10	To National Debt Commissioners	30/10					
10% Treasury 2001	200	30/10	Direct to Bank	30/10	104.0000			9.45	3/11
8½% Treasury 2007	200	30/10	Direct to Bank	30/10	93.7500			9.18	3/11
8% Treasury 1992	100	10/11	Direct to Bank	10/11	98.5625			8.39	3/12
10% Treasury 1994	150	10/11	To National Debt Commissioners	10/11					
8¾% Treasury 1997	100	10/11	To National Debt Commissioners	10/11					
8¾% Treasury 1997	100	10/11	Direct to Bank	10/11	99.6250			8.80	3/12
2½% Index-Linked Treasury 2001	100	10/11	Direct to Bank	10/11	108.6250			3.88(b)	23/11
2½% Index-Linked Treasury 2020	100	10/11	Direct to Bank	10/11	93.5625			3.68(b)	23/11
2½% Index-Linked Treasury 2003	50	2/12	Direct to Bank	2/12	107.7500			3.82(b)	3/12
2½% Index-Linked Treasury 2009	50	2/12	Direct to Bank	2/12	102.6250			3.83(b)	3/12
2½% Index-Linked Treasury 2013	50	2/12	Direct to Bank	2/12	88.7500			3.78(b)	3/12
8% Treasury Convertible 1990	1.000	11/12	Minimum price tender	16/12	98.0000	50.00	48.00 (27/1)	8.90(c)	17/12
10% Treasury 1993	100	21/12	Direct to Bank	21/12	102.5000			9.38	24/12
10½% Exchequer 1997	150	21/12	To National Debt Commissioners	21/12					
9¾% Treasury 2002	100	21/12	To National Debt Commissioners	21/12					
9½% Conversion 2004	100	21/12	Direct to Bank	21/12	99.5625			9.54	24/12
2% Index-Linked Treasury 2006	100	21/12	Direct to Bank	21/12	107.3125			3.98(b)	
8¾% Treasury 1997 'C'(d)	1.000	5/1	Bid price auction	13/1	91.5000(e)	41.50	50.00 (35/2)	10.15	13/1

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

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

(c) Yield to 1990. Holdings may, at the option of the holder, be converted in whole or in part into 8½% Treasury 2007 as on the following dates and at the indicated rates:

Date of conversion	Nominal amount of 8½% Treasury 2007 per £100 nominal of 8% Treasury Convertible 1990	Implied redemption yield (%) to 2007
16 July 1988	105	9.19
16 January 1989	104	9.05
16 July 1989	103	8.91
16 January 1990	102	8.79

(d) 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.

(e) The lowest accepted price for competitive bids. The non-competitive allotment price was £92.45.

and the three reductions in base rates. Retail demand for gilts was strong in late October and November as investors sought safer investments than equities. However, the authorities deliberately refrained from taking full advantage of the opportunities for substantial funding, with the intention of not providing too plentiful an alternative to the equity market. The market's concern about the pressure to fund created by substantial official foreign exchange intervention against sterling in October and again in December was partly relieved by the Chancellor's announcement in his Mansion House speech that although the liquidity created by such intervention would continue in the longer term to be sterilised by funding as and when appropriate, funding would not necessarily have to fall within the financial year in which the intervention took place.

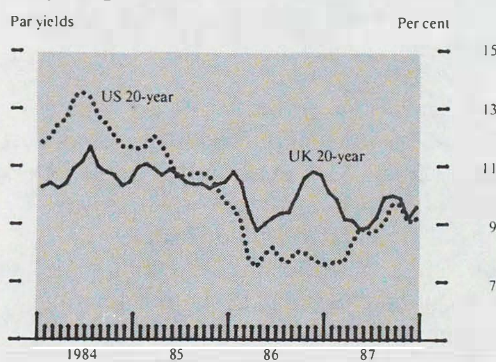
The authorities began the period with calls secured on 9% Treasury 2008 'A', which was the second stock auctioned in the series of three experimental auctions. Only one stock was scheduled to mature during the period—12% Treasury 1987, of which £1,130 million was in market hands. The authorities held quantities of various conventional and index-linked stocks.

