

Operation of monetary policy

This article covers the three months from January to March 1988.

Review

During the period under review, monetary policy continued to be conducted with the primary objective of maintaining sustained downward pressure on the rate of inflation. Policy also sought to achieve exchange rate stability, so far as it was compatible with the primary objective. In the Budget, a target range of 1%–5% for the growth of M0 was set for the financial year 1988/89; the assessment of monetary conditions will in addition continue to take into account the evidence of the other monetary aggregates and other indicators of the monetary and economic situation.

The policy dilemma created by conflicting indications from the domestic economy and from the exchange rate, which had been present almost continuously since early last year, became easier during January and the early part of February but then became particularly acute in March. Throughout the quarter the behaviour of the sterling money market and the gilt-edged market indicated a longer-term concern about the pace of growth of domestic demand and the outlook for inflation, while recognising the contrary short-term exchange rate pressures: this was reflected in the persistent upward slope of the money-market yield curve. The foreign exchange market, however, appeared to be influenced more by the prospects for the UK economy relative to those for other economies, and by the level of UK interest rates relative to rates in other countries.

The economic indicators emerging in January suggested that demand had continued to grow strongly in the fourth quarter of last year, though not at as exceptionally rapid a rate as in the third quarter. There was no discernible impact on domestic demand of the fall in equity prices in October. The supply response of the economy to rapid demand growth was proving to be remarkably strong, but the external current account balance nevertheless weakened in the second half of last year. Moreover, labour costs were evidently under upward pressure. The growth of M0 remained at the upper end of its target range and, although the growth of the broad monetary aggregates was modest during January and February, this reflected seasonal public sector cash surpluses; the twelve-month growth rates of broad money remained high. Meanwhile, the factors which had justified lower interest rates in the final quarter of last year, principally the fragility of financial markets and the global weakness of the dollar, were no longer present in the early part of this year. The dollar strengthened significantly at the beginning of January, assisted initially by concerted official intervention and, more lastingly, by signs of an improvement in the US external trade figures, while the UK equity market recovered during December and was steady throughout January.

Table A
Growth rates of the monetary aggregates^(a)
Percentages

Calendar months	Unadjusted		Seasonally adjusted ^(b)	
	12 months to Dec. 87	12 months to Mar. 88	Oct. 87–Dec. 87	Jan. 88–Mar. 88
M0 ^(c)	+ 4.2	+ 6.4	+1.8	+0.4
Non-interest-bearing M1	+ 9.9	+14.6	+0.9	+6.0
M1	+22.7	+20.6	+2.7	+5.4
M2	+10.4	+13.4	+2.2	+4.1
M3	+22.8	+20.8	+5.0	+4.1
M3c	+20.5	+18.4	+4.2	+3.4
M4	+16.3	+16.8	+3.8	+3.5
M5	+15.8	+16.6	+3.7	+3.6

(a) See the May 1987 *Bulletin* for definitions of the broad money aggregate.

(b) Seasonal adjustments constrained over the financial year.

(c) Weekly average.

Table B
Composition of changes in the money stock^(a)

£ billions; seasonally adjusted (financial year constrained)

Calendar months	Oct. 87-	Jan. 88-	Level outstanding at end-Mar. 88
	Dec. 87	Mar. 88	
1 Non-interest-bearing M1	+ 0.4	+ 2.7	47.0
2 Interest-bearing sight deposits	+ 2.0	+ 2.3	49.2
3 M1 (= 1+2)	+ 2.4	+ 5.0	96.1
4 Private sector holdings of time deposits with banks and bank CDs	+ 6.4	+ 2.6	96.5
5 M3 (= 3+4)	+ 8.8	+ 7.5	192.7
6 Building society holdings of M3 (increase-)	- 1.7	- 1.3	- 15.1
7 Non-bank private sector holdings of:			
Building society shares and deposits(a)	+ 4.0	+ 4.5	134.9
Building society £CDs and time deposits(b)	—	—	2.7
9 M4 (= 5+6+7+8)	+11.2	+10.7	315.2
10 Non-bank, non-building-society private sector holdings of money-market instruments and national savings in M5	+ 0.4	+ 0.5	16.0
11 M5 (= 9+10)	+11.5	+11.2	331.3

(a) See the May 1987 *Bulletin*, 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	Unadjusted				
	Counterparts to M3			Counterparts to M4	Counterparts to M5
	Oct. 87- Dec. 87	Jan. 88- Mar. 88	Apr. 87- Mar. 88	Apr. 87- Mar. 88	Apr. 87- Mar. 88
1 PSBR	- 2.3	- 1.6	- 3.5	- 3.5	- 3.5
2 Net purchases (-) of central government debt by the 'private' sector(b)(c)	- 2.3	- 1.2	- 4.6	- 5.1	- 3.8
3 Net purchases (-) of other public sector net debt by the 'private' sector(b)(c)	- 0.1	+ 0.2	+ 1.1	+ 0.4	+ 0.8
4 External and foreign currency finance of the public sector	+ 5.3	+ 1.3	+ 6.9	+ 6.9	+ 6.9
5 Public sector contribution (= 1+2+3+4)	+ 0.5	- 1.3	- 0.1	- 1.4	+ 0.4
6 Sterling lending to the 'private' sector(b)(d)	+11.2	+13.1	+44.8	+60.7	+60.8
7 Other counterparts(e)	- 2.8	- 4.3	-11.3	-13.9	-13.9
8 Total (= 5+6+7) = change in the aggregate	+8.8	+ 7.5	+33.4	+45.4	+47.3

(a) See 'Measures of broad money', May 1987 *Bulletin*.

(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.

Against this domestic background, and with the exchange rate having weakened a little, interest rates were increased on 1 February by $\frac{1}{2}\%$, reversing in part the three reductions, each of $\frac{1}{2}\%$, between late October and early December last year. The purpose of this move was to maintain the counter-inflationary stance of policy and to emphasise that excessive domestic cost increases would not be validated through currency depreciation. This modest increase in interest rates was not expected to have, and did not have, a direct or immediate impact on the growth of credit. Any initial effect of this increase in interest rates on the external value of sterling was more than offset by the impact of industrial disputes in the domestic motor industry and by the further strengthening of the dollar. However, from the middle of February onwards, sterling appreciated steadily as funds were attracted by the level of UK interest rates relative to those elsewhere, and in particular in Germany; by the market perception of the stable political situation and strong economic growth of the United Kingdom; and in particular by the growing perception of the strength of the UK fiscal position. By the beginning of March, sterling had returned to the DM3 level last seen in the middle of December, although against the dollar and in terms of its effective rate sterling was well below its level in the first half of January.

