Operation of monetary policy

This article covers the three months from October to December 1988.

Review

Following the series of interest rate increases between June and August, monetary conditions were tightened further late in November, when the emerging indicators showed domestic demand stronger than had been expected when interest rates had last been raised. Since November there have been indications of a slowdown in domestic demand, though they are still not conclusive.

There were signs in the early autumn that mortgage lending had begun to slow down and retail sales to flatten out. However, these tentative indications of moderation in domestic demand were not corroborated by any other evidence; and the indicators for October—a sharp increase in retail sales, continuing inflationary pressures and a record current account deficit—showed that domestic demand was stronger than had been expected. In response, interest rates were increased by one percentage point on 25 November, with banks' base rates rising to 13%. Market sentiment had shifted towards the end of October to an expectation that interest rates might need to rise from 12% at some stage, but the indicators which were published in November and the move to 13% immediately after the announcement of the October current account deficit surprised the markets. Market nervousness in the aftermath of the increase in interest rates soon gave way to optimism that the next move would be downwards, albeit not until well into 1989, and this was reflected in the level and slope of the money-market yield curve in the second half of December. Sterling was generally firm during the period and ended the quarter 2.5% up in effective terms.

More recent economic indicators show signs of moderation, though they are still not conclusive. Retail sales declined in November and December; the reduction in house price inflation has been sustained, with the cooling in the housing market in the South East spreading steadily to other regions; and the fiscal position is even tighter than had been expected.

The money and credit aggregates are also beginning to exhibit some signs of moderation. The twelve-month growth rates remain high, with M0 growth of 7.7% over the year to December (seasonally adjusted) remaining well above the target range of 1%–5%. However, the three-month growth of all the main aggregates peaked in September and declined quite sharply thereafter.

Among the counterparts to broad money, sterling lending by banks and building societies to the private sector slackened to £18.8 billion in the period under review, from £22.4 billion and £22.5 billion in the second and third quarters respectively. Higher

Table A
Growth rates of the monetary aggregates[a]
Percentages; *seasonally adjusted (financial year constrained)*

	12 months to end-Sept. 88	12 months to end-Dec. 88	1988 Q3	1988 Q4
M0(b)	+ 8.5	+ 7.7	+3.4	+1.1
Non-interest-bearing M1	+12.4	+12.7	+1.3	+4.3
M1	+17.4	+14.4	+2.8	+1.7
M2	+16.9	+16.9	+4.2	+3.2
M3	+22.7	+20.4	+6.6	+3.8
M3c	+20.3	+18.8	+6.1	+3.5
M4	+18.5	+17.3	+5.7	+3.2
M5	+17.8	+16.4	+5.5	+3.0

(a) See the statistical annex for definitions.
(b) Weekly average.

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

		1988 Q3	1988 Q4	Level outstanding at end-Dec. 88
1	Non-interest-bearing M1	+ 0.6	+ 2.1	50.3
2	Interest-bearing sight deposits	+ 2.1	− 0.3	54.2
3	**M1 (= 1+2)**	**+ 2.8**	**+ 1.8**	**104.5**
4	Private sector holdings of time deposits with banks and bank CDs	+10.5	+ 6.3	118.2
5	**M3 (= 3+4)**	**+13.3**	**+ 8.1**	**222.7**
6	Building society holdings of M3	− 0.3	+ 1.3	18.3
	Non-bank private sector holdings of:			
7	Building society shares and deposits	+ 5.1	+ 4.6	150.5
8	Building society £CDs and time deposits(b)	− 0.2	− 0.2	2.6
9	**M4 (= 5−6+7+8)**	**+18.6**	**+11.2**	**357.4**
10	Non-bank, non-building-society private sector holdings of money-market instruments and national savings in M5	+ 0.4	− 0.3	15.4
11	**M5 (= 9+10)**	**+19.0**	**+10.9**	**372.9**

(a) See the statistical annex for definitions.
(b) Excluding holdings by building societies themselves.

Table C
Counterparts to changes in M3, M4 and M5[(a)]

£ billions: *seasonally adjusted figures (financial year constrained)*

	Counterparts to M4			Counter-parts to M3	Counter-parts to M5
	1988		12 months to end-Dec. 88	12 months to end-Dec. 88	12 months to end-Dec. 88
	Q3	Q4			
1 PSDR (−)	− 3.3	− 3.5	−11.3	−11.3	−11.3
2 Net purchases (−) of central government debt by the 'private' sector(b)(c)	+ 1.1	+ 3.0	+ 3.1	+ 2.9	+ 3.7
3 Net purchases (−) of other public sector net debt by the 'private' sector(b)(c)	—	+ 0.2	+ 0.4	+ 2.0	+ 0.4
4 External and foreign currency finance of the public sector	+ 1.2	+ 0.3	+ 3.4	+ 3.4	+ 3.4
5 Public sector contribution (= 1+2+3+4)	− 1.0	+ 0.1	− 4.4	− 3.0	− 3.8
6 Sterling lending to the 'private' sector(b)(d)	+22.5	+18.8	+81.3	+56.7	+80.7
7 Other counterparts(e)	− 2.9	− 7.6	−24.3	−16.1	−24.3
8 **Total** (= 5+6+7) = change in the aggregate	**+18.6**	**+11.2**	**+52.6**	**+37.6**	**+52.5**

(a) See the statistical annex for definitions.

(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 increases (−) in net non-deposit liabilities.

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

	Persons	ICCs	Building societies	Other OFIs
M3 components				
Percentage growth	20.1	12.4	31.8	26.7
Contribution to M3 growth(b)	9.7	3.2	2.6	4.8
M4 components				
Percentage growth	17.5	11.2	—	26.1
Contribution to M4 growth(b)	12.5	1.9	—	3.0
M3 credit counterparts				
Percentage growth	26.3	31.9	8.4	23.8
Contribution to M3 credit growth(b)	11.1	11.1	0.3	4.6
M4 credit counterparts				
Percentage growth	21.6	32.8	—	23.8
Contribution to M4 credit growth(b)	14.2	7.2	—	2.9

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

(b) Percentage points.

interest rates appear to have affected in particular borrowing by the personal sector, which has become more highly geared and now pays out more in interest on its floating-rate liabilities than it receives on its floating-rate assets. Personal sector borrowing from banks and building societies fell from £13.7 billion in the third quarter to £11.2 billion in the fourth and may moderate further when the annual adjustment schemes operated by many mortgage lenders result in increased repayments by borrowers following recent rises in mortgage rates. Meanwhile, corporate sector borrowing slowed only slightly over the period under review; this sector has remained very profitable with wide margins, and its investment intentions remain strong, notwithstanding the movements in short-term interest rates and the pressures resulting from the strength of sterling.