The previous period had ended with the market lacking any clear sense of direction, and conditions remained quiet in the early

part of October. Despite sterling's strength, the market was concerned about the apparent buoyancy of the domestic economy and the threat of higher interest rates at home, and the upward movements in rates in the United States and Germany. Index-linked stocks in particular were little in demand. Yields at the beginning of October were around 10¼% on short gilts and a little higher on longer stocks.

As the equity markets worldwide began to fall sharply following the raising of US prime rates and the announcement on 14 October of a large US trade deficit for September, the gilt market initially weakened, led by the weakness of US bonds.[1] Thereafter, the market began to move ahead as demand shifted away from equities into fixed-interest assets, with only a slight hesitation on the announcement on 20 October of an increase in bank lending of £4.4 billion in September. By 22 October, yields at the long end were falling towards 10%, and the market was little affected by the authorities' announcement of a £500 million package of tranchettes that day, comprising £200 million each of 10% Treasury 1993 and 10% Conversion 1996 and £100 million of 9% Conversion 2000.

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

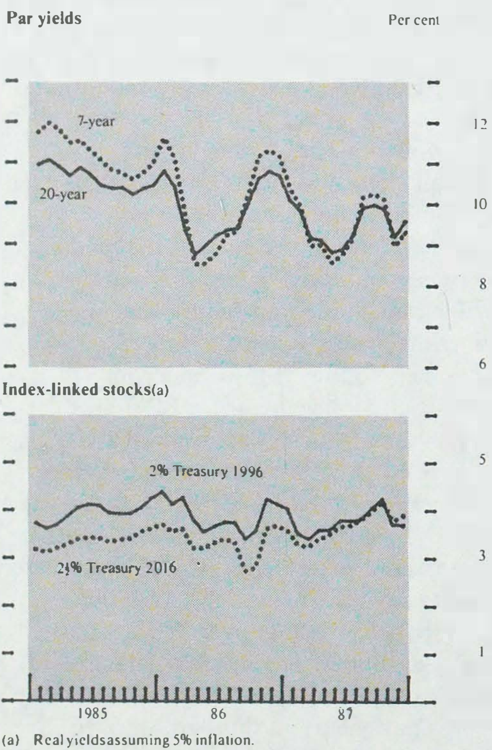


The cut in base rates the following day, sterling's strength, the flat current account balance announced for September and expectations of further cuts in rates served to push the market further ahead as equity prices continued to fall; yields moved below 10% at all maturities and all the tranchettes were exhausted. On 30 October the market opened a little easier as equities showed some recovery following the Chancellor's announcement of the buy-back arrangements for BP shares. However it recovered when the authorities announced a replenishment of their stocks with £600 million of tranchettes comprising £200 million each of 9% Treasury 1994, 10% Treasury 2001 and 8½% Treasury 2007, a smaller package than the market had been expecting. These were exhausted two working days later on 3 November and on that day the Chancellor's Autumn Statement forecasting a PSBR of £1 billion over the year pushed the market further ahead, the announcement of the large rise in reserves in October causing only a momentary markdown. After base rates were cut the next day, yields on short gilts moved below 9%. By 9 November, with the dollar looking ever weaker, the 9% yield barrier was being threatened in the longer maturities, having already been breached at the short end, but this proved to be the peak of the market.