The domestic situation continued to warrant the maintenance of tight monetary conditions, with the evidence becoming available during February reinforcing the earlier concerns. The strength of the upward pressure on sterling therefore represented a considerable difficulty for monetary policy. The scale and persistence of the demand for sterling posed questions about the effectiveness and the domestic impact of the measures that could have been taken to resist it in the foreign exchange market and in the money market. In the circumstances, sterling was allowed to rise on 7 March, reaching DM 3.10 and \$1.86 on 17 March. This tightening of monetary conditions through exchange rate appreciation was offset in part by a $\frac{1}{2}\%$ reduction in interest rates on 17 March, and similarly a further appreciation of sterling early in April prompted another $\frac{1}{2}\%$ reduction in interest rates on 8 April. The combination of a stronger currency and lower interest rates did not represent an ideal response to concerns about excessive growth of domestic demand, but the strength of external demand for sterling had created a situation in which this method of tightening monetary conditions was the only one available.

Monetary aggregates and credit

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

M0 grew more slowly over the three months to March after its acceleration in the last quarter of 1987. Its twelve-month growth rate ended the period at 5.8%, or 6.4% before seasonal adjustment, with the difference due to the timing of Easter in 1987 and 1988. The target range set for the new financial year is 1%–5%. Broad money growth over the first quarter was much the same as in the previous three months. The twelve-month growth rate of the broadest measures, M4 and M5, increased, while that of M3 fell back. The growth in bank and building society lending was higher than in the previous quarter, the increase being mainly attributable to an acceleration in lending to companies.

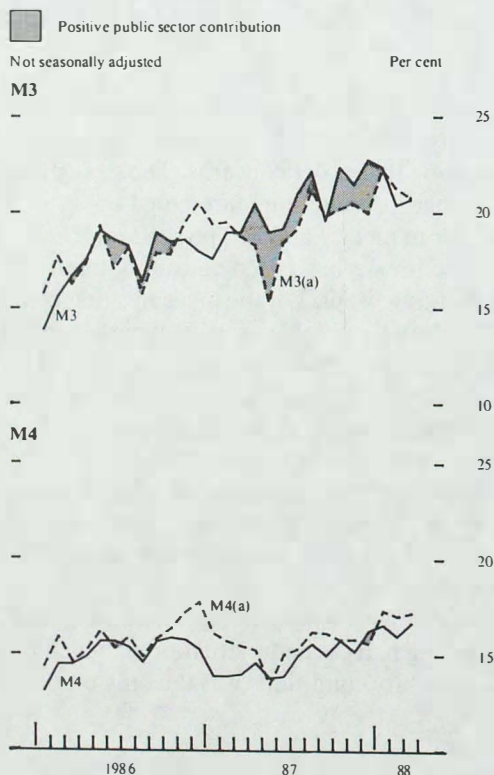
Table D
Sectoral contributions to the growth of the broad aggregates and credit in the twelve months to March 1988^(a)

	Persons	ICCs	Building societies	Other OFIs
M3 components				
Percentage growth	13.8	26.4	39.1	24.3
Contribution to M3 growth(b)	7.2	6.5	2.8	4.1
M4 components				
Percentage growth	12.9	26.3		24.5
Contribution to M4 growth(b)	9.6	4.0		2.5
M3 credit counterparts				
Percentage growth	26.4	24.6	14.3	26.1
Contribution to M3 credit growth(b)	10.9	8.9	0.6	5.0
M4 credit counterparts				
Percentage growth	18.5	24.9		26.1
Contribution to M4 credit growth(b)	12.3	5.5		3.0

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

(b) Percentage points.

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.

This was partly offset by a contractionary public sector contribution.

The public sector had a substantial surplus over the quarter, with high tax revenues, largely a reflection of the rapid rise in company profits over previous years. There was, however, a further increase in the reserves and substantial repayments of public sector foreign currency borrowing, so that external and foreign currency finance of the public sector was strongly positive for the second consecutive quarter, though in contrast to 1987 as a whole the overseas sector was not a heavy purchaser of UK government debt, partly owing to net maturities of Treasury bills.

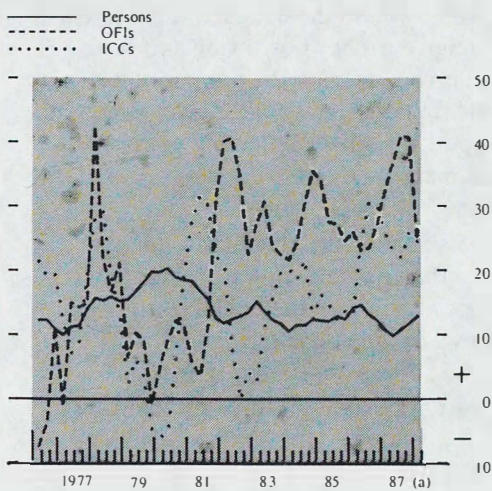
The positive public sector external counterpart was more than offset by the effect of external banking transactions, as the overseas sector built up sterling deposits with the UK monetary sector. In addition, this external banking counterpart was probably affected early in the quarter by the activities of companies drawing bills in sterling and swapping the proceeds into dollars, when this was a relatively cheap means of raising dollar funds. These transactions will have inflated sterling bank lending, but the effect on broad money will have been at least partly offset by the consequences of the foreign exchange transactions that they involved.

Lending by banks and building societies accelerated and the twelve-month growth rate of this lending stood at 20.7% at the end of March. This acceleration was mainly accounted for by a rise in borrowing by industrial and commercial companies, though financial institutions also increased their borrowing. Aggregate mortgage lending by banks and building societies was accelerating throughout the quarter, and was particularly strong in March.

Throughout 1987 industrial and commercial companies had little net recourse to banks, but both deposits and borrowing rose strongly. However, in the first quarter of this year there was a sharp rise in their net borrowing: a number of factors account for this. Corporate tax payments were particularly heavy. They will have been financed by surrenders of certificates of tax deposit (CTDs), by the running down of bank deposits and by additional bank borrowing. The yields on outstanding CTDs were generally above the prevailing level of interest rates, so that CTD surrenders were not particularly heavy. With bill rates depressed relative to other market rates early in the quarter, the cost of borrowing relative to running down bank deposits was less than usual, and a large proportion of corporate tax payments appears to have been financed through additional borrowing, so that both bank lending and broad money were inflated.

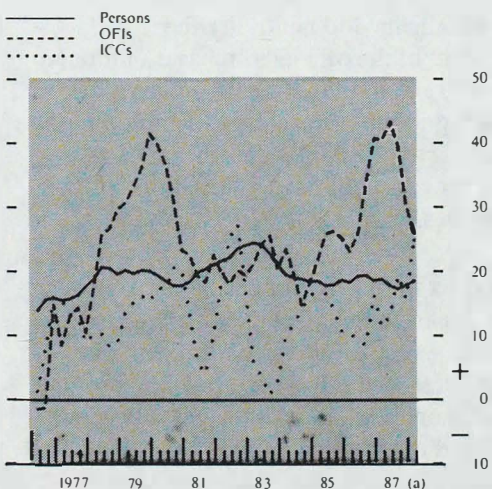
As already mentioned, low bill yields in relation to other market interest rates created opportunities early in the quarter for the use of sterling bills as a relatively cheap means of raising dollar finance. In the quarter as a whole, however, currency borrowing by industrial and commercial companies rose, perhaps reflecting in part the financing of the deteriorating trade balance. In addition, there were at times opportunities for profitable 'hard arbitrage'—borrowing on bills for the sole purpose of redepositing the proceeds in the money market. The Bank believes that there was significant activity of this type early in the quarter, inflating both bank lending and broad money.

