Operation of monetary policy

This article covers the three months from April to June 1988.

Review

The period began with continuing strong upward pressure on the exchange rate which led to further reductions in short-term interest rates, to a low point of 7½% by mid-May. However, it became increasingly apparent that there was a need to tighten monetary policy so as to exert downward pressure on inflation. During the second half of the period, underlying sentiment towards sterling weakened and interest rates abroad rose. Domestic interest rates were therefore increased in a series of ½% steps without creating undue upward pressure on the exchange rate.

Although in early April there were some tentative indications that the pace of domestic output growth might have slowed in the first quarter, it soon became clear that rapid domestic demand growth had continued and that the rate of increase in labour costs and prices was edging upwards. The current account deficit for the first quarter was revised upwards, to £2.8 billion, compared with a deficit of £1.6 billion in 1987 as a whole, and later figures showed no significant narrowing. In addition, money and credit were expanding rapidly. Lending by banks and building societies was exceptionally strong, in particular to the personal sector for mortgage finance. The growth rate of M0 increased.

In the domestic markets, concern about these developments led to upward-sloping yield curves in both the money and the gilt-edged market from the beginning of the period. The cuts in short-term interest rates in the early part of the period were not accompanied by corresponding falls in the longer money-market rates, nor by any significant fall in gilt-edged yields. In mid-May the bullish sentiment towards sterling seen on the foreign exchanges over the last year weakened, as interest rate differentials shifted more favourably to foreign currencies, particularly the dollar, and as evidence grew of the continuing buoyancy of UK domestic demand.

The change in the foreign exchange market's attitude to sterling took place at a time when concerns about the international economy had switched from the fear of recession, prompted by the worldwide stock market setbacks in October 1987, to anxieties about rising inflation in the light of the news that economic growth in the first quarter in the United States, Germany and Japan had been much faster than expected and that price pressures, particularly in primary product markets, were strong; this led to increases in interest rates in a number of overseas countries. The dollar rose significantly on the foreign exchanges, responding not only to tighter US monetary conditions but also to evidence of a narrowing in the US trade deficit.

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

	Unadjusted		Seasonally adjusted(b)	
Calendar months	12 months to Mar. 88	12 months to June 88	Jan. 88– Mar. 88	Apr. 88– June 88
M0(c)	+ 6.4	+ 7.7	+0.4	+2.5
Non-interest-bearing M1	+15.2	+10.7	+6.4	+0.9
M1	+21.0	+18.9	+5.6	+4.2
M2	+13.6	+15.0	+4.2	+4.4
M3	+20.9	+20.3	+4.1	+4.7
M3c	+18.5	+18.8	+3.4	+4.9
M4	+16.8	+16.8	+3.5	+3.9
M5	+16.6	+16.1	+3.5	+3.5

(a) See the May 1987 *Bulletin* for definitions of the broad money aggregates.
(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) in italics*

Calendar months.	Jan. 88– Mar. 88	Apr. 88– June 88	Level outstanding at end– June 88
1 Non-interest-bearing M1	+ 2.8	+ 0.4	47.1
2 Interest-bearing sight deposits	+ 2.3	+ 3.6	52.8
3 M1 (= 1+2)	**+ 5.1**	**+ 4.1**	**99.9**
4 Private sector holdings of time deposits with banks and bank CDs	+ 2.4	+ 5.0	101.3
5 M3 (= 3+4)	**+ 7.5**	**+ 9.0**	**201.2**
6 Building society holdings of M3 (increase–)	– 1.3	– 2.1	– 17.2
Non-bank private sector holdings of:			
7 Building society shares and deposits(b)	+ 4.5	+ 5.3	140.2
8 Building society £CDs and time deposits(c)	—	+ 0.2	2.9
9 M4 (= 5+6+7+8)	**+10.7**	**+12.4**	**327.2**
10 Non-bank, non-building-society private sector holdings of money-market instruments and national savings in M5	+ 0.5	– 0.7	15.2
11 M5 (= 9+10)	**+11.2**	**+11.8**	**342.4**

(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 M4			Unadjusted: Counterparts to M3	Unadjusted: Counterparts to M5
	Jan. 88– Mar. 88	Apr. 88– June 88	Unadjusted July 87– June 88	July 87– June 88	July 87– June 88
1 PSBR	*– 1.6*	*– 2.3*	– 6.6	– 6.6	– 6.6
2 Net purchases (–) of central government debt by the 'private' sector(b)(c)	*– 1.9*	*+ 0.6*	– 3.2	– 2.8	– 2.3
3 Net purchases (–) of other public sector net debt by the 'private' sector(b)(c)	*+ 0.2*	*+ 0.4*	+ 0.7	+ 1.0	+ 0.8
4 External and foreign currency finance of the public sector	*+ 1.6*	*+ 0.2*	+ 5.4	+ 5.4	+ 5.4
5 Public sector contribution (= 1+2+3+4)	*– 1.7*	*– 1.2*	– 3.7	– 2.9	– 2.7
6 Sterling lending to the 'private' sector(b)(d)	*+18.1*	*+22.2*	+69.6	+51.3	+69.0
7 Other counterparts(e)	*– 5.7*	*– 8.6*	–18.6	–14.3	–18.6
8 Total (= 5+6+7) = change in the aggregate	***+10.7***	***+12.4***	**+47.3**	**+34.0**	**+47.7**

(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 private sector 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.

This combination of factors meant that policy adjustment in the United Kingdom through higher interest rates created little upward pressure on the exchange rate. By the end of the quarter the general level of interest rates was 2% higher than at its low point in May: banks' base rates were 9½%, and sterling stood at an effective rate of 75.2 and at $1.7055 and DM 3.1044. Two further ½% rises took banks' base rates to 10½%. The second of these took place on 18 July; sterling closed that day at ERI 75.1, $1.6712 and DM 3.1422, compared with base rates of 8½% and an exchange rate of 78.2, $1.8840 and DM 3.1227 at the beginning of April.

Monetary aggregates and credit

The figures in this section are seasonally adjusted except for twelve-month growth rates or as otherwise stated. Figures for the split of borrowing between industrial and commercial companies and persons are provisional.