On 10 November, the Bank announced a further £400 million package of tranchettes of £100 million each of 8% Treasury 1992, 8¾% Treasury 1997, 2½% Index-Linked Treasury 2001 and 2½% Index-Linked Treasury 2020, the index-linked market looking particularly strong at that time. As expectations of further cuts in interest rates receded and equity prices began to stabilise at lower levels, the market in conventional stocks began to weaken and the two conventional tranchettes were not exhausted until 3 December. Although the US trade deficit in September proved, when announced on 12 November, to be lower (at $14.1 billion) than had been feared, and the PSBR surplus in October gave some ground for encouragement, the

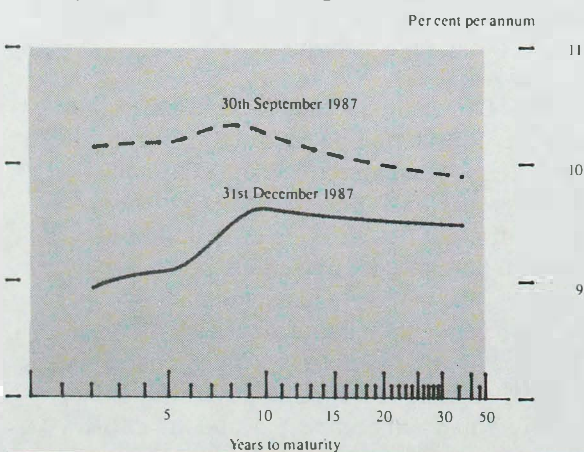
(1) On the morning of 16 October, following the hurricane the previous night, the Bank announced that it would not be dealing in gilts that day, and that gilt-edged market makers were not obliged to make markets, but could do so if they wished. This was followed by an announcement that, in consequence of the suspension of sterling settlements, the CGO service would not be available and settlement of transactions carried out for delivery that day should be postponed until Monday 19 October.

Gross redemption yields on UK government securities



(a) Real yields assuming 5% inflation.

Time/yield curves of British government stocks



market was nervous about the prospect for the US talks on reducing the budget deficit and unsure about the likelihood or implications of a G7 meeting, and was further unsettled by a crop of economic data which showed the UK economy to have been even more buoyant than had previously been thought. Concerns about 'overheating' and its possible inflationary consequences were reflected in the relative resilience of the index-linked sector, which showed greater resistance to the downward movement in prices, the two index-linked tranchettes being exhausted by 23 November. By that date, yields on short-dated stocks had moved back above 9%, and longer yields were pushing at the 9½% level, little encouragement being taken the next day from either lower continental interest rates or the announcement of a small current account deficit of £0.3 billion in October. However, interest in index-linked stock remained sufficiently strong for the Bank to announce on 2 December three more tranchettes of £50 million each of 2½% Index-Linked Treasury 2003, 2½% Index-Linked Treasury 2009 and 2½% Index-Linked Treasury 2013: all were exhausted the following day.

The market failed to take heart from the further ½% cut in base rates on 3 December, although sufficient interest was generated to exhaust the 8% Treasury 1992 and 8¾% Treasury 1997 tranchettes, and prices, including index-linked, drifted weaker. There was a short-lived rally as the dollar fell further following the announcement on 10 December of the record $17.6 billion US trade deficit in November and the next day the authorities announced the issue by tender of £1,000 million of 8% Treasury Convertible 1990 on 16 December. However, weaker US bonds and the weaker tone of sterling as oil prices began to soften dampened the market. Prices steadied on 16 December on news of the £1.6 billion PSBR surplus in November, and the tender stock, of which substantial sales were made at the tender, was exhausted the following day.

The market mood became more robust as December progressed, partly reflecting relief that November's money figures, announced on 18 December, showed only very modest broad money growth after a spate of pessimistic rumours. Accordingly, on 21 December the authorities issued three £100 million tranchettes of 10% Treasury 1993, 9½% Conversion 2004 and 2% Index-Linked Treasury 2006. Although concerned about the £0.6 billion current account deficit in November announced on 23 December, the market took further encouragement from the G7 statement regarding stabilisation of the dollar and the firmer tone of US bonds, and the two conventional tranchettes were exhausted on 24 December.