Monetary aggregates and credit

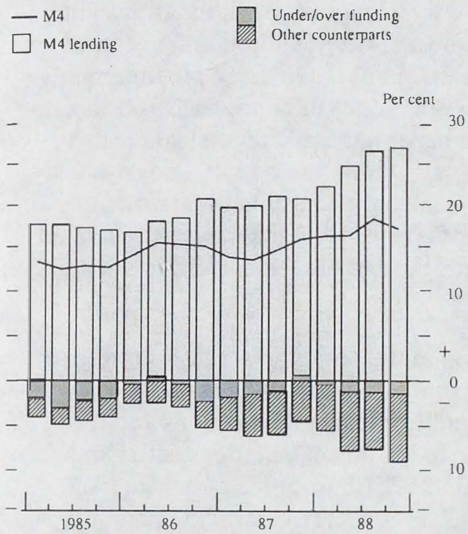
The figures in this section are seasonally adjusted.

Growth of both broad and narrow money was lower in the three months to December than in the previous three months. M0 was temporarily inflated in September as a result of the Post Office strike, and the unwinding of this effect meant that the scale of the underlying slowdown in M0 between the third and fourth quarters is exaggerated by the recorded figures. Within the counterparts to broad money, sterling lending by banks and building societies to the private sector decelerated, particularly to persons, though its pace remained rapid. There was also a resumption of a large amount of external financing of banks, probably associated with the current account deficit. The twelve-month growth rates of all the broad money aggregates fell, but not dramatically; for example, that of M4 was down from 18.5% in September to 17.3% in December.

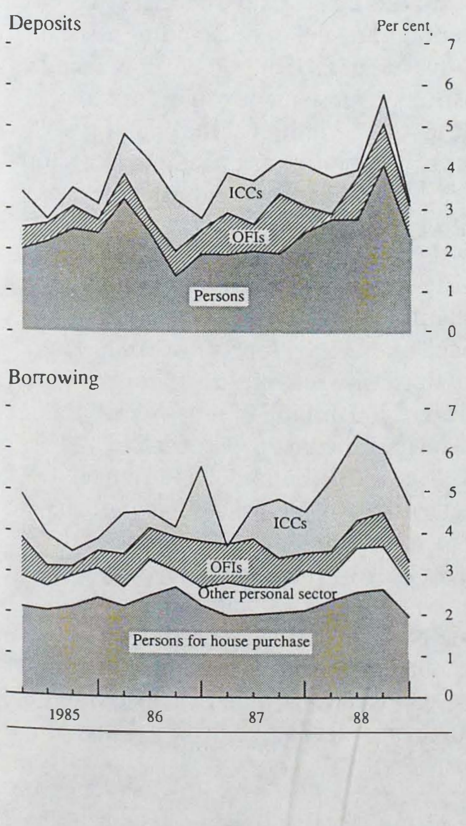
There was a further large PSDR in the fourth quarter (including receipts of £1.1 billion from the privatisation of British Steel), almost entirely offset by a reduction in holdings of public sector debt by the private sector other than banks and building societies. In particular, there was a large redemption of government stock early in the quarter. The change in the government's funding stance that has resulted from the emergence of a PSDR has created an opportunity for other sectors to raise funds through the issuing of fixed-rate sterling debt (see the note on page 34).

Lending by banks and building societies slowed during the three months to December after the rapid increases of the previous two quarters. Nevertheless, its annualised growth rate during the three months under review was more than 20%. Lending to the personal sector, both on mortgage and otherwise, grew less rapidly after the exceptional increases during the summer. Lending to industrial and commercial companies slowed slightly, but continued to show the fastest growth rate of any of the main sectors. Lending to other financial institutions was well down on the growth shown over the previous two quarters.

The sharp fall in lending for house purchase that was seen in September, following the ending of multiple tax relief on mortgages, has been followed by further modest declines as demand in the housing market has slowed down. The slowdown in banks' lending to persons for consumption has been even more pronounced. In contrast, lending to unincorporated businesses, Counterparts to annual growth of M4



Sectoral contributions to quarterly growth of deposits with, and borrowing from, banks and building societies



which is also included within lending to the personal sector, maintained the very rapid growth seen in the previous two quarters.

The external counterparts to broad money—the external and foreign currency transactions of banks and building societies—were large and negative in the last three months, probably reflecting the financing of a substantial part of the current account deficit. In 1988 as a whole, the bank and building society external counterparts exerted a negative influence of £11.5 billion (equivalent to almost 3% of M4), largely representing a build-up of net sterling deposits by the overseas sector.

The personal sector's net indebtedness to banks and building societies continues to move erratically, increasing sharply in the fourth quarter following the moderate third quarter rise. Although the sector's borrowing slackened over the quarter, this was more than matched by the slowdown in the acquisition of deposits. Having adjusted their deposit rates so that they were once more in line with general short-term interest rates, building societies were again able to secure the larger share of net retail inflows, a position they had lost to the banks during the third quarter.

Industrial and commercial companies' net recourse to the banks also rose appreciably in the fourth quarter, with borrowings increasing at a pace only a little below that of earlier quarters and their bank deposits rising only modestly. Takeover and merger activity was particularly strong throughout 1988, with a high proportion being cash financed (see the article on pages 78–85). While it is difficult to be precise, it is likely that this explains some of the strength of corporate borrowing, and may also have affected the movements in corporate bank deposits. Lending to construction companies (up 47% in the year to end-November) and to property companies (up 59%) continues to be very buoyant.

Official operations in financial markets

The figures in this section are not seasonally adjusted.

Money-market operations

The central government had a substantial cash surplus over the period under review, including the receipts from the privatisation of British Steel, and there was also a large increase in the note circulation, but these factors were more than offset by a net repayment of central government debt and modest official sales of sterling in the foreign exchange market (see Table F). Whereas in the previous quarter a similar net flow of cash to the money market had resulted in a reduction in the amount of money-market assistance outstanding, in the period under review the cash flow was more than offset by an increase in the amount of Treasury bills in the market and consequently the amount of outstanding assistance increased modestly. In addition, the flow of maturities of bills in the Bank's portfolio increased to more normal levels, so that the daily cash shortages in the money market over the period were significantly higher than in the third quarter.

Daily cash shortages averaged £470 million in October and £460 million in November, more than accounted for by the daily

