Operation of monetary policy

This article covers the three months from October to December 1989.

Review

During the period under review the adjustment of the domestic real economy to the tightening of monetary policy which began in the middle of 1988 continued. However, for much of this period the adjustment was overshadowed in financial markets by UK domestic political uncertainties and, to a greater extent, by the deutschemark's strength, propelled by the extraordinary developments in Eastern Europe. The resultant fall in the sterling/deutschemark rate was perceived by some commentators as a more general weakness in the UK currency and, with the authorities leaving the level of interest rates unchanged at 15% after the rise on 5 October, there was speculation that the commitment to a firm exchange rate had weakened. But the decline in sterling in the early part of the quarter was seen by the authorities as temporary, and over the period as a whole sterling was steady against both the dollar and the yen. With the domestic economic adjustment on course, an immediate further tightening of policy was unnecessary.

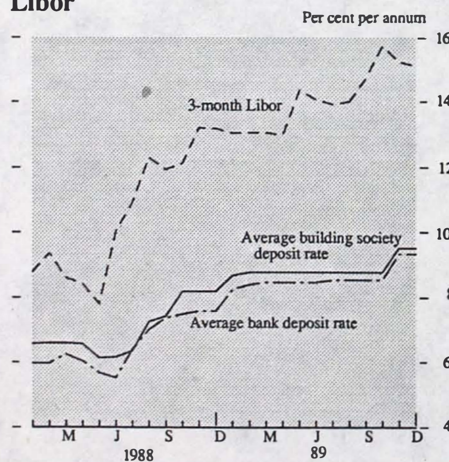
Table A
Growth rates of the monetary and credit aggregates[a]
Percentages; *seasonally adjusted (financial year constrained)*

	12 months to end-Sept. 89	12 months to end-Dec. 89	1989 Q3	Q4
M0 (b)	4.7	6.0	1.7	2.3
Non-interest-bearing M1	-6.5	-5.4	-0.3	4.2
M2	9.9	9.9	3.2	2.5
M4	17.3	18.1	4.5	3.9
M5	16.8	17.8	4.4	3.8
M4 lending	22.1	21.2	5.7	4.2

(a) See the statistical annex for definitions.
(b) Data are based on end-month figures, except M0, which is an average of Wednesdays in each month.

The adjustment of the economy had begun in the personal sector, and household demand continued to be subdued in the period under review. The downturn in the housing market has become more pronounced and widespread. Average house prices in the United Kingdom fell during each of the last seven months of the year, and the housing market is cooling down now even in the North and Scotland, which had been relatively late to respond. The level of consumer spending was unchanged in the third quarter, although preliminary fourth quarter data suggest some increase. The trend rate of growth of retail sales remained very low over the final quarter of the year, despite a pre-Christmas surge. M0 continued to grow at a twelve-month rate somewhat above its 1%–5% target range, but the growth rate of bank lending for consumption over the three months was, at 9.2% at an annual rate, the lowest since the 1970s.

Retail deposit rates and three-month Libor



A slowdown in corporate expenditure also now appears to be underway, although the evidence for this is less conclusive. Industrial investment, which had grown strongly until mid-1989, fell slightly in the third quarter, and surveys of investment intentions indicate a sharp slowdown in capital spending in 1990. Stock accumulation, which had been rapid up to the third quarter, can be expected to reverse in due course. Corporate borrowing slackened in the final months of the year, also suggesting that businesses are responding to the slowdown in demand. This contributed to a slower rate of growth of M4 in the period under review, although the twelve-month growth rate has remained comparatively stable since the middle of 1988. The visible trade deficit narrowed in the fourth quarter, suggesting

that the increase in the current account balance of payments deficit in the previous quarter was erratic, and that there may subsequently have been a better balance between growth of domestic demand and output.

There has been little sign as yet of any easing in cost and price indicators to accompany the slowdown in the real economy, although it was always expected that they would be among the last indicators to respond to the tightening of policy. The level of producer input prices in December was no higher than six months earlier, after a sharp rise in the first half of 1989, with the pattern over the year heavily influenced by metal price movements. However, the twelve-month growth rate of producer output prices was stable at 5% throughout the year. The twelve-month rate of increase of the retail price index, excluding mortgage interest payments, rose a little further in the fourth quarter and there was upward pressure on pay settlements and unit labour costs. Weaker demand will limit the scope for future price increases, and wage rises unsupported by productivity gains will therefore increasingly reduce profit margins.

The background to the 1% rise in interest rates on 5 October, in the context of rate increases generally in Europe, was described in the November 1989 *Bulletin* (pages 493–4). After that, market impatience with the pace of adjustment in the United Kingdom led to further weakness in the pound in succeeding days, until the sharp fall in US equities on 13 October abruptly changed sentiment and sterling recovered against the dollar. Towards the end of the month, the United Kingdom entered a period of temporary market nervousness, particularly in the foreign exchange market, associated with the resignation of the Chancellor of the Exchequer and subsequently the Conservative Party leadership election.