Growth rates of M4 sectoral deposits



(a) 1988 Q1 figures are provisional.

Growth rates of M4 sectoral borrowing



(a) 1988 Q1 figures are provisional.

On a longer-term view, the growth of lending to industrial and commercial companies continues to appear surprisingly high in the light of their buoyant revenues and low expenditures on investment and stockbuilding. The industrial analysis of advances in the year to February indicates that borrowing by manufacturing industry was modest and that part of the explanation of high borrowing by the sector as a whole was a particularly strong demand for loans by property companies, which borrowed over £5 billion over the year to February, representing almost one third of lending to the company sector. Takeover and merger activity earlier in the year may also have been important in explaining the rapid increase in lending over the year as a whole.

The personal sector's net recourse to banks and building societies had fallen in the fourth quarter and remained lower in the first. On the evidence available, the saving ratio is likely to be little changed in the first quarter. However, the increase in the personal sector's deposits with banks and building societies in the first quarter was even stronger than in the fourth quarter of 1987. The main reason for the accelerated increase in these deposits since last autumn appears to be a shift away from equities and other equity-related assets following the fall in stock market prices. In particular, inflows into unit trusts have fallen from over £2 billion a quarter during the middle of last year to under £0.4 billion a quarter over the last six months. Rates paid on bank deposits tended to follow market rates more closely than did rates on building society deposits, so that the banks' competitive position improved during February, but worsened when market rates fell in March. Nevertheless, it was the societies which benefited most from the increased inflows, suggesting that their accounts are viewed as a closer substitute for unit trusts than are bank deposits. Deposits with banks and building societies may have been inflated by the redemption of the 2% Index-Linked 1988 stock at the end of March, since a substantial number of holders were in the personal sector.

Borrowing by the personal sector from the banks and building societies was also higher than in the previous quarter. The twelve-month growth rate of personal sector lending by banks and building societies rose to 18.5% by the end of the quarter. Much of this represented increased lending to households, particularly as the quarter progressed, with a very sharp increase in March. The building societies' share of this lending showed a sharp rise, following the large pick-up in their increased retail inflows. During the quarter, mortgage rate differentials changed little, so that the increase in the societies' share of the market must be attributed to competition on non-price terms.

Financial institutions' bank deposits rose by £1.8 billion in the three months to March, well below the recent trend rate of growth. Most of this increase is accounted for by the building societies which, notwithstanding a higher rate of lending, were able to build up liquidity. Other non-bank financial institutions built up their bank deposits by only £0.4 billion, low compared with the large quarterly increases seen last year. This may partly be an indirect consequence of the fall in stock market prices in October last year. Not only did the value of overseas portfolios fall as a consequence of the change in prices, but some financial institutions made heavy sales of overseas securities in the last quarter of 1987, and switched these funds into domestic equities.

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

£ billions; seasonally adjusted^(a)

	1987				1988
	Year	Q2	Q3	Q4	Q1
Sterling deposits					
Other financial institutions	+15.6	+2.3	+3.2	+3.7	+1.8
ICCs	+10.1	+3.8	+2.7	+2.2	+1.5
Persons	+8.1	+1.9	+2.3	+2.7	+3.4
Total	+33.8	+8.0	+8.1	+8.6	+6.8
<i>of which, transit items allocated to ICCs</i>	-0.2	-1.4	+0.8	-0.1	+1.0
Sterling lending					
Other financial institutions	+10.5	+2.9	+2.6	+2.1	+2.2
ICCs(b)	+9.7	+1.6	+4.3	+4.0	+5.7
Persons	+18.2	+4.3	+4.5	+5.5	+4.9
Total	+38.3	+8.8	+11.4	+11.5	+12.8
<i>of which, transit items allocated to ICCs</i>	-0.1	-0.9	+0.5	—	+0.7
Foreign currency deposits					
Other financial institutions	+7.4	+1.9	+2.6	+1.8	+0.3
ICCs	-0.7	-1.4	-0.5	+0.4	—
Persons	+0.2	-0.2	—	+0.2	+0.1
Total	+6.8	+0.3	+2.0	+2.4	+0.4
Foreign currency lending					
Other financial institutions	+7.1	+3.9	-1.2	-0.6	-0.1
ICCs	+3.3	+0.8	-0.1	+0.6	+2.2
Persons	+0.1	+0.1	+0.1	-0.2	+0.1
Total	+10.5	+4.7	-1.2	-0.1	+1.9

(a) Seasonal adjustments constrained over the calendar year.

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

If the institutions had previously hedged these foreign currency investments they may have unwound the hedging, leading to a reduction in both their foreign currency borrowing and their sterling deposits. Sterling borrowing from the monetary sector by financial institutions in the first quarter was also below the trend for the previous twelve months, possibly reflecting more subdued levels of activity in capital markets.

Over the financial year 1987/88 the objective of funding the PSBR through debt sales to the non-bank private sector and external and foreign currency finance of the public sector was achieved. Some flexibility was available at the end of the financial year in funding the underlying change in foreign exchange reserves, but it was not necessary to take advantage of this.

There was a public sector debt repayment of £3.5 billion over the financial year. However, official sales of sterling in the foreign exchange market of some £12.7 billion meant that net debt sales of £3.4 billion to the domestic non-bank private sector and £5.7 billion to the overseas sector were needed to meet the funding objective: these sales helped to neutralise the expansionary monetary effect of the official purchases of foreign exchange. In addition, to the extent that official purchases of foreign exchange contributed to the increase of £3.5 billion in the overseas sector's holdings of sterling bank deposits net of its sterling bank borrowings, they will not have affected the domestic monetary aggregates.

The public sector counterpart to M4 was modestly negative over the financial year, owing in part to net disposals of gilt-edged stocks by building societies. As the differences between banks and building societies have lessened it has become more useful to look at measures of broad money which include deposits with both types of institution, and the funding aim for 1988/89 will be to fund the net total of maturing debt, the PSBR, and the underlying change in foreign exchange reserves by debt sales to the private sector other than banks and building societies.

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 large cash surplus, reflecting in particular heavy receipts of corporation tax. There were also substantial net sales of central government debt, only partially offset by official sales of sterling in the foreign exchange market. Thus a significant increase in money-market assistance was required, particularly in January when large amounts of tax were received.

Gross official sales of gilt-edged stock during the period totalled £3.1 billion; after allowance for redemptions and official purchases of stock nearing maturity, net sales amounted to £1.7 billion, less than in the preceding quarter but close to the average quarterly figure for the financial year. Net acquisitions of gilt-edged stock by the monetary sector of £0.8 billion were unusually high, but net purchases by the overseas sector of £0.4 billion were the smallest since 1986.