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

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

	1988				
	Year	Q1	Q2	Q3	Q4
Sterling deposits					
Other financial institutions	+13.6	+ 1.2	+ 5.7	+ 2.9	+ 3.9
ICCs	+ 6.0	+ 2.5	+ 0.3	+ 2.7	+ 0.5
Persons	+16.7	+ 3.4	+ 2.8	+ 7.3	+ 3.2
Total	+36.3	+ 7.0	+ 8.8	+12.9	+ 7.6
of which, transit items allocated to ICCs	*+ 0.1*	*+ 0.9*	*− 0.8*	*+ 0.6*	*− 0.7*
Sterling lending					
Other financial institutions (a)	+10.3	+ 2.2	+ 2.9	+ 3.0	+ 2.2
ICCs(a)(b)	+23.3	+ 5.9	+ 6.3	+ 5.6	+ 5.5
Persons	+23.1	+ 4.6	+ 6.5	+ 6.6	+ 5.5
Total	+56.7	+12.7	+15.6	+15.2	+13.2
of which, transit items allocated to ICCs	—	*+ 0.6*	*− 0.5*	*+ 0.4*	*− 0.4*
Foreign currency deposits					
Other financial institutions	+ 2.3	—	+ 0.2	+ 0.3	+ 1.8
ICCs	+ 0.3	+ 0.2	− 0.6	+ 0.5	+ 0.3
Persons	+ 0.2	+ 0.1	+ 0.1	− 0.1	+ 0.1
Total	+ 2.8	+ 0.3	− 0.3	+ 0.7	+ 2.1
Foreign currency lending					
Other financial institutions	+ 1.1	− 0.1	− 0.5	+ 0.6	+ 1.1
ICCs	+ 8.3	+ 2.1	+ 2.1	+ 2.3	+ 1.8
Persons	+ 0.3	− 0.1	+ 0.1	+ 0.1	+ 0.3
Total	+ 9.7	+ 1.8	+ 1.6	+ 3.0	+ 3.2

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

Table F
Influences on the cash position of the money market

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

	1987	1988		12 months to end-Dec. 88
	Q4	Q3	Q4	
Factors affecting the market's cash position				
CGBR (+)	−1.6	−0.4	−2.2	−4.6
of which, on-lending to local authorities and public corporations	*+0.4*	*+1.3*	*+1.4*	*+5.6*
Net sales (−) of central government debt(a)	−3.0	+1.3	+3.9	+4.4
of which: Gilt-edged	*−2.5*	*+1.6*	*+3.7*	*+4.9*
National savings	*−0.2*	*−0.4*	—	*−1.5*
CTDs	*−0.3*	*+0.1*	*+0.2*	*+1.0*
Currency circulation (increase −)	−1.4	−0.7	−1.2	−1.5
Reserves etc	+5.9	+1.0	+0.8	+3.1
Other	−0.3	+0.5	+0.1	−0.6
Total (A)	**−0.4**	**+1.7**	**+1.4**	**+0.8**
Official offsetting operations				
Net increase (+) in Bank's commercial bills(b)	+2.0	−1.9	+0.9	+0.4
Net increase (−) in Treasury bills in market	−1.4	—	−2.1	−1.3
Securities(c) acquired (+) under sale and repurchase agreements with banks	—	—	—	—
Other	−0.2	+0.2	−0.4	+0.1
Total (B)	**+0.4**	**−1.7**	**−1.6**	**−0.8**
Changes in bankers' operational balances at the Bank (= A + B)	—	—	−0.2	—

(a) Other than Treasury bills.
(b) By the Issue and Banking Departments of the Bank of England.
(c) Gilt-edged stocks and promissory notes related to guaranteed export credit and shipbuilding paper.

volumes of maturing assistance and the net take-up of sterling Treasury bills, which together averaged £540 million and £550 million respectively in the two months. Exchequer transactions injected daily averages of £60 million of cash into the money market in October and £90 million in November. During these two months the Bank was offered predominantly shorter-dated paper in its operations to relieve cash shortages, and the maturing of such paper increased the size of the daily shortages on subsequent days within the period. Longer-dated paper was offered to the Bank only occasionally, at times of market nervousness over the possibility of an increase in interest rates, in particular towards the end of October and in the middle of November.

The average daily position in December was a cash shortage of £430 million, with daily volumes of maturing assistance averaging £300 million and Exchequer transactions and the marked seasonal increase in the note circulation each taking a daily average of £60 million of cash from the money market. Most of the daily cash shortages occurred early in the month and the nervous mood of the market was reflected in offers to the Bank of longer-dated paper, which in turn resulted in relatively light maturities of bills in the Bank's portfolio during the second half of the month.

At the end of September, outstanding assistance (excluding that provided through purchases of Treasury bills) amounted to £7.3 billion, almost all in the form of eligible bills held outright. With maturing assistance exceeding the daily shortages over the first two months of the period, the total of outstanding assistance declined, to a low for the quarter of £5.0 billion on 22 November. However, outstanding assistance subsequently increased to a peak level within the quarter of £7.7 billion at the end of December, with payments of corporation tax resulting in a short period of heavy flows of cash to the Exchequer during the last three days of the quarter.

The weekly tender for thirteen-week sterling Treasury bills had been increased from £100 million to £400 million on 23 September and remained at this level for five weeks. Thereafter, the amount of thirteen-week bills on offer reverted to £100 million, but in addition £400 million of nine-week bills were offered at the four tenders between 28 October and 18 November. The issue of these £3.1 billion of additional bills meant that money-market assistance fell by less than it otherwise would have done during October and November. Some of the additional bills were bought back by the Bank in its daily operations during the period under review and £400 million matured in late December. Nevertheless, some £2 billion of the additional bills remained outstanding at the beginning of 1989, and the running-off of these bills during January helped offset the drain of cash from the money market caused by heavy tax payments in that month.

The Bank announced on 23 January that it would establish money-market dealing relationships with Greenwell Montagu Gilt-Edged and S G Warburg Discount Limited as from 13 February. These firms applied successfully for a money-market dealing relationship with the Bank in response to the paper 'Bank of England operations in the sterling money market' published in October 1988 and reprinted on

Table G
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
2% Index-Linked Treasury 1994	400	27/5	Tender, no minimum price	2/6	95.25(b)	40.00	55.25 (18/7)	2.97(c)	18/10
2½% Index-Linked Treasury 2013	200	21/10	Direct to Bank	21/10	96.00			3.66(c)	28/10

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

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

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

Table H
Financing of the public sector
£ billions: *seasonally adjusted (financial year constrained)*

	1988 Q2	Q3	Q4	12 months to end-Dec. 88
1 Central government borrowing on own account	−3.1	−2.6	−3.0	−10.4
2 Other public sector borrowing(a)	+0.3	−0.6	−0.5	− 0.9
3 PSDR (−)(=1+2)	**−2.8**	**−3.3**	**−3.5**	**−11.3**
4 Net sales (−) of central government debt to the private sector(b)	+0.5	+1.1	+3.0	+ 3.1
of which: Gilt-edged stocks	*+0.7*	*+1.3*	*+3.1*	*+ 4.1*
National savings	*−0.4*	*−0.2*	—	*− 1.3*
CTDs	*+0.1*	*−0.2*	*+0.4*	*+ 0.4*
5 Net sales (−) of local authorities' and public corporations' debt to the private sector(b)	+0.2	—	+0.2	+ 0.4
6 External and foreign currency finance (−) of the public sector	+0.3	+1.2	+0.3	+ 3.4
of which, gilt-edged stocks	*−0.5*	*+0.1*	*−0.6*	*− 1.0*
7 Total financing (−) of the public sector from the private(b) and overseas sectors (=4+5+6)	**+1.0**	**+2.3**	**+3.5**	**+ 6.9**

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

(b) Non-bank non-building society private sector.