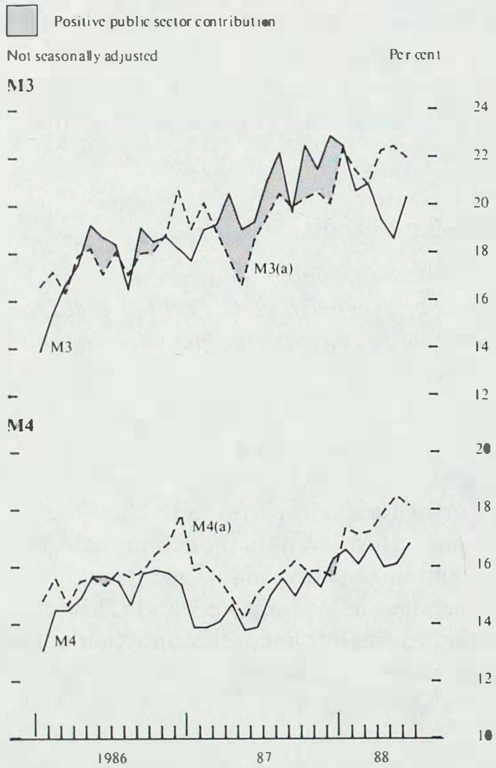
M0 grew rapidly over the three months to June; its twelve-month growth rate increased to 7.7%. There was little change in the twelve-month growth rates of broad money measures; those of M3 and M5 fell a little, to 20.3% and 16.1% respectively, while that of M4 was unchanged at 16.8%. Within the counterparts to broad money, bank and building society lending accelerated, including a marked acceleration in lending to persons. This more rapid growth in lending was offset by a modest contraction in the public sector counterpart and by contractionary external banking transactions.

During the latest three months, M0 growth moved further above its 1%–5% target range set for the financial year. Its recent rapid rate of increase is consistent with the strong growth of retail sales; moreover, although in recent years M0 has increased consistently more slowly than consumer spending, there are signs that the differential between these growth rates may have narrowed. This may reflect slower financial innovation and, in the most recent period, perhaps lower interest rates as well. The large rise of 1.1% in M0 recorded in June may have been in part due to tax rebate money, with employees paid in cash receiving their rebates from mid-June onwards.

The public sector counterpart to broad money growth was contractionary over the three months to June, during which the public sector recorded a large surplus. Tax revenue remained buoyant, and the further calls on British Gas shareholders in April and BAA shareholders in May, as well as the repayment of British Telecom preference shares (also in May), boosted inflows to the public sector. The contractionary influence of this surplus was in part offset by a reduction in holdings of public sector debt by the private sector (other than banks and building societies) mainly arising from two large stock redemptions, and by public sector external transactions, which had a small expansionary effect. These external transactions included a modest underlying rise in the reserves (mostly in the early part of the period), offset in part by overseas take-up of central government debt.

Taken together, public sector transactions resulted in overfunding of £1.2 billion over the latest quarter and £3.7 billion over the year to end-June (equivalent to 1.3% of M4). The substantial overfund over the year to end-June reflected in particular 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.

Table D
Sectoral contributions to the growth of the broad aggregates and credit in the twelve months to June 1988[(a)]

	Persons	ICCs	Building societies	Other OFIs
M3 components				
Percentage growth	14.2	19.4	45.5	29.4
Contribution to M3 growth(b)	7.2	4.9	3.2	5.0
M4 components				
Percentage growth	14.5	19.8	—	29.3
Contribution to M4 growth(b)	10.6	3.1	—	3.1
M3 credit counterparts (c)				
Percentage growth	28.3	30.6	30.7	20.8
Contribution to M3 credit growth(b)	11.7	10.8	1.0	4.2
M4 credit counterparts (c)				
Percentage growth	20.5	31.4	—	20.8
Contribution to M4 credit growth(b)	13.5	6.8	—	2.5

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

(b) Percentage points.

(c) Figures for the split of borrowing between ICCs and persons are provisional.

underfunding of the public sector in the second quarter of 1987, when there was a large rise in the reserves.

The external and foreign currency transactions of banks and building societies had a contractionary influence on broad money growth over the quarter. Their most notable features may reflect recent trends in the balance of payments. There was a large build-up of sterling deposits (net of borrowings) by the overseas sector, mostly in April and June, in line with the profile of relative interest rates in the United Kingdom and overseas: short-term interest rate differentials narrowed (especially against the United States) in May, but widened again in June, despite a wordwide tightening of monetary conditions, as short-term interest rates in the United Kingdom increased sharply. In addition, there were heavy net foreign currency borrowings by UK industrial companies.

A further contractionary influence on broad money growth over the quarter was the increase in the sterling net non-deposit liabilities of banks and building societies, in particular the £0.9 billion rights issue by Barclays Bank.

Lending by banks and building societies accelerated further, taking the twelve-month rate of growth of such lending to 22.8% at the end of June, compared with 20.8% at the end of March. Growth was particularly fast in April and June. As in the previous quarter the most rapid growth was in borrowing by industrial and commercial companies, but in the period under review borrowing by persons, which accounts for nearly two thirds of outstanding lending, also increased more rapidly than in the recent past. Borrowing by financial institutions grew more slowly.

Industrial and commercial companies had substantial net recourse to banks over the three months under review, as they had in the first quarter. In the first quarter this reflected particularly heavy corporate tax and dividend payments. In the second quarter there was a pick-up in input costs in manufacturing industry (reflecting the growth in non-oil commodity prices over the past six months), which may have affected companies' profit margins and so their need for bank finance. There is also evidence of higher investment expenditure.

This acceleration in borrowing may also in part be explained by companies substituting bank for equity finance following the fall in stock market prices in October: although net issues on the stock market were higher than in the first quarter, they were still modest by the standards of 1987. Also, takeover and merger activity has continued at high levels, with a noticeable increase in international takeovers since 1987, and cash finance has since late 1987 become more prominent. During June, lending to companies was boosted by around £1 billion associated with takeover activity. A further temporary expansionary influence on bank lending in June may have been the tax rebates of up to £1 billion paid out to employees at the end of the month; these will have been paid for initially by companies, with subsequent reimbursement by the public sector after the end of the quarter.

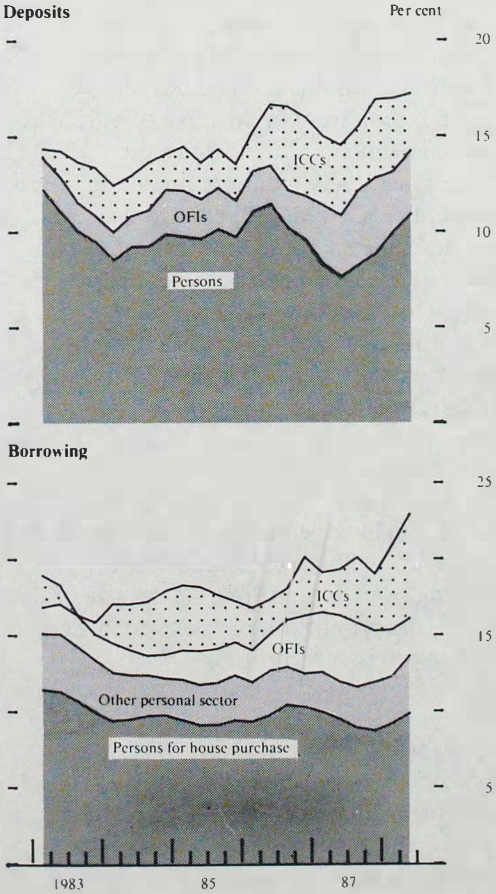
At the beginning of the year, there were signs that bill arbitrage operations were taking place at the three-month maturity; but the unwinding of such operations in April was not large enough to