Table F
Financing of the public sector

£ billions; seasonally adjusted (financial year constrained)

Calendar months	July 87- Sept. 87	Oct. 87- Dec. 87	Jan. 88- Mar. 88	Apr. 87- Mar. 88
Central government borrowing on own account	+0.3	-1.7	-1.8	-3.4
Other public sector borrowing ^(a)	-0.3	-0.6	+0.2	-0.1
PSBR	—	-2.3	-1.6	-3.5
Net sales of central government debt to the non-bank private sector	+1.1	-2.3	-1.2	-4.6
<i>of which: Gilt-edged stocks</i>	+1.2	-2.0	-0.6	-2.4
<i>National savings</i>	-0.4	-0.3	-0.7	-2.0
<i>CTDs</i>	+0.3	+0.2	-0.2	+0.1
Net sales of local authorities' and public corporations' debt to the non-bank private sector	+0.2	-0.1	+0.2	+1.1
External and foreign currency finance of the public sector	-2.1	+5.3	+1.3	+6.9
<i>of which, gilt-edged stocks</i>	-2.3	-0.5	-0.4	-5.0
Total financing of the public sector from the non-bank private and overseas sectors	-0.8	+2.8	+0.3	+3.4

(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	Jan. 87- Mar. 87	Apr. 87- June 87	July 87- Sept. 87	Oct. 87- Dec. 87	Jan. 88- Mar. 88
Gross official sales(a)	+2.7	+4.0	+2.6	+3.8	+3.1
less Redemptions and net official purchases of stock within a year of maturity	-3.3	-2.6	-1.2	-1.3	-1.4
Equals net official sales(b)	-0.7	+1.4	+1.4	+2.5	+1.7
of which, net purchases by:					
Monetary sector(b)	+0.3	-1.4	+0.2	—	+0.8
Overseas sector	+0.8	+1.7	+2.3	+0.5	+0.4
Non-bank private sector	-1.7	+1.1	-1.2	+2.0	+0.6

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

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

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

Table H
Influences on the cash position of the money market

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

Calendar months	Jan.- Mar. 87	Oct.- Dec. 87	Jan.- Mar. 88	Apr. 87- Mar. 88
Factors affecting the market's cash position				
CGBR (+)	+1.2	-1.6	-2.1	+ 0.7
of which, on-lending to local authorities and public corporations	+2.3	+0.4	+1.4	+ 4.2
Net sales (-) of central government debt(a)	+0.7	-3.0	-1.9	- 9.1
of which: Gilt-edged	+0.7	-2.5	-1.7	- 7.0
National savings	-1.1	-0.2	-0.7	- 2.1
CTDs	+1.1	-0.3	+0.5	—
Currency circulation (increase)	+1.0	-1.4	+0.2	- 1.9
Reserves etc	+1.6	+5.9	+0.6	+11.4
Other	-0.8	-0.3	-0.3	- 0.5
Total (A)	+3.7	-0.4	-3.5	+ 0.6
Official offsetting operations				
Net increase (+) in Bank's commercial bills(b)	-5.7	+2.0	+2.4	+ 2.5
Net increase (-) in Treasury bills in market Securities(c) acquired (+) under sale and repurchase agreements with banks	+1.1	—	—	- 1.1
Other	+1.4	-0.1	—	- 1.5
Total (B)	-3.6	+0.5	+3.4	- 0.9
Changes in banks' operational balances at the Bank (= A + B)	+0.1	+0.1	-0.1	- 0.3

(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

	1988		
	Jan.	Feb.	Mar.
Change in reserves	- 1,233	- 166	+ 1,713
of which:			
Net borrowing (+)/payment (-) of public debt	- 611	- 141	- 512
Valuation change on roll-over of E MCF swap	- 660	—	—
Underlying change in reserves	+ 38	- 25	+ 2,225
Annual revaluation of reserves	—	—	+ 2,879
Level of reserves (end of period)	43,093	42,927	47,519(a)

(a) After the annual revaluation.

The market's holdings of Treasury bills fell by £1 billion during the first quarter, largely as a result of the maturity in January of the 63-day bills issued in November 1987. This helped to reduce the size of the necessary build-up in market assistance during the tax-paying season in January. The amount of official assistance outstanding to the money market (excluding that provided through dealings in Treasury bills) increased from £7.2 billion at the end of December 1987 to £12.5 billion by the end of January and reached a peak of £13.7 billion on 26 February, before declining to £9.7 billion at the end of March. Early in January the Bank bought a large quantity of bills under sale and repurchase agreements, while between 13 January and 25 March £1.3 billion of assistance was provided through purchase and resale agreements directly with the banks in gilt-edged stocks and the provision to them of finance against promissory notes related to export credit and domestic shipbuilding paper. At the end of March, however, the outstanding assistance provided by the Bank to the market consisted almost entirely of eligible bills held outright.

Daily shortages in the money market averaged £490 million over the quarter, down from £690 million the previous quarter. The averages for January, February and March were £720 million, £350 million and £410 million respectively. The January figure reflected the scale of the net flows of funds to the Exchequer, but the impact of these flows on the daily shortages was offset somewhat by the sale and repurchase agreements and by the high proportion of longer-dated bills offered to the Bank by the market in the expectation of an increase in interest rates. Longer-dated bills continued to be offered to the Bank throughout the first three weeks of February but thereafter the offers were predominantly of short-dated paper, which had the effect of increasing the daily amounts of maturing assistance during March.

Under the terms of the BP Share Purchase Arrangements, which were published on 6 November 1987 and closed on 6 January 1988, the Bank purchased nearly 39 million partly-paid ordinary shares in the British Petroleum Company p.l.c., at a price of 70 pence per share.

Official reserves

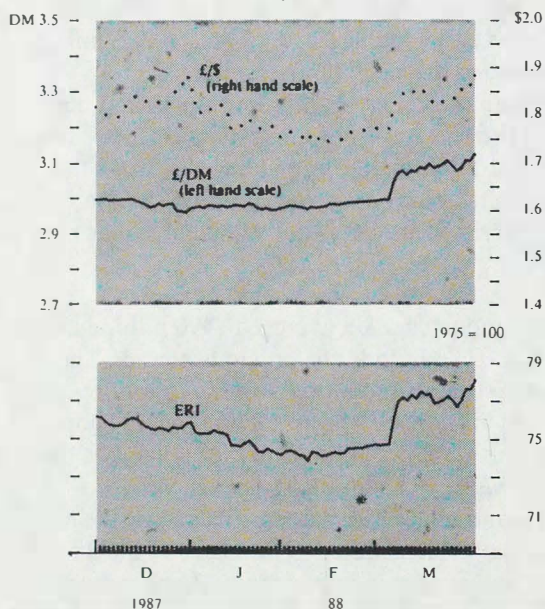
Over the three months to end-March the official reserves increased by \$3,193 million to \$47,519 million, much of which was accounted for by the annual revaluation at the end of March. There was almost no change in the underlying level of the reserves in January or February, but an increase of \$2.2 billion in March.