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

	1987 Q4	1988 Q1	Q2	Q3	Q4
Gross official sales(a)	+3.8	+3.1	+0.9	−0.1	−1.7
less					
Redemptions and net official purchases of stock within a year of maturity	−1.3	−1.4	−2.3	−1.5	−1.9
Equals net official sales(b)	+2.5	+1.7	−1.4	−1.5	−3.7
of which, net purchases by:					
Monetary sector(b)	—	*+0.8*	*−1.5*	*−0.5*	*−1.1*
Building societies	*−0.5*	*−0.2*	*+0.4*	*+0.4*	—
Overseas sector	*+0.1*	*+0.1*	*+0.5*	*−0.1*	*+0.6*
Non-bank non-building society private sector	*+2.9*	*+1.1*	*−0.7*	*−1.3*	*−3.1*

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.

pages 92–103. These new relationships bring the number of the Bank's money market dealing counterparties to ten.

Gilt-edged operations

In response to the continuing strength of government finances and the relatively modest level of official purchases of sterling over the first nine months of the financial year, the authorities issued very little stock, confining issues in the period under review to the reactivation of an earlier index-linked tap stock and a single tranchette of index-linked stock (see Table G). Moreover, with the objective of funding over the financial year as a whole the total of maturing debt and any underlying change in the foreign exchange reserves, net of the PSDR, by sales of debt outside the bank and building society sectors, the Bank purchased significant amounts of stock in the secondary market. Gross official purchases totalled £1.7 billion over the period and with redemptions of stock and net official purchases of stock under one year's maturity amounting to £1.9 billion, the total of stock outstanding in market hands declined by £3.7 billion. Despite this favourable technical position, yields in the gilt-edged market fell significantly only during October; in the following two months the market was depressed by more general economic and monetary developments.

The heaviest net seller of gilts over the quarter was the private sector other than banks and building societies, which made net sales of £3.1 billion. The overseas sector made net purchases of £0.6 billion, but this was more than offset by net sales of £1.1 billion by banks. The holdings of the building societies remained unchanged. The public sector was nevertheless exactly funded (on a seasonally adjusted basis) over the quarter, reflecting the strength of the government's cash position.

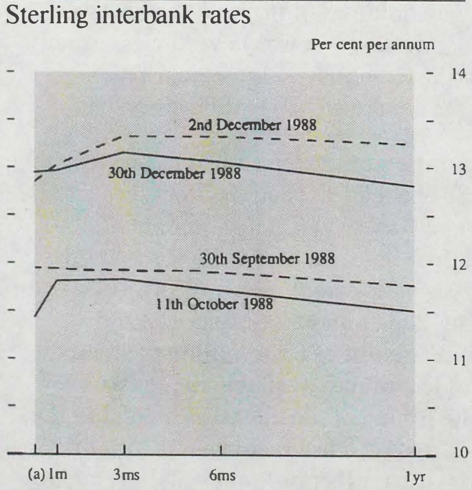
On 14 December the authorities announced a reverse auction for 10% Exchequer Stock 1989 and 11% Exchequer Stock 1989, to be held on 13 January. Holders of these two stocks were invited to apply to sell all or part of their holdings to the Bank either on a competitive offer-price basis or, for small amounts of stock, on a non-competitive basis. The Bank announced that it would purchase up to a maximum amount of £500 million of stock. This extended the range of techniques available to the Bank for purchasing stock, while the timing of the offer was helpful in the management of the money market since it coincided with the seasonal drain of cash from the market in January. At the auction the Bank was offered a total of £1.6 billion of stock and purchased £280.1 million of the 10% Stock at an average accepted yield of 12.44% and £219.1 million of the 11% Stock at an average accepted yield of 12.22%. The prices at which the Bank accepted offers of stock spanned a very narrow range and the average accepted prices were only slightly above the market prices prevailing immediately before the auction.

One gilt-edged market maker, Morgan Grenfell Government Securities Limited, withdrew from the market during the quarter, while another, Hoare Govett Sterling Bonds Limited, announced its withdrawal on 4 January, reducing the number of market makers to twenty-two.

Table K
Changes in UK official reserves
$ millions

	1988		
	Oct.	Nov.	Dec.
Change in reserves	**− 434**	**+ 992**	**+ 645**
of which:			
Net borrowing (+)/payment (−) of public debt	− 1,660	+ 564	+ 184
Valuation change on roll-over of EMCF swap	+ 102	—	—
Underlying change in reserves	+ 1,124	+ 428	+ 461
Level of reserves (end of period)	**50,048**	**51,040**	**51,685**

Sterling interbank rates



(a) For one week.

Official reserves

The official reserves increased by $1.2 billion over the three months to end-December. In underlying terms the reserves rose strongly in October and modestly over the following two months.

ECU Treasury bills

The initial monthly series of six tenders of ECU Treasury bills began on 11 October and continued on 8 November, 13 December and 10 January. At these four tenders the Bank offered a total of ECU 3.1 billion of bills, comprising ECU 1.0 billion at one-month's maturity, ECU 1.3 billion at three months and ECU 0.8 billion at six months, bringing the stock of bills outstanding to ECU 1.9 billion as at 13 January. On average the tenders have been covered 3.6 times. At each tender the average accepted yield at each maturity was significantly below the bid rate for ECU-denominated bank deposits, although as expected this margin narrowed from just below $\frac{1}{4}$% at the first two tenders to $\frac{3}{16}$% at the subsequent two. A secondary market in the bills is developing satisfactorily, with customer interest and market turnover increasing and market participants willing to take positions in the bills.

Market developments

The period under review began in the wake of the rally in financial markets that followed the announcement on 27 September of the UK current account statistics for August. The authorities had signalled their view that a reduction in interest rates was not warranted through the Bank's announcement on the last day of September of 2.30 pm lending at the unchanged rate of 12%. October opened with banks' base rates at 12% and interbank interest rates beginning to react to the Bank's signal. The downward slope of the gilt-edged yield curve, which had become firmly established in August, remained a feature of the market, while the real yield on long index-linked stock had declined steadily during most of September.

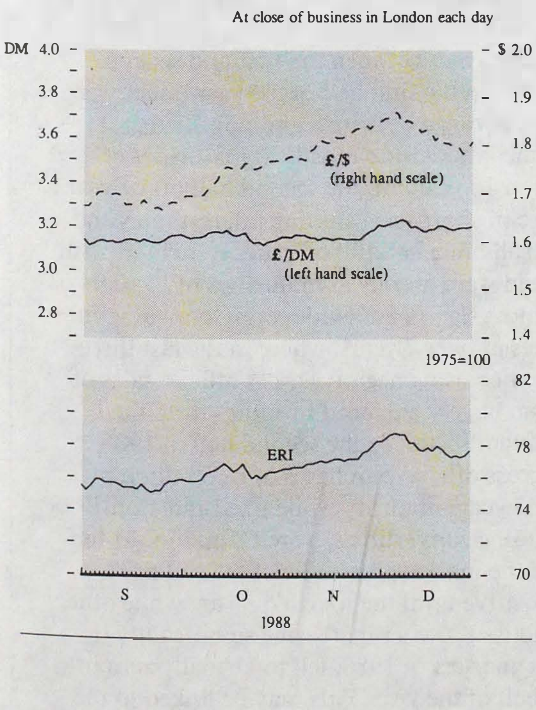
Although the money market's expectations of a reduction in interest rates in the near future soon diminished, with interbank interest rates moving steadily upwards over the first few days of October, the expectation nevertheless persisted that the next move in interest rates, though not likely to occur for a few months, would be downwards. Thus the downward slope of the money-market yield curve beyond three months became increasingly pronounced, with the twelve-month interbank rate rising less than the rates for shorter maturities (see Table L).