Despite the authorities' restrained sales of stock at times of particular weakness in the equity market, gross official sales were greater than in the previous period (when funding conditions had been difficult), amounting to £1.6 billion in October, £1.2 billion in November, of which £320 million represented calls secured by earlier part-paid sales, and £1.0 billion in December, of which £490 million were accounted for by the initial call on 8% Treasury Convertible 1990.

During the period as a whole, gilt-edged yields fell, with yields on 5-year stocks falling from $10\frac{1}{4}$% on 1 October to $9\frac{1}{16}$% on 31 December, and those on 20-year stocks falling from $10\frac{9}{32}$% to $9\frac{25}{32}$%. Thus the yield curve moved downwards but acquired a

steeper upward slope. Yields on index-linked stock also fell. The real rate of return on Treasury 2½% Index-Linked 2016 fell from a little over 4% on 1 October to $3\frac{29}{32}$% on 31 December (both calculated before tax, assuming 5% inflation).

The more bullish tone to the gilt market was reflected in an increase in turnover during the period under review. Total gilt turnover averaged £4.6 billion per day—as compared with £3.6 billion in the third quarter. This was lower than in the second quarter, although average turnover in late October and during November was considerably higher. Intra-market turnover was slightly less than turnover with outside customers. Average daily turnover in long gilt futures contracts on the London International Financial Futures Exchange was 26,500 contracts per day during the period under review, much the same as in the previous quarter. However, this average concealed considerable variation within the quarter: average daily turnover was 32,000 contracts in October and 31,000 contracts in November, compared with only 16,500 in December. During the quarter, call warrants exercisable into £100 million of gilt-edged stock were issued, but £100 million also matured, leaving £780 million outstanding. £100 million of put warrants were issued and with no maturities this raised the amount outstanding to £430 million.

On 7 January trading commenced in the medium gilt futures contract on the London International Financial Futures Exchange, ahead of the third of the planned series of three experimental auctions of gilt-edged stock on 13 January, announced on 5 January. The auction was of £1,000 million of 8¾% Treasury Loan 1997 'C', which made this issue the largest on the list. The amount of stock on offer was covered with a small margin, allocation being at an average yield of just under 10%, with the lowest accepted bid yielding $10\frac{5}{32}$%.

Other capital markets

Developments in the capital markets in the final three months of 1987 were dominated by the sharp fall in share prices in mid-October. This is described in detail on pages 51–8. It brought to an abrupt end the advance which had continued with only slight interruptions since late 1986. The FT-Actuaries all-share index fell from 1,190 on 15 October to 1,075 on the 19th and to 952 on the 20th, before staging a short-lived recovery to 1,007 on the 21st. Share prices continued to drift downwards until the all-share index bottomed out at 785 on 10 November; this represented a fall of roughly 33% in a month, taking the index back to the level of October 1986. Thereafter, share prices showed considerable daily changes, but with no overall trend until the week beginning 14 December, when, in the wake of some recovery on Wall Street, share prices rose every day, gaining more than 4% over the week. Some slight further gains were made in quiet trading in the period around Christmas and were maintained into the New Year. Despite the sharp fall in the final three months of 1987, share prices opened at the beginning of 1988 a little higher than at the beginning of 1987, with the overall dividend yield at 4.2%, compared with 4.0% a year earlier and below 3% at the peak of the market.

The slide in share prices was followed by a sharp cut-back in announcements of new issues of equity. Very few of the issues

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

	1986	1987			
	Q4	Q1	Q2	Q3	Q4
UK private sector					
Loan capital and preference shares	+ 106	− 777	+ 435	+ 750	+ 544
Equity	+2,339	+1,571	+2,133	+7,298	+3,917
Unit trusts	+1,743	+1,726	+1,234	+2,982	+ 389
Issues on the unlisted securities market	+ 145	+ 105	+ 184	+ 457	+ 215
Local authorities					
Stocks	− 25	—	− 14	− 35	− 3
Bonds	− 49	− 25	− 56	− 28	− 16
Overseas	+ 104	—	+ 11	—	+ 177