The money and foreign exchange markets

Sterling ended 1987 at its highest level against the dollar since January 1982, as the dollar weakened in response to the record US trade deficit for November and to nervousness about the prospects for reducing the US budget deficit. Meanwhile, sterling had fallen back against the Deutschmark after the ½% cut in UK interest rates in early December. Sterling opened January at DM 2.9625, \$1.8725 and an effective rate of 75.7, with attention focused primarily on the dollar. Domestic interbank interest rates had firmed significantly and the yield curve had steepened in the

Sterling exchange rates

At the close of business in London each day



second half of December as the money market took the view that, in the light of the pace of growth of domestic demand and credit, the next move in interest rates would be likely to be upwards, following three half-point reductions in interest rates between mid-October and early December. Interbank rates opened the year at $8\frac{3}{4}\%$, $8\frac{3}{4}\%$ and $9\frac{1}{2}\%$ at the one, three and twelve-month maturities respectively. Banks' base rates were $8\frac{1}{2}\%$.

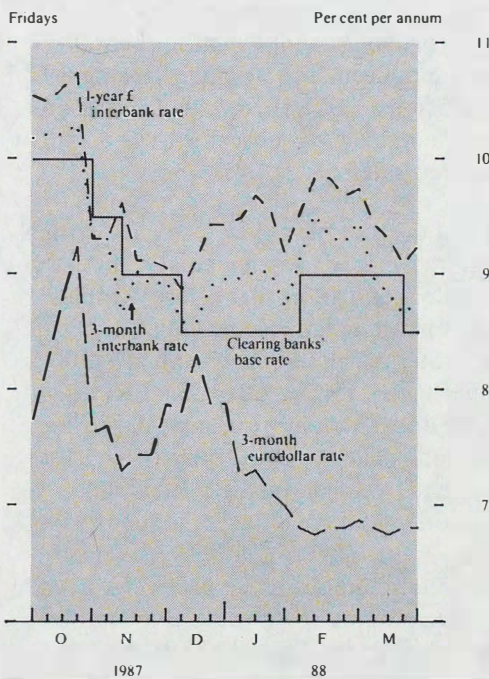
The dollar strengthened markedly in early January as a result of concerted official intervention, in which the Federal Reserve played a prominent part, and of the smaller than expected US trade deficit for November, announced on 15 January. Sterling had fallen to \$1.8040 by the close on 6 January and eased again to reach \$1.7620 by 15 January. Against the deutschemark, sterling rose to above DM 2.9750 early in the month, prompted by firmer sterling interbank interest rates, and steadied at around DM 2.9800 for the first three weeks of the month.

The continued signs of buoyancy of domestic demand, the recovery of the dollar and the stability of world equity markets reinforced the view of participants in the money market that part of the earlier reductions in interest rates might soon be reversed, and the three-month interbank rate rose above 9% on 6 January, while the twelve-month rate crept up to a peak of $9\frac{3}{4}\%$ on 13 January; and the discount market displayed keenness to sell longer-dated bills in the Bank's daily operations. This made the handling of the seasonal money-market shortages arising from corporate tax receipts easier than usual. However, with a wide gap—of up to $\frac{1}{2}\%$ at times—having opened up between three-month interbank interest rates and bill yields (which were held down by the Bank's heavy demand for bills), which provided opportunities for profitable arbitrage involving the drawing of bills and the placing of the proceeds on deposit, the Bank nevertheless chose to supply some of the needed additional money-market assistance directly to the banking system through sale and repurchase agreements. This had the effect of bringing about a modest narrowing of the margin between interbank rates and bill yields.

With no immediate official moves to change interest rates, and the markets interpreting the provisional figures released on 18 and 19 January for retail sales volumes in December and manufacturing output in November as signs of a slowdown in economic activity, longer interbank interest rates fell during the third week of January, bringing the one, three and twelve-month rates down to $8\frac{7}{8}\%$, $8\frac{3}{4}\%$ and $9\frac{1}{4}\%$ respectively on 25 January. Interest rates remained at these levels over the rest of the month. Sterling softened during this period, accentuated by the announcement on 28 January of the UK current account figures for December.

Against the background of the continuing strength of domestic demand and credit, the slightly lower exchange rate and the stability in the equity market, the authorities considered it appropriate to tighten monetary conditions, and on 1 February the Bank invited the discount houses to borrow at 2.30 pm at an interest rate of 9%, signalling a $\frac{1}{2}\%$ rise in rates. This was the first occasion since May 1984 on which a rise in rates of $\frac{1}{2}\%$ had been undertaken. The commercial banks followed by increasing their base rates to 9%. Following the Bank's announcement, interbank interest rates moved up immediately in all maturities, with the

Short-term interest rates in London



three-month rate moving back above 9% to $9\frac{3}{4}\%$. In the foreign exchange market, sterling appreciated modestly on news of the increase in interest rates, and moved up further on 2 February, encouraged by a reduction in US prime rates, but eased back a little over the remainder of the week in line with period interbank interest rates, which fell slightly as initial fears in the money market of a further increase in interest rates receded.

News of the strike at Ford on 8 February, together with industrial unrest elsewhere in the motor and shipping industries, sent sterling down to lows of DM 2.9690 and 73.9 in effective terms. Interbank interest rates moved sharply upwards to 9%, $9\frac{1}{2}\%$ and $9\frac{7}{8}\%$ at one, three and twelve months respectively on market fears that there might be a further increase in the general level of interest rates. Interest rates fell back a little over the course of the week, but remained significantly higher than their early-February levels and stayed at around these higher levels throughout the rest of the month. The three-month interbank interest rate closed the month at $9\frac{1}{4}\%$.

The dollar strengthened on 12 February on the announcement that the US trade deficit had fallen to \$12.2 billion in December; this took sterling down to \$1.7275, its lowest value against the dollar during the quarter and almost 8% below its level at the beginning of January. Thereafter, the strength of overseas demand for sterling, encouraged by the strong UK fiscal position and by the level of UK interest rates, including relatively high rates for overnight and one-week money, pushed sterling steadily upwards during the last two weeks of February, to DM 2.9940, \$1.7755 and an ERI of 74.7 early on 29 February. Although it eased slightly (to DM 2.9880 and \$1.7665) after the announcement later that day of the large UK visible trade deficit for January, sterling quickly recovered on market doubts about the accuracy of the figures.

Demand for sterling strengthened in early March, while period interbank interest rates began to ease slightly. With a tightening of monetary conditions clearly called for on domestic grounds, and no reasons for believing the demand for sterling to be either temporary or reversible, the authorities judged it appropriate to allow sterling to appreciate, and on 7 March sterling rose strongly, to close at DM 3.0445. Sterling also strengthened against the dollar, to close at \$1.8160 and an ERI of 76.2. A further appreciation the next day took sterling to DM 3.0720, \$1.8425 and an ERI of 77.0, levels around which the currency remained until the Budget on 15 March. Meanwhile, interbank interest rates eased in expectation of a cut in interest rates after the Budget: by 14 March the one-month rate was down by $\frac{3}{8}\%$ from its end-February level and the three and twelve-month interest rates were down by $\frac{7}{16}\%$.