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	Q3	Q4	Q1	Q2
Sterling deposits					
Other financial institutions	+15.6	+ 3.3	+ 3.6	+ 2.7	+ 4.1
ICCs	+10.1	+ 2.6	+ 2.3	+ 0.9	+ 2.4
Persons	+ 8.2	+ 2.3	+ 2.7	+ 3.2	+ 2.8
Total	+33.8	+ 8.1	+ 8.6	+ 6.8	+ 9.2
of which, transit items allocated to ICCs	*− 0.2*	*+ 0.8*	*− 0.1*	*+ 0.9*	*− 0.8*
Sterling lending					
Other financial institutions	+10.5	+ 2.6	+ 2.1	+ 2.4	+ 2.6
ICCs(b)(c)	+ 9.7	+ 4.3	+ 4.0	+ 5.6	..
Persons(c)	+18.2	+ 4.5	+ 5.5	+ 4.8	
Total	+38.4	+11.4	+11.6	+12.8	+15.4
of which, transit items allocated to ICCs	*− 0.1*	*+0.5*	—	*+ 0.6*	*− 0.5*
Foreign currency deposits					
Other financial institutions	+ 7.1	+ 2.4	+ 1.6	+ 0.2	+ 0.3
ICCs	− 0.4	− 0.4	+ 0.6	+ 0.1	− 0.7
Persons	+ 0.2	—	+ 0.2	+ 0.1	+ 0.2
Total	+ 6.8	+ 2.0	+ 2.4	+ 0.4	− 0.2
Foreign currency lending					
Other financial institutions	+ 7.1	− 1.2	− 0.6	− 0.1	− 0.6
ICCs	+ 3.3	− 0.1	+ 0.6	+ 2.1	+ 2.1
Persons	+ 0.1	+ 0.1	− 0.2	− 0.1	+ 0.1
Total	+10.5	− 1.2	− 0.2	+ 1.9	+ 1.5

(a) Seasonal adjustments constrained over the calendar year.
(b) Includes Issue Department take up of commercial bills and guaranteed shipbuilding paper.
(c) See footnote to Table 12.3 of the statistical annex.

Contributions to growth of deposits with, and borrowing from, banks and building societies



show clearly in the banking figures for that month, though heavy lending to corporate business in general will have helped to maintain the size of the bill market.

Within the industrial sector, manufacturing companies' borrowing from banks in the three months to May (not seasonally adjusted) was noticeably higher than over the previous three months; it increased by 21% over the year to end-May, with most of the increase concentrated in the second half of that year. This lending in part reflects the pick-up in investment by manufacturing companies during the first quarter, which is likely to have continued into the second. Lending to the construction industry and property companies continued to grow rapidly: over the year to end-May lending to the construction industry grew by 37% (£2¼ billion) and that to property companies by 56% (£5¾ billion).

Personal sector deposits with banks and building societies increased even more rapidly in the second quarter than in the first, maintaining the acceleration seen since the stock market fall in October. Tax rebates disbursed in June might have contributed to this growth at the very end of the period. Inflows to building societies were again particularly buoyant, reflecting partly their increased interest rate competitiveness in April and May, but also the perception of the societies as a safe haven for savings.

Net borrowing by the personal sector from the banks and building societies has increased during the 1980s as the saving ratio has fallen. Despite the recent rapid growth in deposits, this trend has been sustained and the personal sector's net recourse to banks and building societies increased sharply in the latest quarter. Persons' borrowing accelerated rapidly, with the household sector's borrowing, both on mortgage and otherwise, very buoyant. The twelve-month growth rate of lending by banks and building societies on mortgage increased to 19.6%, with building societies raising further their share of new mortgage lending within M4.

Among the financial institutions, borrowing grew a little more slowly than in the first quarter. Bank borrowing by securities dealers, both in sterling and in foreign currency, increased in the three months to May, after remaining flat or falling in the period immediately before and after the October 1987 equity market fall; bank borrowing by leasing companies continued to increase, perhaps reflecting higher company investment.

Growth in financial institutions' deposits in the second quarter was similar to that of the previous six months. The fuller bank deposit figures available for the first quarter show that the modest rise in financial institutions' deposits consisted of contrasting movements in deposits of different groups of institutions. Life assurance and pension funds' deposits continued the strong rise which began when the stock market fell; investment and unit trusts ran down their bank deposits sharply, a reflection of their low inflows.

Official operations in financial markets

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

During the three months under review the central government had an almost balanced cash position, after taking into account

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

Calendar months	Apr.– June 87	Jan.– Mar. 88	Apr.– June 88	July 87– June 88
Factors affecting the market's cash position				
CGBR (+)	+4.0	−2.1	+0.1	−3.2
of which, on-lending to local authorities and public corporations	*+2.3*	*+1.4*	*+1.7*	*+3.5*
Net sales (−) of central government debt(a)	−2.2	−1.9	+1.2	−5.7
of which: Gilt-edged	*−1.4*	*−1.7*	*+1.4*	*−4.3*
National savings	*−0.6*	*−0.7*	*−0.4*	*−1.9*
CTDs	*−0.2*	*+0.5*	*+0.2*	+0.5
Currency circulation (increase −)	−0.4	+0.2	+0.3	−1.2
Reserves etc	+4.6	+0.6	+0.6	+7.5
Other	−0.2	−0.3	−0.9	−1.3
Total (A)	**+5.8**	**−3.5**	**+1.3**	**−3.9**
Official offsetting operations				
Net increase (+) in Bank's commercial bills(b)	−2.3	+2.4	−1.0	+3.8
Net increase (−) in Treasury bills in market	−1.3	+1.0	−0.3	+0.3
Securities(c) acquired (+) under sale and repurchase agreements with banks	−1.1	—	—	—
Other	−1.2	—	+0.2	−0.1
Total (B)	**−5.9**	**+3.4**	**−1.1**	**+4.0**
Changes in bankers' operational balances at the Bank (= A + B)	−0.1	−0.1	+0.2	+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 G
Financing of the public sector
£ billions: *seasonally adjusted (financial year constrained)*

Calendar months	Oct. 87– Dec. 87	Jan. 88– Mar. 88	Apr. 88– June 88	July 87– June 88
Central government borrowing on own account	− 1.7	−1.8	−3.2	−6.3
Other public sector borrowing(a)	− 0.7	+0.2	+0.8	+0.1
PSBR	**− 2.3**	**−1.6**	**−2.3**	**−6.2**
Net sales of central government debt to the private sector(b)	− 3.0	−1.9	+0.6	−3.2
of which: Gilt-edged stocks	*− 2.7*	*−1.0*	*+0.7*	*−1.7*
National savings	*− 0.3*	*−0.8*	*−0.4*	*−1.8*
CTDs	*+ 0.2*	*−0.3*	*+0.2*	*+0.3*
Net sales of local authorities' and public corporations' debt to the private sector(b)	—	+0.2	+0.4	+0.7
External and foreign currency finance of the public sector	+ 5.6	+1.6	+0.2	+5.4
of which, gilt-edged stocks	*− 0.3*	*−0.1*	*−0.5*	*−3.1*
Total financing of the public sector from the private(b) and overseas sectors	**+ 0.3**	**−1.7**	**−1.2**	**−3.4**

(a) Includes on-lending from central government to local authorities and public corporations.
(b) Non-bank non-building society private sector.

receipts from the final calls secured on the privatisations of British Gas and British Airports Authority. With a net redemption of central government debt, a fall in the currency circulation and modest official sales of sterling in the foreign exchange market, this meant that there was a small fall in the amount of money-market assistance outstanding.