Interbank rates eased modestly in response to the marked strengthening of sterling which began on 10 October but, in contrast to the rally at the end of September, sentiment in the money market was not particularly bullish and interbank rates began to drift up again. Thus although the announcement on 13 October of the $12.2 billion US trade deficit in August sent sterling upwards against a weaker dollar, interbank rates moved up in response to domestic economic indicators, including the

Table L
Sterling interest rates, gilt yields and exchange rates

Date	Interbank interest rates (per cent per annum)			Gilt yields (per cent per annum)				Exchange rates		
				Conventionals			Index-linked			
	3 months	6 months	12 months	Short	Medium	Long	Long	ERI	£/$	£/DM
3 October (opening)	$11\frac{29}{32}$	$11\frac{29}{32}$	$11\frac{23}{32}$	$10\frac{1}{16}$	$9\frac{13}{16}$	$9\frac{21}{32}$	$3\frac{7}{8}$	75.9	1.6930	3.1642
11 October (close)	$11\frac{23}{32}$	$11\frac{23}{32}$	$11\frac{1}{2}$	$9\frac{7}{8}$	$9\frac{5}{8}$	$9\frac{15}{32}$	$3\frac{13}{16}$	76.4	1.7190	3.1819
14 October (close)	12	$11\frac{7}{8}$	$11\frac{21}{32}$	$9\frac{15}{16}$	$9\frac{11}{16}$	$9\frac{17}{32}$	$3\frac{25}{32}$	76.9	1.7565	3.1898
19 October (close)	$11\frac{31}{32}$	$11\frac{7}{8}$	$11\frac{5}{8}$	$9\frac{25}{32}$	$9\frac{17}{32}$	$9\frac{13}{32}$	$3\frac{11}{16}$	76.6	1.7525	3.1706
27 October (close)	12	$11\frac{31}{32}$	$11\frac{3}{4}$	$9\frac{3}{4}$	$9\frac{17}{32}$	$9\frac{13}{32}$	$3\frac{5}{8}$	76.3	1.7680	3.1382
8 November (close)	$12\frac{3}{32}$	$12\frac{5}{32}$	12	10	$9\frac{11}{16}$	$9\frac{17}{32}$	$3\frac{17}{32}$	76.7	1.7697	3.1686

Sterling exchange rate



news that underlying average earnings growth had risen to $9\frac{1}{4}$% in the year to August and retail price inflation to 5.9% over the year to September. The three-month interbank rate returned to a level of 12% on 14 October. However, the money-market yield curve remained strongly downward-sloping beyond three months. News of the 1% fall in retail sales in September, published on 17 October, halted but did not reverse the increase in interbank rates and caused sterling to weaken slightly.

The gilt-edged market advanced steadily during the first half of October, assisted by the strengthening of sterling, some modest retail interest, a small rally in US bonds following indications in the United States of slower than expected economic activity, and perhaps by the expectation that UK short-term interest rates were at their peak. Moreover, the technical position created by the PSDR and its implications for the supply of gilt-edged stock exerted downward pressure on yields, particularly at the long end. The combination of lower yields and an upturn in expected rates of inflation resulted in lower perceived real yields on conventional gilts and thereby made the index-linked sector more attractive, with the effect again concentrated on the longer maturities. The 2% Index-Linked Treasury 1994 tap stock, remaining from the issue by tender on 2 June, was reactivated on 14 October and sold out on 18 October.

Market sentiment shifted significantly at the end of the third week of October. Although the market had always realised that a further tightening of monetary conditions might be necessary, the release of the September money and credit figures on 20 October, together with the Chancellor's Mansion House speech that evening, led to a marked change of mood. Interest rate expectations were expressed in terms of 12% rates continuing well into 1989, with the balance of probabilities now favouring an increase rather than a reduction as the next move. This perception was reinforced by the foreign exchange market's reassessment of the value of sterling against the deutschemark and by general nervousness ahead of the announcement of the UK current account figures. By the opening on 27 October, sterling had fallen back to the same effective rate at which it had stood at the beginning of the month, although it was firmer against the dollar and weaker against the deutschemark, while the money-market yield curve had flattened beyond three months. Prices of conventional gilts had fallen back, in particular at the short end, but the index-linked sector continued to move ahead and a £200 million tranchette of index-linked stock issued on 21 October was exhausted on 28 October (see Table G).

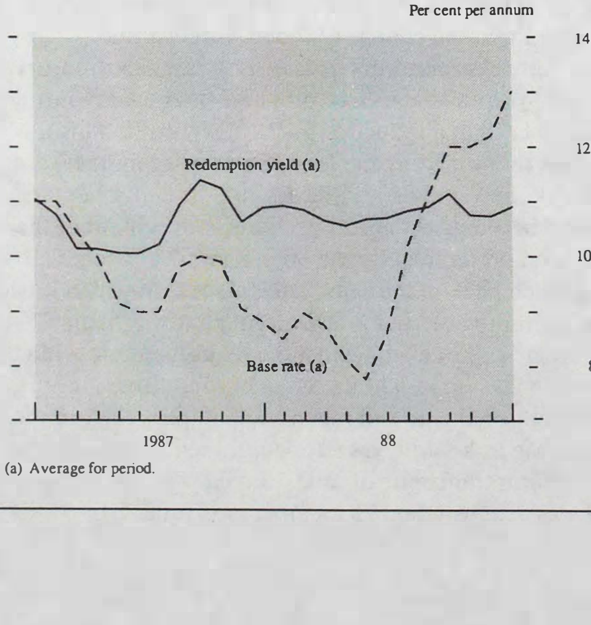
Declining British government security issues and the market for other fixed-rate sterling bonds

The PSBR has fallen substantially since 1983, and in 1987 a surplus (public sector debt repayment, or PSDR) was achieved for the first time since the early 1970s. In 1985 the authorities also ended the policy of overfunding. Despite this, gross official sales of British government securities (BGS) remained fairly flat between 1983 and 1987, averaging some £1.2 billion per month. This reflected the increased total of maturities, the reduction in other public sector debt held by non-banks (and the consequent increase in the rest of the public sector's reliance on borrowing from central government) and official intervention in the foreign exchange market which needed to be sterilised by the sale of government debt (especially important in 1987). In 1988 there was a net redemption of BGS issues, through scheduled redemptions and some additional buying-in.