Sterling strengthened further after the Budget, rising to DM 3.1055, \$1.8560 and an ERI of 77.8 at the opening on 17 March, an appreciation of 7% against the dollar, 5% in effective terms and 4% against the deutschemark since the middle of February. This implied a tightening of monetary conditions which the authorities considered it appropriate to offset in part, through a reduction in interest rates. On 17 March the Bank therefore invited discount houses to borrow at 2.30 pm at a rate of $8\frac{1}{2}\%$, signalling a $\frac{1}{2}\%$ fall in the general level of interest

rates; bank base rates were cut by $\frac{1}{2}\%$ to $8\frac{1}{2}\%$. This reduction in rates was accompanied by a steepening in the money market yield curve, reflecting continuing longer-term concern about inflationary pressures in the domestic economy.

In the foreign exchange market, sterling weakened a little on 17 and 18 March following the announcement of lower interest rates, but in the week beginning 21 March sterling began to edge upwards again, in particular against the dollar, though money-market interest rates were little changed. However, sterling eased again early on 25 March in advance of the announcement of the UK current account deficit for February and fell sharply once the announcement was made, closing the day at DM 3.0785, \$1.8345 and an ERI of 76.7, while interbank interest rates firmed as the money market became less hopeful of a further reduction in interest rates.

During the last four days of the month sterling recovered strongly from this setback, in part in response to statements by the Governor and the Chancellor confirming that priority would continue to be given to maintaining the counter-inflationary stance of monetary policy. Sterling closed the month at \$1.8845 and at its highs for the quarter of DM 3.1250 and an ERI of 78.1, leaving the rate against the dollar virtually unchanged over the three months but having appreciated over the quarter by 5.5% against the deutschemark and by 3% on the ERI. Interbank interest rates fell back in anticipation of a further reduction in interest rates, to close the period at $8\frac{1}{2}\%$, $8\frac{7}{16}\%$ and $9\frac{1}{16}\%$ for the one, three and twelve-month maturities respectively, down by $\frac{1}{8}\%$ at one month, $\frac{1}{4}\%$ at three months and $\frac{3}{8}\%$ at twelve months when compared with the beginning of January. Thus the money-market yield curve flattened a little over the quarter.

Sterling continued to appreciate in the first week of April, rising to just above DM 3.14 and to an ERI of 78.4. In response to the further tightening of monetary conditions which this implied, the Bank signalled a further $\frac{1}{2}\%$ reduction in the general level of interest rates on 8 April by inviting the discount houses to borrow at 2.30 pm at a rate of 8%; bank base rates fell to 8%—their lowest level since May 1978.

The gilt-edged market

Although the gilt-edged market was nervous during the first three months of the year about the strength of UK domestic demand and its potential consequences for inflation, this was more than offset by the growing strength of the fiscal position and the prospect of a significant public sector debt repayment in the next financial year, and by the strength of external demand for sterling assets. Retail demand for gilts responded in mid-January to the downward movement in prices, which had been under way since late November, and was again evident in the second half of February and early March.

The last of the of three experimental auctions of gilt-edged stock took place on 13 January with an auction of £1.0 billion of $8\frac{3}{4}\%$ Treasury Loan 1997 'C' (see the note on pages 194–7). Although the coverage of 1.07 at this auction was the lowest of the three auction issues and the gap in yield terms between the average yield and the lowest acceptable bid was the widest (at 16 basis points, compared with 2 and 3 basis points at the previous

Sterling interbank rates

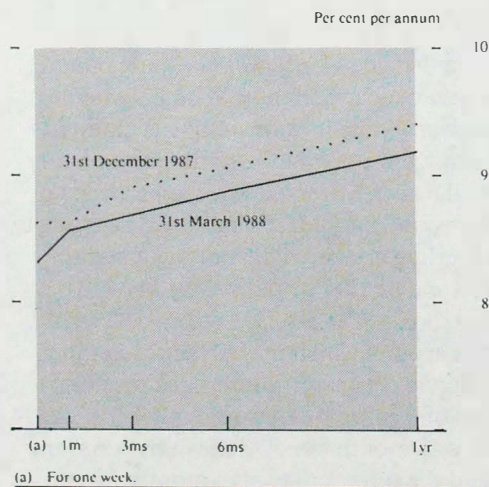


Table K
Issues of gilt-edged stock

Stock	Amount issued (£ millions)	Date announced	Method of issue	Date issued	Price paid per £100 stock (£)	Payable per £100 stock		Redemption yield at issue (per cent)	Date exhausted
						Initial payment(a) (£)	Further instalments (£)		
8¼% Treasury 1997 'C'(b)	1,000	5/1	Bid price auction	13/1	91.5000(c)	41.50	50.00 (25/2)	10.15	13/1
8% Treasury 1992	300	18/1	Direct to Bank	18/1	95.4375			9.31	21/1
9½% Conversion 2004	150	18/1	To National Debt Commissioners	18/1					
9½% Conversion 2005	150	18/1	Direct to Bank	18/1	99.6250			9.54	21/1
2½% Index-Linked Treasury 2003	50	22/1	Direct to Bank	22/1	104.2500			4.12(d)	26/1
2½% Index-Linked Treasury 2013	50	22/1	Direct to Bank	22/1	85.1875			4.04(d)	25/1
2½% Index-Linked Treasury 2020	50	22/1	Direct to Bank	22/1	90.0625			3.90(d)	25/1
9½% Conversion 2005	200	3/2	To National Debt Commissioners	3/2					
2½% Index-Linked Treasury 2011	100	3/2	Direct to Bank	3/2	105.1250			3.95(d)	11/2
2½% Index-Linked Treasury 2024	100	3/2	Direct to Bank	3/2	78.3750			3.70(d)	19/2
10% Treasury 1992	200	19/2	Direct to Bank	19/2	101.8750			9.42	22/2
10% Treasury 1992	100	19/2	To National Debt Commissioners	19/2					
9½% Treasury 1999	100	19/2	Direct to Bank	19/2	100.5000			9.42	22/2
9½% Treasury 1999	50	19/2	To National Debt Commissioners	19/2					
2½% Index-Linked Treasury 2013	100	19/2	Direct to Bank	19/2	88.1875			3.84(d)	1/3
8½% Treasury 1994(e)	1,050	11/3	Minimum price tender	16/3	97.0000	50.00	47.00 (25/4)	9.17	18/3
8% Treasury 1991	150	30/3	Direct to Bank	30/3	97.4375			8.82	8/4
2% Index-Linked Treasury 1992	250	30/3	Direct to Bank	30/3	101.4375			2.44(d)	19/4
9% Conversion 2000	150	30/3	To National Debt Commissioners	30/3					
8½% Treasury 2007	150	30/3	To National Debt Commissioners	30/3					