Money-market operations

There were particularly heavy cash shortages in the money market during the second half of April, reflecting heavy maturities of bills in the Bank's portfolio and a central government surplus. Moreover, for part of this period the money market was optimistic about the near-term outlook for interest rates and reluctant to sell longer paper to the Bank. In order to handle the largest of these shortages, the Bank offered, on eight successive days, sale and repurchase facilities in bills to the discount houses, with 3–4 week maturities. The daily shortages averaged £870 million in April (compared with £410 million in March); the daily volumes of maturing assistance averaged £820 million.

In May the market had become less optimistic about interest rate prospects and sold more longer-dated bills, especially in the first two weeks. Maturing repurchase facilities served to keep the daily shortages high, averaging £620 million, with the daily volumes of maturing assistance averaging £660 million, but during June the daily shortages were very much smaller, averaging £180 million with maturing assistance averaging only £260 million daily: there was a money-market surplus on four days and a flat position on three. When assistance was required, the bearish mood of the market elicited offers of mainly longer-dated paper.

At the end of March, outstanding assistance (excluding that provided through dealings in Treasury bills) amounted to £9.7 billion, consisting almost entirely of eligible bills held outright. By the end of April, the total had increased to £10.1 billion, of which £3.6 billion were in the form of bills held under sale and repurchase agreements. At end-May, total assistance outstanding had fallen to £9.6 billion, including bills of £0.6 billion for subsequent resale and market advances outstanding of £0.7 billion. At the end of the quarter almost all of the £8.9 billion of outstanding assistance was in the form of eligible bills held outright. The reduction in the amount of official assistance outstanding to the money market over the three months would have been larger but for a small increase in the amount of Treasury bills in market hands.

Over the period, discount houses progressively reduced the size of their eligible bank bill holdings, from £5.5 billion at the begining of April to £3.0 billion at the end of June, and shortened their books, with the proportion of bills of residual maturity of more than one month falling from 45% to 36%. As the size of the daily shortages diminished, the proportion of sales which were to the Bank fell, from 85% in April to 50% in June.

Gilt-edged operations

The aim of the authorities for the financial year 1988/89, as stated in the *Financial Statement and Budget Report,* is to fund the total of maturing debt (net of the overall PSDR), and any underlying change in the foreign exchange reserves, by sales of debt outside the bank and building society sectors.

Table H
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
2½% Index-Linked Treasury 2011	100	13/4	Direct to Bank	13/4	109.0000			3.77(b)	24/5
2½% Index-Linked Treasury 2020	100	13/4	Direct to Bank	13/4	96.0000			3.63(b)	12/7
8% Treasury 1992	150	20/5	To National Debt Commissioners	20/5					
8¼ Treasury 1993	800	20/5	Minimum price tender	25/5	97.2500	40.00	57.25 (27/6)	8.98	25/5
2% Index-Linked Treasury 1994	400	27/5	Tender, no minimum price	2/6	95.2500(c)	40.00	55.25 (18/7)	2.97(b)	

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

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

Calendar months	Apr. 87– June 87	July 87– Sept. 87	Oct. 87– Dec. 87	Jan. 88– Mar. 88	Apr. 88– June 88
Gross official sales(a)	+4.0	+2.6	+3.8	+3.1	+0.9
less					
Redemptions and net official purchases of stock within a year of maturity	−2.6	−1.2	−1.3	−1.4	−2.3
Equals net official sales(b)	+1.4	+1.4	+2.5	+1.7	−1.4
of which, net purchases by:					
Monetary sector(b)	*−1.4*	*+0.2*	—	*+0.8*	*−1.5*
Building societies	*+0.1*	*+0.2*	*−0.5*	*−0.2*	*+0.4*
Overseas sector	*+1.0*	*+2.2*	*+0.3*	*+0.1*	*+0.5*
Non-bank non-building society private sector	*+1.7*	*−1.3*	*+2.7*	*+1.0*	*−0.7*

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 K
Changes in UK official reserves
$ millions

	1988 Apr.	May	June
Change in reserves	**+ 338**	**+ 676**	**− 14**
of which:			
Net borrowing (+)/payment (−) of public debt	− 228	− 138	− 98
Valuation change on roll-over of EMCF swap	+ 52	—	—
Underlying change in reserves	+ 514	+ 814	+ 84
Level of reserves (end of period)	**47,857**	**48,533**	**48,519**

The strength of government finances meant that the funding need during the quarter was very modest. Against this background the authorities needed to issue less stock than for some considerable time (see Table J). In total, including the receipt of calls already secured, gross official sales of stock amounted to £0.9 billion over the period. However, these were more than offset by redemptions and official purchases of stock nearing maturity, so that stock outstanding in market hands fell by £1.4 billion. This favourable technical position in the gilt-edged market was not reflected in generally lower yields, partly because of market concerns about monetary and economic developments, and partly because of heavy issues of eurosterling bonds, amounting to £2.9 billion in the second quarter.

Banks and building societies made net sales of gilts of £1.1 billion, although building societies alone made net purchases of £0.4 billion. The overseas sector continued to make net purchases, but although their net purchases of £0.5 billion were greater than in the previous two quarters, they remained lower than the quarterly average seen in 1987. The non-bank non-building society private sector and the overseas sector together made net sales of £0.2 billion of stock, but despite this the public sector was overfunded by £1.2 billion (seasonally adjusted) over the quarter, because of the strength of the government's cash position.

On 2 August the Bank announced that the fourth auction of gilt-edged stock, to be held on 10 August, would be for £750 million of 8½% Treasury 1994 'A', partly-paid with a call of £50 on 19 September.

Official reserves

Over the three months to end-June the official reserves increased by $1 billion. In underlying terms the reserves increased by $1.3 billion between end-March and end-May but changed very little in June.

Market developments

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

The period under review can be divided into two distinct sub-periods, distinguished by changing sentiment towards sterling on the foreign exchanges; until the middle of the period there was considerable upward pressure, but this subsequently subsided to a significant degree. This early pressure on sterling provoked cuts in interest rates, but market concerns about inflation steepened the yield curve. When pressure on sterling subsided after mid-May, interest rates were raised and yields on gilt-edged stocks moved higher.