The sharp fall in new gilt-edged issues in 1988 has created an opportunity for increased issuance of other fixed-rate sterling debt, especially by blue chip companies and overseas sovereign borrowers whose issues investors regard as substitutes for BGS. As can be seen in Chart 1, short rates have risen sharply since May while long yields have remained comparatively stable. Issues at the long end of the market are now relatively more attractive for issuers.

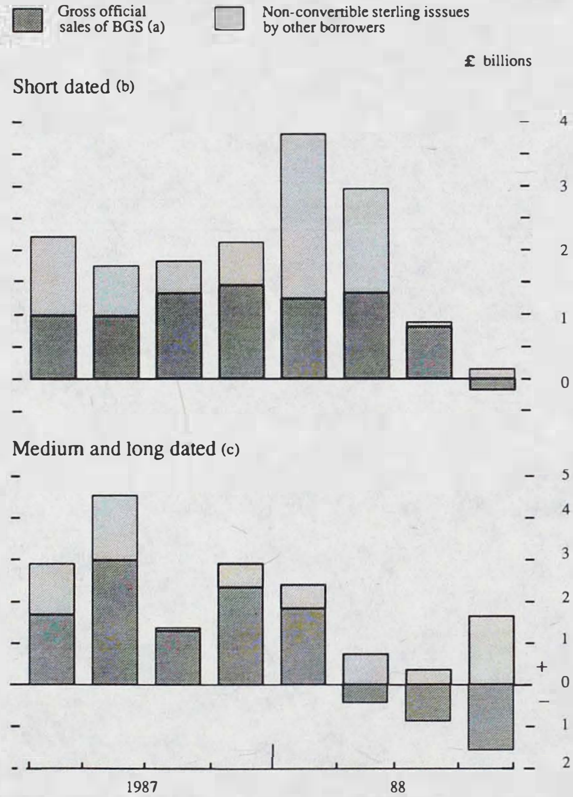
Chart 2 shows gross issues of non-convertible fixed-rate sterling bonds (both domestic and euro-sterling) by non-government borrowers and gross official sales of BGS (including indexed-linked issues) over the past two years. Two maturity categories are shown: short-dated bonds (maturity of less than 7 years) and medium and long-dated bonds (maturity greater than 7 years). The differing behaviour of long and short rates and the resultant twist in the yield curve produced a significant change in the nature of new issues in the sterling bond market between the first and second halves of 1988. In the first half of the year issues were made by a wide range of British and non-British borrowers, the latter group mostly at maturities of between 5 and 10 years. In the second half of the year (after the rise in short-term sterling interest rates and short yields) all but a handful of issues were by British borrowers and were mainly at maturities of 15 years or more. The most significant evidence of 'crowding-in' is for maturities of over 7 years, where in the last three quarters the increasing negative gross official sales of BGS has been largely balanced by issues from the non-government sector. In the second half of 1988, there were gross official purchases of £2.5 billion of gilts of over 7 years maturity while fixed-rate non-BGS issues, excluding convertibles, were £2 billion. At the short end of the market gross official sales of BGS remained positive until the fourth quarter, while other sterling bond issues, after increasing significantly in the first two quarters of 1988, fell to virtually zero in the second half of the year. This may be linked to the absence of foreign borrowers from the market in the second half after the rise in short-term rates.

Chart 1
Redemption yield on 25 year corporate debenture and loan stocks and base rates



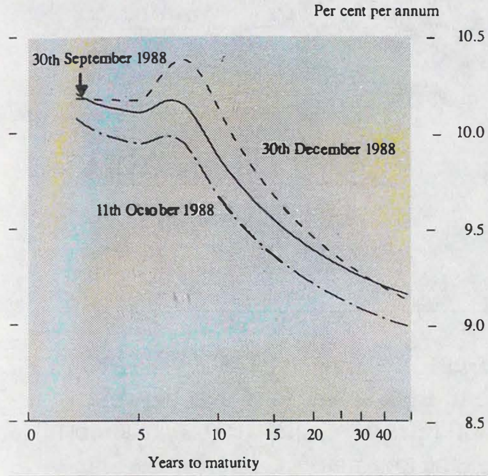
(a) Average for period.

Chart 2
Gross issues of sterling fixed-interest securities

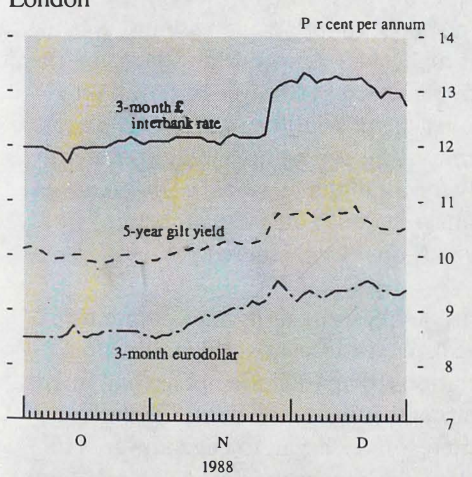


(a) Defined as net sales of BGS over one year to maturity excluding transactions under purchase and resale agreements.
(b) Maturity of less than seven years.
(c) Maturity of more than seven years.

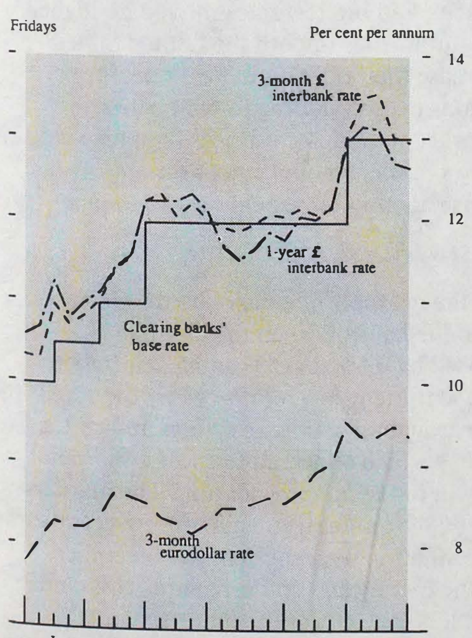
Time/yield curves of British government stocks



Short-term interest rates and yields in London



Short-term interest rates in London



The September current account deficit of £560 million announced on 27 October was better than many had expected and the initial response was a strengthening of sterling and a small decline in interbank interest rates and in conventional gilt yields. However, a subsequent reassessment of the trade data, and of the prospects for inflation in the light of the Chancellor's Autumn Statement on 1 November, caused these rates and yields to back up again, despite the firmness of sterling, although gilts at the longest maturities benefited from the Autumn Statement forecast of the public sector debt repayment in 1988/89, leaving long yields at below $9\frac{1}{2}$%. This encouraged private sector issuers to enter the long-term sterling bond market (see the note on page 34). By 8 November, the date of the US Presidential election, interbank interest rates and conventional gilt yields had risen to well above their levels immediately before the UK current account figures were announced. In addition, the decline in the yield on long index-linked stock, which had been sustained since mid-September and was particularly pronounced in the second half of October, came to an end early in November, with the lowest yield (on $2\frac{1}{2}$% Treasury 2016, calculated before tax and assuming a 5% rate of inflation) during the quarter, and since June 1987, being $3\frac{17}{32}$% on 8 November.