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

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

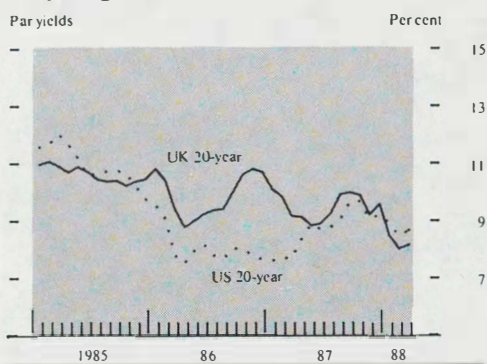
(e) Of which £250 million was reserved for the National Debt Commissioners.

two auctions) this third experimental auction can nevertheless be regarded in some respects as the most interesting of the series. It achieved sales of stock in conditions that probably would not have allowed equivalent sales to be achieved by other means; and it also proved successful in helping the market establish a new trading level after a period in which it had lacked direction. The Bank announced on 27 April that it expects to hold two further auctions in the financial year to end-March 1989, the first in July or August 1988 and the second in January or February 1989.

The aim of the authorities—which was achieved over the financial year 1987/88—remained that of fully funding over the financial year as a whole the net total of maturing debt, the PSBR, and any underlying change in the foreign exchange reserves by debt sales to the non-bank private sector, although the funding required to sterilise the liquidity created by official foreign exchange intervention against sterling would not necessarily have had to fall within the financial year in which the intervention took place. The authorities began the period with a call of £0.5 billion already secured on 8% Treasury Convertible 1990. Two stocks were scheduled to mature during the period, 7¾% Treasury 1985/88 and 2% Index-Linked Treasury 1988, of which £0.4 billion and £1.0 billion respectively were in market hands at the beginning of January. The authorities held some of the tranchette of £100 million 2% Index-Linked Treasury 2006 issued on 21 December, together with quantities of conventional and other index-linked stocks.

1987 had ended with the market slightly firmer, reversing some of the marked weakness of mid-December. However, at the beginning of January the market opened hesitantly, with yields moving upwards before the announcement on 5 January that the last in the series of three experimental auctions would take place

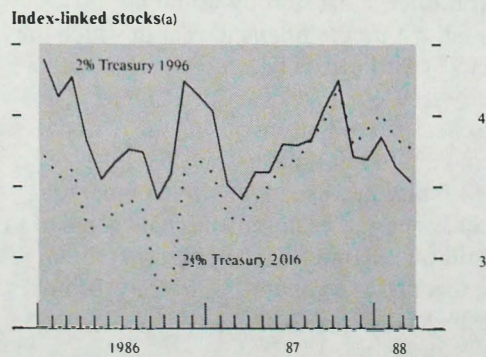
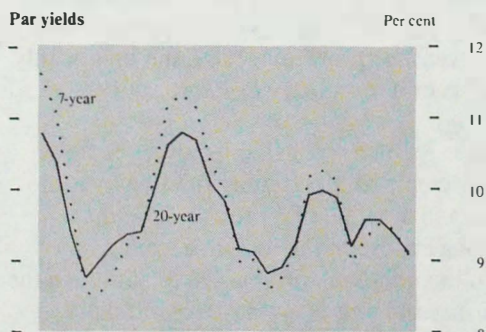
Gross redemption yields on UK and US 20-year government securities



the following week. Prices of all stocks continued to decline at the end of the first week in January, reflecting concern about the strength of domestic demand and the outlook for US bonds. Index-linked stocks showed the largest downward movements in price, while the auction stock, 8½% Treasury 1997 'C', demonstrated resilience in its when-issued form. Prices eased further on the morning of the auction on 13 January and the immediate market reaction to the result of the auction was disappointment, with prices of all stocks marked down sharply. At the close that day, the yield on short gilts stood at around 9½%, up by ¾% since the beginning of the year, while medium and long yields were 10% and 9½% respectively, up ¾% and ¼% since the beginning of the year. The long-maturity (to 2016) index-linked stock was yielding a real rate of return of 4½%, up by ¾% (calculated before tax and assuming a 5% rate of inflation). Trading had commenced in the new medium gilt futures contract on the London International Financial Futures Exchange on 7 January, before the auction, but turnover was modest during its first week.

Despite the initial sense of disappointment, the auction helped to initiate a strong recovery in the market in the second half of January, with retail demand reawakened by the rise in yields at the time of the auction, when medium gilt yields rose briefly above 10%. The auction issue was in consequence absorbed very quickly, and the upward momentum was maintained by the announcement on 15 January of an improvement in the US trade deficit for November and by the release during the next week of data showing an increasingly undemanding PSBR and what appeared to be signs of a slowdown in economic activity. The Bank's supplies of the 2006 index-linked tranchette were exhausted on 14 January and a £450 million package of tranchettes, comprising £300 million 8% Treasury 1992 and £150 million 9½% Conversion 2005, was announced on 18 January and exhausted on 21 January.

Gross redemption yields on UK government securities



(a) Real yields assuming 5% inflation.

Although the market eased back on the announcement on 21 January of a large increase in bank lending in December, the underlying strength of sentiment brought yields down over the day and, with the index-linked sector particularly buoyant, the authorities announced on 22 January the issue of £50 million each of additional tranches of three index-linked stocks, 2½% Index-Linked Treasury 2003, 2013 and 2020. The two longer maturities were exhausted on 25 January and the shorter maturity the following day. This gave further encouragement to the conventional market, where yields continued to decline.

The half percentage point increase in short-term interest rates on 1 February surprised the market, but affected prices in the conventional sector only briefly. Index-linked stocks remained firm even following the announcement on 3 February of the issue of £100 million each of 2½% Index-Linked Treasury 2011 and 2½% Index-Linked Treasury 2024, but yields on conventional issues rose sharply between 4 and 8 February on fears of a further increase in interest rates and concern about industrial unrest. Retail demand was minimal, but picked up a little later in the week and the 2011 index-linked tranchette was exhausted on 11 February. The market remained subdued as the rally in US bonds came to an end, but the announcement on 16 February of the substantial PSBR surplus in January gave the market a new sense of direction, which was reinforced by the ending of the

Ford strike on 18 February. The 2024 index-linked tranchette issued on 3 February was exhausted early on 19 February and later that day the Bank announced the issue of a further package of tranchettes, consisting of £200 million 10% Treasury 1992, £100 million 9½% Treasury 1999 and £100 million 2½% Index-Linked Treasury 2013.

The market remained firm during the remainder of February, with the conventional stocks in the 19 February package being exhausted on 22 February and the index-linked stock on 1 March. Overseas demand for gilts was particularly strong over the second half of February and the market was undeterred by the announcement on 29 February of the UK current account deficit in January, taking heart instead from the fiscal outlook.