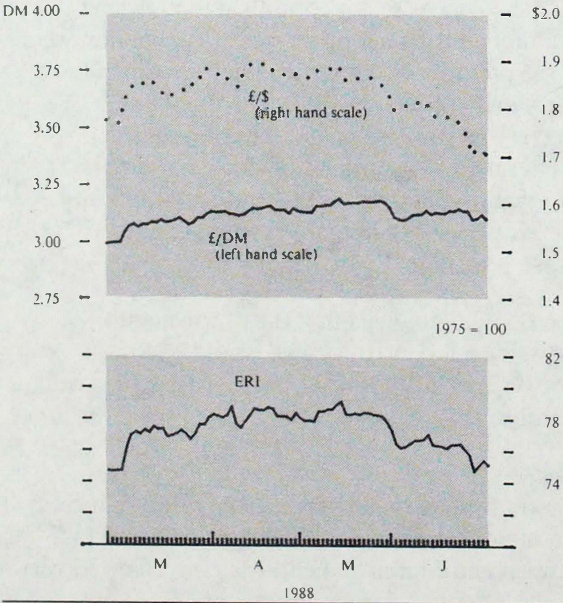
At the beginning of the period, sterling stood at ERI 78.2, $1.8840 and DM 3.1227, following the ½% reduction in the general level of interest rates on 17 March. Banks' base rates were 8½%, and interbank rates at the one, three and twelve months' maturities were 8 9/16%, 8 19/32% and 9 1/16% respectively, with little evidence of pressure for a change in either movement in the overall level of rates or in the slope of the yield curve. Prices in the gilt-edged market had recovered a little from the depressing effect of the trade deficit in February announced in late March, with yields of 9 1/32%, 9 1/16% and 9 11/32% in the short, medium and long maturities at the beginning of April, and a real rate of return on a long index-linked stock of 3¾% (calculated before tax and assuming a 5% rate of inflation).

The upward pressure on sterling seen in March continued in April and early May, and banks' base rate fell to 7½%

After sustained upward pressure on sterling late in March, the dollar firmed early in April, on market speculation that the forthcoming G7 meeting would place a floor to its value. Although this served to restrain sterling against the dollar, the pound continued to strengthen against the deutschemark, pushing towards DM 3.14 in London and breaking that level in New York on 7 April. To offset the implied tightening in overall monetary conditions, the Bank signalled a ½% reduction in the overall level of interest rates on 8 April by the announcement of 2.30 pm lending at 8%; banks' base rates followed soon after.

Sterling exchange rates

At the close of business in London each day

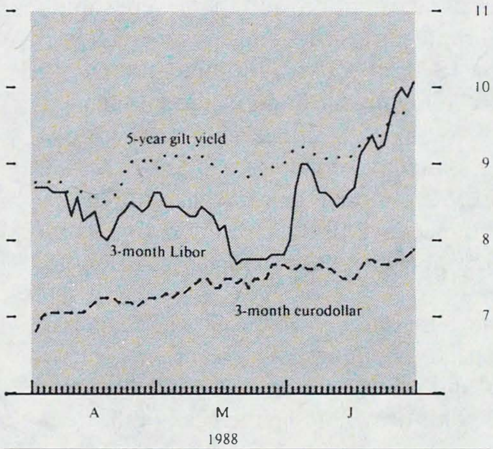


In the following days sterling fell back, partly in anticipation of the G7 meeting. However in the wake of disappointing US trade figures announced on 14 April, sterling moved up sharply not only against the dollar but also against other currencies, supported by firmer oil prices. Some further support was given by the publication on 21 April of UK money and banking figures for March, which were interpreted as giving little scope for further reductions in interest rates; by 22 April the pound had reached an ERI of 78.8 and was trading above $1.89 and DM 3.15. Subsequent profit-taking ahead of the UK trade figures for March, and following the Chancellor's comments on 24 April that further rises in sterling would be unsustainable, pushed the effective index down to 77.9 during the morning of 29 April.

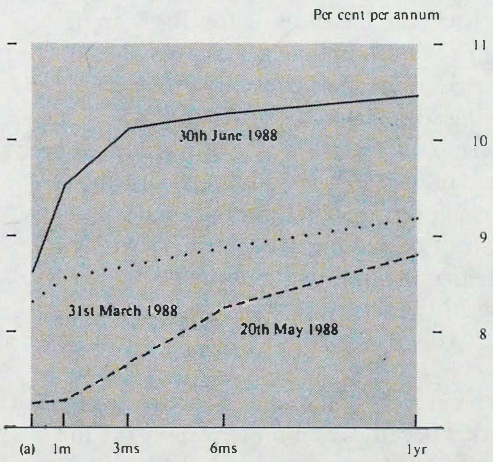
The initial estimate of an improved current account deficit for March of £254 million, announced later that day, caused some reversal of these losses, but the effect was more than offset by weaker oil prices in the wake of OPEC's failure to agree production cuts, and the ERI fell to 77.9 on 6 May. However, market analysis suggesting that the pound was undervalued against the deutschemark re-established a bullish tone, and with the mark itself softening, sterling strengthened sharply. By 16 May sterling had reached ERI 79.2, the highest level for nearly three years, and $1.8922 and DM 3.1916.

Sterling turned down following the Bank's signal on 17 May, through 2.30 pm lending at 7½%, of a further ½% reduction in the

Short-term interest rates and yields in London over the quarter

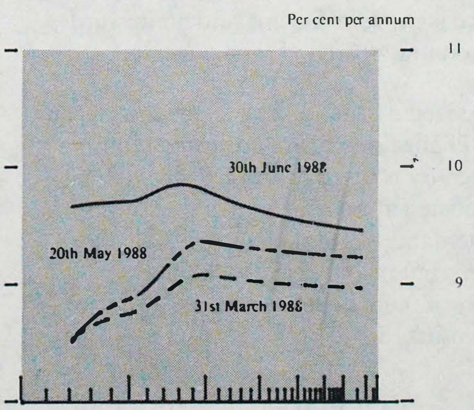


Sterling interbank rates



(a) For one week.

Time/yield curves of British government stocks



level of interest rates, and the parallel reduction of clearing banks' base rates. By the close of business that day it stood at ERI 78.4, \$1.8612 and DM 3.1700. However, despite the much improved US trade deficit of \$9.7 billion in March, published on 17 May, it retained a firm undertone, varying little from these values in the thin markets which preceded the publication of UK trade figures for April due on 27 May.

The domestic money markets then looked for higher interest rates

The strength of demand for sterling resulted in part from the size of the interest rate differential between the United Kingdom and overseas, and in part from concern about the prospects for the dollar in the absence of evidence of a sustained improvement in the US current account, as well as from more general bullish sentiment towards the prospects for the UK economy. In contrast, the domestic money market and the gilt-edged market were more cautious and, despite the strength of sterling, little sustained market pressure had developed to push rates below $8\frac{1}{2}$%. The discount market ran large books but mainly confined to short-dated paper, and expectations that interest rates might move lower did not push bill rates significantly below the Bank's established buying rates.