The dollar declined sharply following the US election and again after the announcement on 16 November of the US trade deficit for September. Sterling moved up to $1.8320 at the opening on 17 November, but interbank interest rates showed no response to this as the domestic money market remained focused on the series of UK economic and monetary indicators announced during the third week of November and became nervous over the possibility of higher US interest rates. The UK indicators provided no clear evidence of a progressive slowdown of domestic demand. The preliminary October retail sales figure was up nearly 2% on the previous month; manufacturing margins increased further; there was no further decline in building society mortgage commitments; the underlying growth of M0 remained at almost $7\frac{3}{4}$%; and retail price inflation rose to 6.4%. Interbank rates reached $12\frac{1}{4}$% throughout the range of maturities from three to twelve months on 16 November, but settled back to $12\frac{3}{16}$% thereafter, and the gilt market also weakened.

The announcement on 25 November of the record £2.4 billion UK current account deficit in October came as a shock to financial markets. Sterling fell sharply immediately following the announcement to $1.8125 and DM 3.1250 but began to recover as money-market rates moved up to discount a half percentage point increase in banks' base rates. The current account figures, together with the other evidence which had become available earlier in November, suggested that domestic demand could still be growing too rapidly, and at noon the Bank signalled a full percentage point increase in the general level of interest rates to 13% by announcing 2.30 pm lending to the discount market; this was followed by an identical move in banks' base rates. Sterling strengthened throughout the afternoon while period interbank interest rates rose steadily towards the 13% level. Gilt prices fell sharply, in particular at the shorter maturities, taking medium-term yields to above 10% for the first time since September (see Table M). Following the signal of an increase in interest rates to 13% the Bank purchased eligible bills from the discount market at discount rates declining from $12\frac{7}{8}$% at band 1

Table M
Sterling interest rates, gilt yields and exchange rates

Date	Interbank interest rates (per cent per annum)			Gilt yields (per cent per annum)				Exchange rates		
				Conventionals			Index-linked			
	3 months	6 months	12 months	Short	Medium	Long	Long	ERI	£/$	£/DM
24 November (close)	$12\frac{5}{32}$	$12\frac{7}{32}$	$12\frac{3}{16}$	$10\frac{1}{4}$	$9\frac{15}{16}$	$9\frac{11}{16}$	$3\frac{21}{32}$	77.2	1.8375	3.1498
25 November (close)	$12\frac{15}{16}$	$12\frac{27}{32}$	$12\frac{3}{4}$	$10\frac{1}{2}$	$10\frac{3}{32}$	$9\frac{25}{32}$	$3\frac{11}{16}$	77.6	1.8457	3.1681
28 November (close)	$13\frac{1}{8}$	$13\frac{5}{32}$	$12\frac{15}{16}$	$10\frac{5}{8}$	$10\frac{1}{4}$	$9\frac{13}{16}$	$3\frac{23}{32}$	77.7	1.8362	3.1834
2 December (close)	$13\frac{11}{32}$	$13\frac{11}{32}$	$13\frac{1}{4}$	$10\frac{21}{32}$	$10\frac{1}{4}$	$9\frac{27}{32}$	$3\frac{11}{16}$	78.5	1.8585	3.2161
14 December (close)	$13\frac{3}{16}$	$13\frac{3}{16}$	13	$10\frac{11}{16}$	$10\frac{11}{32}$	$9\frac{29}{32}$	$3\frac{3}{4}$	77.7	1.8330	3.1821
20 December (close)	$12\frac{7}{8}$	$12\frac{25}{32}$	$12\frac{5}{8}$	$10\frac{11}{32}$	$10\frac{3}{32}$	$9\frac{3}{4}$	$3\frac{3}{4}$	77.8	1.8060	3.2093
30 December (close)	$13\frac{5}{32}$	$13\frac{1}{8}$	$12\frac{7}{8}$	$10\frac{13}{32}$	$10\frac{13}{32}$	$9\frac{21}{32}$	$3\frac{3}{4}$	77.8	1.8080	3.2074

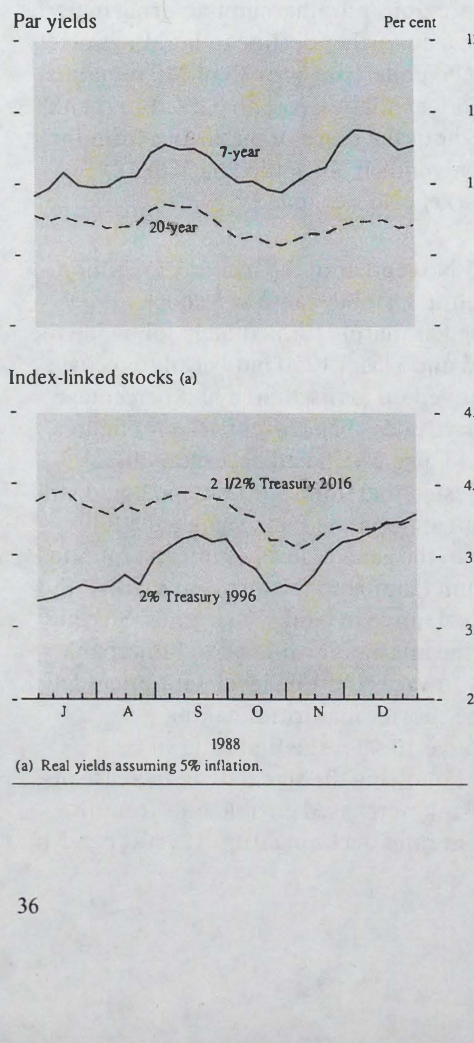
(1–14 days) maturities and $12\frac{13}{16}$% at band 2 (15–33 days) to $12\frac{11}{16}$% at band 3 (34–63 days) and $12\frac{5}{8}$% at band 4 (64–91 days) maturities. These discount rates were equivalent to an almost flat yield curve at 13% across the four maturity bands.

Interbank interest rates and gilt yields rose further on 28 November, in part in response to the $\frac{1}{2}$% increase in US banks' prime rates to $10\frac{1}{2}$% (their highest level since May 1985), but then remained relatively steady for the next two weeks, despite underlying nervousness over the possibility of a further increase in interest rates. Sentiment was helped by the strength of sterling, which firmed consistently for more than a week, rising to its peak levels for the quarter against the dollar on 5 December at $1.8717 and against the deutschemark on 7 December at DM 3.2425.

A small but perceptible rise in US short-term market interest rates caused sterling to weaken a little against the dollar after 5 December, while expectations of an increase in German interest rates led to a significant strengthening of the deutschemark on 9 December. Domestic interest rates began to edge upwards in response to the weakening of sterling, but the money market was encouraged by the provisional retail sales volume for November, announced on 12 December, and interest rates moved no higher despite rumours that the authorities in both the United States and Germany would increase their official interest rates. However, these expectations caused sterling to fall further and this depressed the gilt market, although gilt prices then responded favourably at all maturities to the announcement on 14 December of the reverse auction to be held on 13 January 1989.