Table M
Sterling debt issues announced
£ millions

	Fixed-rate(a)			FRNs
		Sterling eurobonds		
	Domestic Issues(b)	UK borrowers	Overseas borrowers	
1986	1,054	1,787	1,539	3,700
1987	1,142	3,544	4,413	1,247
Q1	66	1,431	1,775	250
Q2	820	1,090	1,306	150
Q3	83	620	507	411
October	2	44	265	211
November	—	359	360	225
December	171	—	200	—
Q4	173	403	825	436

(a) Of which, £153 million were equity-related in the fourth quarter.
(b) All UK borrowers in 1987.

notified to the Bank for late October, November and December went ahead as planned; only £291 million of new equity was announced in November and £141 million in December, against a monthly average of £1.25 billion in the first ten months of the year. The BP privatisation sale, which included £1.5 billion of new shares, was the major issue that straddled the slide in share prices, although it was not the only issue left largely with underwriters.

Twenty-two sterling debt issues were announced in the fourth quarter for a total of £1.8 billion. This represented a slightly higher level of issuing activity than in the third quarter, but was much lower than in the first half of the year. Convertible issues, which had remained comparatively resilient in the third quarter following a rise in sterling interest rates in the summer, became less attractive following the slide in equity prices, and there was only a single convertible issue after mid-October.

Two sterling eurobond issues in the fourth quarter were noteworthy; Barclays raised £250 million over 20 years, the second-largest ever issue, and the World Bank issued a second tranche of its earlier 20-year stock (issued in June) to take the total amount outstanding to £350 million, the largest long-dated issue in the market. Two notable issues in the domestic sector were a 25-year unsecured loan stock for £91 million by British and Commonwealth and a 30-year debenture for £80 million by First Debenture Finance—a vehicle to raise finance for four investment trusts managed within the Kleinwort Benson Group. There were four floating-rate issues for £436 million; all but one were mortgage backed.

In the fourth quarter, British companies were responsible for four bond issues in currencies other than sterling: Barclays (through different subsidiaries) made two US dollar issues for $200 million and $400 million; and Polly Peck and Prudential each borrowed Swiss francs.

Sterling commercial paper

Gross issues of sterling commercial paper were £5,810 million during the fourth quarter, compared with £5,005 million in the previous three months. Redemptions during the latest three months amounted to £5,904 million, and the total of paper outstanding fell from £2,147 million to £2,053 million. By the end of December 106 programmes had been notified to the Bank and paper had actually been issued under 82 of these.

Special scheme lending for exports and home shipbuilding

Revised margins over three-months' sterling Libor and six-months' US dollar Libor paid by the Export Credits Guarantee Department and the Department of Trade and Industry to banks under the fixed-rate sterling and foreign currency finance schemes are to be paid on all new agreements to provide such finance entered into by banks on or after 1 December 1987. These reflect changes in market conditions since the margins were last reviewed (see June 1982 *Bulletin*, pages 205–6). This type of finance is used for exports of capital goods and home shipbuilding sales on credit terms of two years

or more. Under the terms of the new scheme, the banks agreed to co-operate in allowing their existing and future fixed-rate export finance loans to be refinanced using funds raised with the benefit of ECGD's guarantee from cheaper, mainly capital markets, sources. The banks would, however, continue to receive a residual margin on any loans refinanced. The new margins are set out below:

Per cent	Loans of up to £10 million (or equivalent)		Loans of over £10 million (or equivalent)	
	Sterling	Foreign currency	Sterling	Foreign currency
Loan horizon(a)				
Up to 12 years	$\frac{3}{4}$	$\frac{5}{8}$	$\frac{5}{8}$	$\frac{1}{2}$
Over 12 years	$\frac{7}{8}$	$\frac{3}{4}$	$\frac{3}{4}$	$\frac{5}{8}$

(a) The 'loan horizon' is the total period from signature of a loan until its final repayment.