At the longer end of the market, increasing evidence of the strength of domestic demand pushed the money-market yield curve steeper as short-term rates moved lower. At the beginning of April the three-month interbank rate was $8\frac{19}{32}$%, and was little changed ahead of the $\frac{1}{2}$% reduction in base rates on 8 April; by 18 April it had fallen to 8%, but subsequently firmed to $8\frac{3}{8}$% on concern about the growth of credit, with parallel firming in bill rates. Despite sterling's increasing strength it remained above 8%, though it fell to $7\frac{13}{16}$% immediately after the cut in base rates to $7\frac{1}{2}$% on 17 May. The positive differential between three-month and twelve-month rates was $\frac{1}{2}$% on 8 April, when base rates were cut to 8%; it then widened to fluctuate around $\frac{3}{4}$%, and by 17 May was $\frac{7}{8}$%. Following the further $\frac{1}{2}$% reduction in base rates that day it widened again to more than 1%.

This steepening in the interbank yield curve reflected the view that the lower interest rates moved, the greater the likelihood that the next move would be upwards. This view was reinforced by economic indicators that pointed to continued buoyancy in domestic demand. Although in April there were some signs that demand might be slackening, with retail sales in March slowing, these soon proved to be misleading. The monetary aggregates continued strongly, with M0 growing above its target range and lending, particularly to the personal sector, growing rapidly, by £6.6 billion in March (published on 21 April) and by £8.2 billion in April (published on 19 May). Indications of emerging inflationary pressure, together with higher commercial interest rates in the United States, served to make the domestic money market increasingly nervous about the future path of interest rates.

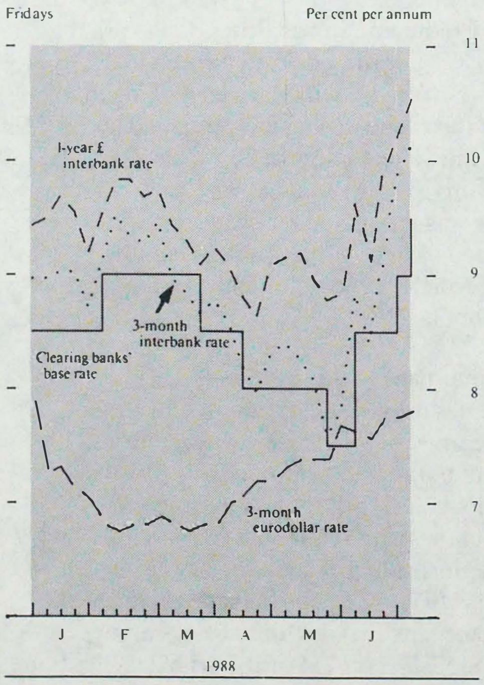
The gilt-edged market was particularly bearish

These concerns were also present in the gilt-edged market. April began with prices drifting a little easier, after recovering in the last few days of March from the depressing effect of the trade deficit in February announced on 25 March. The $\frac{1}{2}$% reduction in interest rates to 8% on 8 April caused some price rises, with the yield on short gilts falling to $8\frac{15}{16}$%, and the 8% Treasury 1991 tranchette was exhausted on that day. Longer conventional yields showed little change but index-linked prices continued to move higher, reflecting worries about inflation, and there were some official sales of the 1992 tranchette; index-linked prices fell back on the announcement on 13 April of two additional index-linked tranchettes. Immediately following the announcement the next day of a $13.8 billion US trade deficit in February, conventional gilt prices fell, but they soon recovered and began to rise as the dollar weakened, and on 15 April the index-linked sector also strengthened on the announcement of the RPI figure for March and on 19 April the 1992 tranchette was exhausted.

By 18 April yields on short, medium and long gilts had fallen to $8\frac{25}{32}$%, $8\frac{31}{32}$% and $9\frac{5}{16}$% respectively, down $\frac{1}{4}$%, $\frac{3}{32}$% and $\frac{1}{32}$% since the beginning of the month, and yields on long gilts moved below those on long US bonds. This proved to be the peak of the market over the quarter.

The banking statistics for March, published on 21 April, removed residual expectations of further interest rate cuts in the near future. Gilt prices fell sharply, and despite intermittent recovery remained lower in a quiet market as sterling weakened ahead of the publication of the UK current account figures for March. The initial estimate of a £254 million deficit was published on 29 April and was better than most market expectations, and prices improved as sterling strengthened. However, the recovery was short-lived as concern mounted about the upward trend in world interest rates ahead of the US bond auctions, and about OPEC's failure to underpin oil prices by reaching an agreement on reduced production limits. Subsequently, sterling's strength in early May induced some firming of prices, but the $\frac{1}{2}$% cut in interest rates to $7\frac{1}{2}$% on 17 May served primarily to steepen the yield curve.

Short-term interest rates in London



After base rates had been cut to $7\frac{1}{2}$%, the money market and the short end of the gilt market became even more responsive to changes in the value of sterling. In the money market the three-month interbank rate settled at around the $7\frac{7}{8}$% level, with the twelve-month rate at $8\frac{3}{4}$%. The effect of economic indicators on the money market primarily depended on their effect on the exchange rate; the current account deficit for April, announced on 27 May, prompted a weakening in sterling and an upward movement in money-market rates.

The short end of the gilt-edged market also weakened as sterling softened: but, with the exchange rate firm and strong retail interest, was robust enough for a new short-dated stock, $8\frac{1}{4}$% Treasury 1993, to be exhausted at issue by tender on 25 May. In the index-linked sector, demand was sufficient to exhaust the 2011 tranchette on 24 May, but prices eased back on the announcement on 27 May of the issue by tender on 2 June of £400 million of 2% Index-Linked 1994.

Sterling weakened in late May and early June and $8\frac{1}{2}$% base rates were quickly re-established

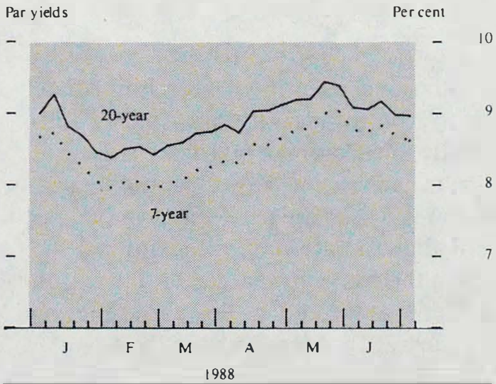
Sterling began to weaken in late May; by 1 June it stood at ERI 77.3, $1.8255 and DM 3.1526. The markets saw this as giving the authorities an opportunity to establish higher interest rates. The three-month interbank rate rose to 8% and short gilt yields moved above 9$\frac{1}{4}$%. The authorities judged a $\frac{1}{2}$% increase in interest rates appropriate, and on 2 June the Bank announced 2.30 pm lending at 8%; banks' base rates followed. Nevertheless by the morning of 6 June the effective index had fallen to 76.2, while the three-month interbank rate had risen to 8$\frac{25}{32}$%.