Having discounted fully the prospect of a move by the German authorities, the markets rallied a little when the German Lombard rate was increased by 0.5% to 5.5% on 15 December and this more optimistic sentiment was reinforced by the small decline in the underlying growth of average earnings and by the weekly Bank Return figures which appeared to show a sharp fall in the twelve-month growth of the note circulation. The markets were encouraged further by the announcements on 16 December of unchanged retail price inflation over the year to November and on 20 December of the money and credit data for November. Interbank interest rates fell below 13% at the three, six and twelve-month maturities, with a pronounced downward slope of the yield curve across this range of maturities, while gilt yields eased back towards their levels of a month earlier.

Gross redemption yields on UK government securities



(a) Real yields assuming 5% inflation.

Thereafter, the money and gilt markets remained steady as sterling softened, in a seasonally quiet market, ahead of the announcement on 23 December of the November current account deficit. The announcement of a figure close to market expectations caused very little movement in the markets, but interbank interest rates and gilt yields firmed modestly over the period between Christmas and the New Year, reflecting nervousness about the strength of domestic demand and, in particular, the rise in the growth of the note circulation apparently indicated by the weekly Bank Return.

Market turnover

Transactions in eligible bills by discount houses, including sales to the Bank, averaged £1.2 billion daily over the quarter. This reversed the marked decline in turnover in the previous quarter, when sentiment was more bearish and money-market cash shortages were generally smaller. Discount house transactions in certificates of deposit averaged £0.6 billion daily over the quarter, up slightly from the average of £0.5 billion in the third quarter. Meanwhile, the average daily turnover in the short sterling futures contract on the London International Financial Futures Exchange fell back to 15,900 contracts in the fourth quarter from 17,400 in the third, perhaps reflecting a modest fall in the degree of uncertainty with which market participants held their expectations about future movements in short-term interest rates. Nevertheless, turnover remained well above its level in the first five months of 1988.

Total turnover in gilts picked up a little in the period under review, averaging £4.3 billion a day compared with £4.1 billion in the third quarter and £4.4 billion in the second. Intra-market transactions accounted for just under half of total turnover. Futures market activity remained subdued, perhaps reflecting the greater stability of the prices of long gilts. Average daily turnover in the long gilt futures contract on the London International Financial Futures Exchange was 17,800 contracts, down from 21,800 and 18,900 contracts in the second and third quarters respectively. Interest in the medium gilt futures contract continued to be extremely low, with daily turnover averaging 110 contracts in October, 50 contracts in November and almost nothing in December. During the quarter, £200 million of call warrants exercisable into gilt-edged stock were issued and £100 million matured, leaving the total outstanding at the end of December at £450 million. The amount of put warrants outstanding remained at £300 million, with £100 million of both redemptions and new issues during the quarter.

Sterling commercial paper

Gross issues of sterling commercial paper during the fourth quarter totalled £9,338 million, compared with £9,488 million in the previous three months. Redemptions of £9,964 million reduced the total of paper outstanding to £3,126 million at the end of December, £626 million below its level three months earlier. The Bank had been notified of 156 programmes by the end of December, and paper had been issued under 124 of these.

Other capital markets

Equity prices, as measured by the FT-Actuaries all-share index, fell by 0.5% in the fourth quarter. This marked an end to the gradual upward drift in prices since October 1987, and reflected growing unease at the prospects for inflation and interest rates in the United Kingdom, as well as a lacklustre performance by Wall Street. Prices were generally strong in October as economic news was reasonably well received, but the underlying mood remained nervous and the market reacted adversely to October's trade figures and to the announcement of a rise in base rates at the end of November. Prices fell by 7%, but they began to recover in the second full week of December on better than expected economic news. This recovery was sustained until the end of the year, although the earlier losses were not wholly offset.

Equity issues (excluding government share sales) amounting to almost £1.2 billion were announced in the fourth quarter, taking the total for the year to £5.5 billion (compared with £13.9 billion in 1987). In addition, the British Steel flotation raised £1.2 billion from the first instalment, and was comfortably oversubscribed. Apart from this, the largest issue was the Racal Telecom offer-for-sale of £272 million.

The level of sterling debt issues was £3.4 billion in the fourth quarter, £1 billion more than in the third, but considerably lower than the levels in the first and second quarters. All but a handful of issues were by domestic issuers and these were mainly for maturities of 10 years and more. This emphasis reflected the relatively favourable conditions for long-dated issues; short-term interest rates have risen sharply since May, but, in part because of the expectation in the bond market that the government will continue to run a financial surplus and that there will be sizable net redemptions of gilt-edged stocks, long-term interest rates have remained at much the same level as they were in the first half of the year.

Some of the recent long-dated issues have been styled eurobonds for marketing reasons. However, these issues have usually been priced and distributed as domestic bonds, priced initially at a margin over a nominated gilt-edged stock and placed with institutional investors by a small number of banks and stockbrokers. They have also tended to incorporate restrictive covenants binding on the issuer; in particular, several recent issues have included devices to deter takeovers of the borrower—for example, an investor put which may be exercised if the ownership of the borrower changed.

There were only five FRN issues in the fourth quarter, for a total of £919 million, of which two were mortgage backed and three were by building societies. They included a £500 million issue for The Mortgage Corporation, the largest non-gilt-edged issue yet seen in the sterling bond market. During the fourth quarter, UK companies together with their overseas subsidiaries launched eleven eurobond issues worth approximately £1 billion in currencies other than sterling. The most important issuing currency was the US dollar, accounting for about 60% of the total amount raised, and there were issues in six other currencies. As in the third quarter, UK banks and building societies were particularly active fund-raisers in the non-sterling eurobond markets and were responsible for 75% of the total amount raised by British borrowers.

Table N
Sterling capital issues: amounts announced
£ millions

	Equities	Fixed-rate(a)			FRNs
		Domestic issues(b)	Sterling eurobonds		
			UK borrowers	Overseas borrowers	
1987	13,891	2,301	3,544	4,413	1,247
Q1	1,803	190	1,431	1,775	250
Q2	3,648	1,127	1,090	1,306	150
Q3	5,956	483	620	507	411
Q4	2,484	501	403	825	436
1988	5,473	3,324	4,391	3,160	5,809
Q1	808	350	1,890	1,340	1,090
Q2	1,578	1,046	1,173	1,670	2,155
Q3	1,895	541	183	—	1,645
Oct.	719	851	300	100	634
Nov.	306	335	400	50	185
Dec.	167	201	345	—	100
Q4	1,192	1,387	1,045	150	919

(a) Of which, £695 million was equity-related in the fourth quarter.
(b) All UK borrowers except for two 'bulldog issues' in 1988 Q4 for £200 millions. Excludes local authority issues.