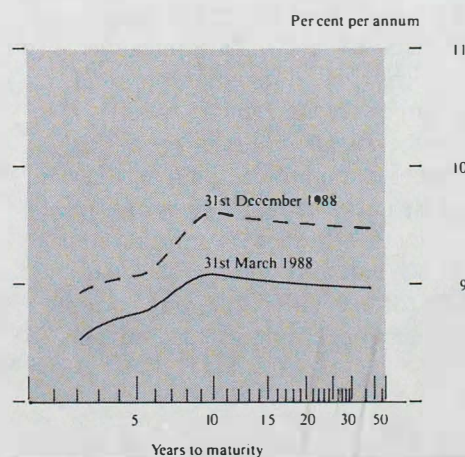
The market continued to be optimistic ahead of the Budget, taking encouragement in the second week of March from the appreciation of sterling and strong retail demand, although prices rose only modestly. The announcement on 11 March of the issue by tender on 16 March of £800 million 8½% Treasury 1994 was well received. This partly-paid issue was not made free of tax to overseas residents, so as not to encourage unnecessarily further inflows of sterling across the foreign exchanges. In response to the Budget on 15 March, the prices of long-dated stocks rose on news of forecast public sector debt repayments, but fell back as the market considered the macroeconomic implications of the tax reductions announced in the Budget. The new tap stock was undersubscribed on 16 March but substantial sales were made at a pre-opening mini-tender on 17 March and the stock was exhausted at a premium early the next day. The half percentage point reduction in short-term interest rates on 17 March led to profit-taking, although shorter yields fell below 9%.

Over the last two weeks of the month the market followed the movements of sterling closely. Prices moved steadily upwards from 21 March, but lost these gains following the announcement on 25 March of the UK current account deficit for February. Thereafter, the market rallied strongly on the final three days of the month as sterling strengthened significantly and there was reinvestment demand for low-coupon and shorter-dated index-linked issues following the redemption on 29 March of 2% Index-Linked Treasury 1988. A £400 million package of tranchettes, comprising £250 million 2% Index-Linked Treasury 1992 and £150 million 8% Treasury 1991, was announced on 30 March. The 1991 tranchette was exhausted on 8 April, and the 1992 tranchette on 19 April.

Gilt-edged yields fell by around ¼% at all maturities during the period under review, with yields on five, ten and twenty-year stocks standing at 9%, 9¼% and 9⅝% at the end of March. Yields on index-linked stocks also fell, with the real rate of return (before tax and assuming a 5% rate of inflation) on 2% Index-Linked Treasury 2016 declining from 3⅜% on 4 January to 3⅜% on 31 March.

The generally optimistic mood of the gilt market was reflected in total gilt turnover during the three months, which averaged £4.6 billion per day, the same as in the fourth quarter of last year. March was the most active month, with turnover averaging £5.0 billion per day. Total turnover was divided equally between intra-market transactions and those with outside customers.

Time/yield curves of British government stocks



Average daily turnover in the long gilt futures contract on the London International Financial Futures Exchange was 28,500 contracts per day over the first quarter of this year, slightly up on the previous quarter and with February the busiest month when average daily turnover was 33,800 contracts. Trading in the medium gilts contract began on 7 January but interest has been limited, with an average daily turnover of 1,300 contracts in January, 400 in February and less than 300 in March. The amount outstanding of call warrants exercisable into gilt-edged stock increased from £780 million to £800 million over the quarter, with issues of £200 million and expiries of £180 million. The amount of put warrants outstanding rose from £430 million to £550 million, with £200 million issued and £80 million expiring.

Other capital markets

Equity prices showed no significant overall change during the first quarter, with the FT-Actuaries all-share index opening the quarter at 886 and closing it at 896. However, the index remained above 900 for much of the quarter, peaking at 951 on 18 March, before falling sharply in the following two weeks. The dominant mood in the market was one of caution; this was, in part, a reaction to the October crash and, in part, a reflection of continued nervousness on Wall Street. The rise in the sterling exchange rate subdued equity prices during March.

New equity issues to raise £754 million were announced. This was well below pre-October levels, but the pace of issuing activity intensified during the quarter. Most issues were modest in size: the largest was a rights issue for £175 million by Lucas Industries in March.

The sterling bond market was particularly busy in the first quarter, with more than forty public issues for a total of £4.3 billion; all but three issues took the form of eurobonds. UK borrowers, including large commercial companies, banks and building societies, raised nearly £2.1 billion from fixed-rate issues and a further £0.9 billion from floating-rate notes. Building societies were especially active borrowers. In part, this reflected a doubling in their wholesale borrowing ceiling to 40% of total funding, but they were also empowered in January to raise subordinated debt, and three societies took advantage of this. Virtually all the fixed-rate issues had maturities of five to seven years, although two convertible issues had maturities of fifteen years. Among the floating-rate notes, there were a further four mortgage-backed issues and two issues by building societies, including an innovative issue for the Halifax Building Society, which incorporated a 'Dutch auction' arrangement to enhance liquidity.

UK borrowers and their overseas subsidiaries were responsible for nineteen bond issues in foreign currencies, which raised the equivalent of £1.5 billion. Borrowers included British Gas, British Telecom and several subsidiaries of British Petroleum, as well as a number of building societies and banks. The most common issuing currencies were US dollars and Swiss francs, which together accounted for almost 75% of the non-sterling borrowing.

Table L
Amounts raised in the domestic capital market

£ millions; not seasonally adjusted
Net cash raised +

	1987				1988
	Q1	Q2	Q3	Q4	Q1
UK private sector					
Loan capital and preference shares	- 777	+ 435	+ 750	+ 544	+ 83
Equity	+1,571	+2,122	+7,298	+3,740	+351
Unit trusts	+1,726	+1,234	+2,982	+ 389	+355
Issues on the unlisted securities market	+ 105	+ 184	+ 457	+ 215	+102
Local authorities					
Stocks	—	—	14	— 35	— 3
Bonds	— 25	— 56	— 28	— 16	— 5
Overseas	—	+ 11	—	+ 177	—

Table M
Sterling debt issues announced

£ millions

	Fixed-rate(a)			FRNs
	Sterling eurobonds			
	Domestic Issues(b)	UK borrowers	Overseas borrowers	
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
Q4	173	403	825	436
January	142	625	250	175
February	4	530	160	275
March	58	735	930	425
1988				
Q1	204	1,890	1,340	875

(a) Of which, £305 million were equity-related in the first quarter.

(b) All UK borrowers in 1987 and so far in 1988.

Sterling commercial paper

Gross issues of sterling commercial paper during the first quarter were £7,369 million, the largest quarterly total to date and substantially above the £5,810 million recorded in the fourth quarter of last year. Redemptions amounted to £6,575 million, bringing the total of paper outstanding to £2,861 million at the end of March, compared with £2,053 million three months earlier. By the end of March 123 programmes had been notified to the Bank, and paper had been issued under 103 of these.