On 6 June the Bank signalled a further $\frac{1}{2}$% rise in rates by announcing 2.30 pm lending at 8$\frac{1}{2}$%, and banks' base rates moved to this level. In the money market, the three-month interbank rate settled at around 8$\frac{1}{2}$%; but the yield curve retained its steep upward slope, and in the bill market discount rates moved to above the Bank's newly-established buying rate. In the gilt-edged market, prices of longer stocks firmed on the two quick rises in rates, which were interpreted as evidence of the authorities' commitment to maintain downward pressure on inflation. Some further encouragement was given by improved US bond prices on news of the lower US trade deficit in April (announced on 14 June); by 15 June short gilt yields had fallen to 9$\frac{3}{16}$%, from 9$\frac{3}{8}$% on 3 June, and long yields to just under 9$\frac{1}{2}$% from 9$\frac{21}{32}$%, so that the yield curve remained upward-sloping.

Sentiment towards sterling had changed, especially as tighter monetary conditions were established worldwide

The sharp upward revision, to £2.8 billion, of the estimated first quarter current account deficit, published on 16 June, and the £1.2 billion deficit in May, announced on 27 June, contributed to a marked change in sentiment in the foreign exchange market, bringing it more closely into line with the domestic market's perception. In addition, international developments were independently making sterling a relatively less attractive currency. The narrowing in the US trade deficit in March and April changed the market's attitude towards the dollar; and this was then reinforced by signs of tightening in US monetary policy, including the rise in commercial banks' prime rates, by $\frac{1}{2}$%, to 9% on 11 May. This move towards a tighter policy stance was repeated in other countries; in particular a rise in German money-market rates was followed on 21 June by a $\frac{1}{4}$% rise in the Bundesbank's repurchase rate and a $\frac{1}{2}$% rise in the discount rate on 30 June, and by the end of the period interest rates in Japan were also edging upwards.

Gross redemption yields on US government securities

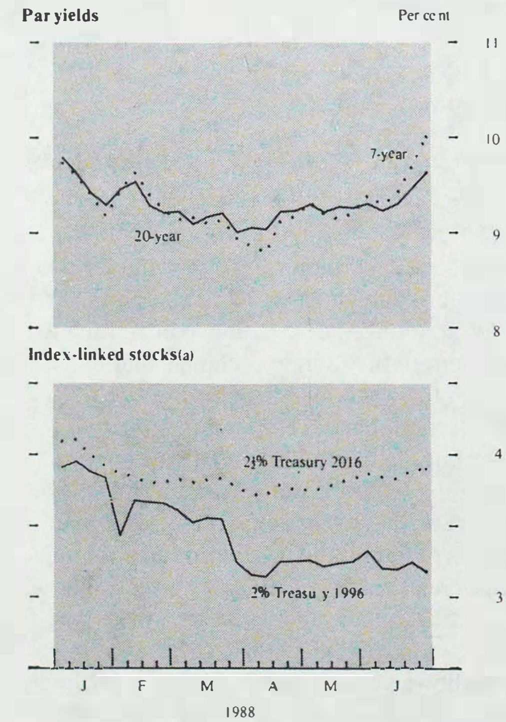


All these factors affected the sterling exchange rate, despite rising interest rates in the United Kingdom (see below). After reaching ERI 77.2 on 13 June, the pound fell sharply the next day against the stronger dollar, after the publication of the US trade figures, and more modestly against the mark as German money-market rates firmed; by 17 June it had fallen to 76.0 on the effective index. Sterling was marked down further ahead of the May trade figures due on 27 June. When these proved far worse than expected sterling fell again, to close at 74.8, \$1.7037 and DM 3.1002.

Domestic demand remained strong and base rates rose by a further 1% by the end of the quarter

The domestic indicators continued to be strong. Although the buoyancy of manufacturing output gave some encouragement in terms of the supply-side response to demand growth, input prices were accelerating, in part because of worldwide commodity price

Gross redemption yields on UK government securities



(a) Real yields assuming 5% inflation.

trends, and provisional estimates of average earnings growth of $8\frac{3}{4}$% in the twelve months to April (published on 16 June) pointed to tightening conditions in the labour market. Retail price inflation rose to 4.2% in the twelve months to May, according to figures released on 17 June, and rapid growth in house prices was becoming geographically more widespread.

After the rise in base rates to $8\frac{1}{2}$% on 6 June, domestic money-market rates were little changed until the stronger dollar and domestic economic indicators increased nervousness about higher base rates. The three-month interbank rate stood at $8\frac{15}{16}$% by Friday 17 June, but after the weekend it opened at $9\frac{7}{32}$%, on press reports of the German authorities' intention to raise their rates. These reports were borne out the next day, and evidence of continuing high bank lending was published on 20 June. Market sentiment became increasingly bearish, so that when the Bank signalled a further $\frac{1}{2}$% rise in the general level of interest rates, lending at 2.30 pm on 22 June at 9%, with clearing banks' base rates following, market interest rates moved up to discount a further $\frac{1}{2}$% rise. By 28 June, the three-month interbank rate had risen to $9\frac{15}{16}$% and the twelve-month rate to $10\frac{9}{32}$%, in response to the trade figures published the previous day. On 28 June the Bank again used 2.30 pm lending to signal a $\frac{1}{2}$% rise in the general level of interest rates and clearing banks' base rates moved up to $9\frac{1}{2}$%. The exchange rate rose on the $\frac{1}{2}$% increase on 22 June, but after the announcement of the May trade figures on 27 June the ERI fell to 74.8. As domestic money-market rates firmed to discount a further 1% rise, there was some recovery, but with the actual increase on 28 June being no more than $\frac{1}{2}$% and with the Bundesbank's discount rate rising by $\frac{1}{2}$% on 30 June this was not sustained.

Sterling ended the quarter at ERI 75.2, \$1.7055 and DM 3.1044, down 4.8%, 9.5% and 0.6% respectively over the period as a whole. At the end of the period, when banks' base rates were $9\frac{1}{2}$%, money-market interest rates at the three and twelve months' maturities were 10% and $10\frac{5}{16}$% respectively, up $1\frac{13}{32}$% and $1\frac{1}{4}$% over the quarter.

In the gilt-edged market the stronger sentiment seen immediately after the establishment of $8\frac{1}{2}$% base rates was not sustained and prices fell from mid-June. By the end of the quarter, yields on short, medium and long gilts had risen to $9\frac{3}{4}$%, $9\frac{25}{32}$% and $9\frac{29}{32}$% respectively, up $\frac{23}{32}$%, $\frac{23}{32}$% and $\frac{9}{16}$% over the period as a whole. With increasing market concern about inflation, the index-linked sector was more robust than the conventional sector during June and over the period as a whole: at the end of the quarter the yield on $2\frac{1}{2}$% Index-Linked Treasury 2016 was $3\frac{29}{32}$%, up only $\frac{5}{32}$%.

Market expectations of higher interest rates increased in the first two days of July and on 4 July the three-month interbank rate opened at $10\frac{9}{32}$%. The Bank signalled that a $\frac{1}{2}$% increase in the general level of interest rates was appropriate, by lending at 2.30 pm at 10%, and clearing banks' base rates increased in parallel. However market rates continued to rise, and on 18 July the Bank signalled a further $\frac{1}{2}$% rise by lending at 2.30 pm at $10\frac{1}{2}$%, and clearing banks' base rates also rose to $10\frac{1}{2}$%.

Market turnover

Transactions in eligible bank bills by discount houses, including sales to the Bank, averaged £1.2 billion daily over the quarter. Declining money-market shortages and the development of bearish sentiment were reflected in the declining daily average within the period, from £1.6 billion in April, to £1.4 billion in May and £0.7 billion in June.

Despite the predominantly bearish mood in the gilt-edged market, total turnover in gilts was only a little lower over the three months as a whole than in the first quarter, averaging £4.4 billion a day compared with £4.6 billion. However, activity was subdued in May, with turnover averaging only £3.9 billion per day and with medium and long stocks particularly inactive. Total turnover was divided almost equally between intra-market transactions and those with outside customers.

Activity in the futures market was also more subdued. Average daily turnover in the long gilt futures contract on the London International Financial Futures Exchange was 21,000 contracts (£1.1 billion in cash terms), compared with 28,500 contracts in the previous quarter. As in the cash market, May was the least active month, with daily turnover averaging only 19,500 contracts. Interest in the medium gilts contract was minimal throughout the period, with daily turnover averaging only 130 contracts. When the September long gilt contract began trading, its notional coupon was 9%, compared with 12% on earlier contracts. This was done to ensure a sufficient supply of relatively cheap-to-deliver stocks; the 12% notional coupon had caused just one long stock to stand out from the others as cheap-to-deliver. It also brought it into line with the notional coupon on the medium gilt contract, and may have had an expansionary effect on turnover because more contracts were needed to hedge a given cash position. During the quarter there were maturities of £100 million of outstanding call warrants exercisable into gilt-edged stock; there being no new issues, this left the total outstanding at the end of the period at £700 million. There were no issues or redemptions of put warrants, the amount outstanding remaining at £550 million.

Sterling commercial paper

Gross issues of sterling commercial paper during the second quarter were £7,554 million, compared with £7,372 million in the previous three months. Redemptions totalled £7,154 million, bringing the total of paper outstanding to £3,264 million at the end of June, compared with £2,864 million three months earlier. By the end of June, 132 programmes had been notified to the Bank, and paper had been issued under 113 of these.

Other capital markets

In the second quarter, the dominant mood in the equity market continued to be one of caution. Prices showed little overall change in April and May, reflecting concern about the effects of sterling's strength on exporting companies and a lacklustre performance by Wall Street. However, they began to edge upwards in June, as sterling weakened against the dollar and Wall Street showed strong gains. Takeover speculation also contributed to higher prices in certain sectors in late May and early June. The FT-Actuaries all-share index reached 970 on 23 June, the highest level since the October 1987 fall in prices. However, on average, prices as measured by this index were just $2\frac{1}{2}$% higher in the second quarter than in the first, and remained more than 20% lower than the level immediately before 19 October.

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

	1987			1988	
	Q2	Q3	Q4	Q1	Q2
UK private sector					
Loan capital and preference shares	+ 435	+ 750	+ 544	+ 83	+ 298
Equity	+2,122	+7,298	+3,740	+351	+1,747
Unit trusts	+1,234	+2,982	+ 389	+355	+ 416
Issues on the unlisted securities market	+ 184	+ 457	+ 215	+102	+ 139
Local authorities					
Stocks	− 14	− 35	− 3	—	—
Bonds	− 56	− 28	− 16	− 5	− 15
Overseas	+ 11	—	+ 177	—	—

New equity issues to raise almost £1.6 billion were announced in the second quarter, roughly twice as much as in the first. However, this increase was largely due to the announcement of a single rights issue, by Barclays Bank for £921 million; the underlying level of new issues showed little change and remained well below pre-October 1987 levels. In contrast, announcements of issues of loan capital and preference shares, including convertibles, showed further strong growth: they amounted to £0.8 billion in the second quarter, compared with £0.4 billion in the previous three months and £2.3 billion in the whole of 1987. This buoyancy reflected a generally favourable economic climate; in particular, sterling's strength on the foreign exchanges in April and May encouraged overseas interest in sterling borrowing, and there was strong investor interest, in part stemming from a decline in issues of gilt-edged stocks. In addition, several issues by British companies were prompted by takeovers; this accounted for the sizable number of issues of convertible preference shares.

Table M
Sterling capital issues: amounts announced
£ millions

	Equities	Fixed-rate(a)			FRNs
			Sterling eurobonds		
		Domestic issues(b)	UK borrowers	Overseas borrowers	
1987	13,891	2,332	3,544	4,413	1,247
Q1	1,803	190	1,431	1,775	250
Q2	3,648	1,146	1,090	1,306	150
Q3	5,956	493	620	507	411
Q4	2,484	503	403	825	436
1988					
Q1	808	436	1,890	1,340	1,090
April	1,127	394	250	745	450
May	275	243	705	555	500
June	176	198	318	370	1,205
1988					
Q2	1,578	835	1,273	1,670	2,155

(a) Of which, £1,025 million was equity-related in the second quarter.
(b) All UK borrowers in 1987 and so far in 1988. Excludes local authority issues.

This buoyancy in fixed-rate issues was seen also in the eurosterling market. A wide range of British and overseas borrowers made fixed-rate issues for widely differing amounts and maturities, bringing total issues so far this year to £6.2 billion, compared with £2.4 billion in the second half of 1987. This increased supply was forthcoming just as new issues of gilt-edged stocks declined rapidly. The Japan Development Bank was the first Japanese public sector borrower to tap the sterling bond market for more than twenty years, and several British and overseas companies made their debut in the sterling eurobond sector of the market. There was, however, only one issue by the bank and building society sectors, in contrast to the first quarter when these categories of borrower were particularly active. A number of issues incorporated innovative features aimed at meeting the particular needs of borrowers or investors. In addition, several issues by British companies were offered to shareholders as a rights entitlement, while being underwritten by an international syndicate of banks; this marked a further significant step in the integration of the formerly quite distinct sterling eurobond market with the domestic capital market.

The flow of fixed-rate eurosterling issues, in particular by overseas borrowers, began to ease in June as sterling slipped on the foreign exchanges and sterling interest rates began to edge upwards. However, this was offset by an increased flow of issues of floating-rate notes. In the second quarter, there were six mortgage-backed issues for a total of £950 million, seven issues totalling £1,005 million by building societies and an innovative variable-rate note for Lloyds Bank which aimed to balance the issuer's desire to minimise borrowing costs against investors' requirement for liquidity.

UK borrowers and their overseas subsidiaries made eighteen bond issues in currencies other than sterling, raising the equivalent of £1 billion, of which 34% were in US dollars and 24% in Swiss francs. Building societies were active borrowers, issuing the equivalent of £322 million, including their first yen-denominated bond issues.