From November onwards, events in Eastern Europe led to a substantial strengthening of the deutschemark as expectations increased of a rise in German interest rates to dampen inflationary pressures there. Sterling, like other currencies, fell against the deutschemark, but it firmed against the dollar, to end the quarter little changed from its level at the end of September, and against the yen, the weakness of which was somewhat surprising. Sterling's 10% decline against the deutschemark over the quarter was the main factor behind the 6% fall in its exchange rate index. Notwithstanding this, domestic markets were relatively calm throughout November and December (once the immediate impact of the Chancellor's resignation had subsided), indicating that they did not believe that the foreign exchange market developments required an immediate change in monetary policy. Indeed, at times the downward slope of the interbank yield curve strongly pointed to an expectation that interest rates would begin to fall in the next few months.

During January, sterling's exchange rate index has recovered a little as the deutschemark has fallen back from its peak level, while both longer-term money-market interest rates and gilt yields have risen in response to nervousness on worldwide capital markets and an increasing recognition that UK interest rates need to remain high for a considerable period ahead.

Monetary aggregrates and credit

The figures in this section are seasonally adjusted.

Components of money

Growth of M0 in the year to December was 6.0% (see Table A), compared with around 5% (after adjustment for the effects of the postal strike) in September. But it is always difficult to interpret M0 around Christmas. The strong growth in retail sales in December (2.1%) appears to have been a contributory factor in the growth of M0.

For the first time in the year, non-interest-bearing deposits increased over the three months (see Table B). All of the fourth quarter rise of 4.3% occurred in December, following some decline in both October and November. Some of the rise may have resulted from transactions related to the water privatisation. Despite the increase, non-interest-bearing deposits in December were 10.1% down from a year earlier, reflecting the introduction of interest-bearing current accounts by the major banks early in 1989.

The growth of M4 declined slightly in the fourth quarter, from 4.5% to 3.9%, although the twelve-month growth rate was marginally higher at 18.1%. Personal sector holdings rose by over £10 billion (3.4%). Industrial and commercial companies (ICCs) increased their holdings by £3.8 billion (5.6%) (see Table C).

Wholesale deposits accounted for just over half the increase in broad money (53%, or £8.5 billion). The increase in retail deposits (£7.0 billion) was around £2½ billion lower than in the third quarter. Building societies continued to offer slightly lower retail deposit rates than the banks, making up the shortfall in their retail funds through the wholesale markets.

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

		1989 Q3	1989 Q4	Level outstanding at end-Dec. 89
	M4 private sector holdings of:			
1	Notes and coin	0.2	0.5	15.5
2	Non-interest-bearing bank deposits	-0.3	1.4	32.6
3	Interest-bearing retail bank deposits	5.0	1.8	92.6
4	Building society shares and deposits	4.7	3.8	141.8
5	Other interest-bearing bank deposits (including CDs)	7.5	7.1	136.4
6	Other building society deposits (including CDs)	0.5	1.4	4.4
7	**M4 (=1+2+3+4+5+6)**	**17.6**	**16.0**	**423.0**
8	M4 private sector holdings of money-market instruments and national savings in M5	0.3	0.2	16.8
9	**M5 (=7+8)**	**17.9**	**16.1**	**439.9**

(a) See the statistical annex for definitions. The M4 private sector comprises all UK residents other than the public sector, banks and building societies.

Table C
Sectoral analysis of deposits with, and borrowing from, banks and building societies
£ billions; *seasonally adjusted (financial year contrained)*

		1988 Year	1989 Year	Q1	Q2	Q3	Q4
	Personal sector						
1	Deposits	36.9	39.3	9.0	8.5	12.2	9.6
	of which:						
	Banks	16.7	21.8	3.9	4.9	7.5	5.5
	Building societies	20.2	17.5	5.1	3.5	4.8	4.0
2	Borrowing	47.8	45.9	11.7	10.8	11.6	11.9
	of which:						
	Mortgage	34.5	31.1	7.5	7.2	7.6	8.8
	Consumption	5.8	5.5	1.6	1.7	1.3	0.9
	Unincorporated businesses	7.6	9.3	2.6	1.9	2.7	2.1
3	**Net recourse (=2-1)**	**11.0**	**6.6**	**2.7**	**2.3**	**-0.7**	**2.3**
	ICCs						
4	Deposits	6.3	13.1	3.2	4.7	—	5.1
	of which:						
	Sterling	6.0	11.1	4.2	3.1	0.1	3.7
	Foreign currency	0.3	2.0	-1.0	1.6	-0.1	1.4
5	Borrowing	32.4	38.2	8.4	8.8	14.4	6.6
	of which:						
	Sterling (a)	24.1	29.4	5.9	7.0	11.0	5.4
	Foreign currency	8.3	8.8	2.5	1.8	3.4	1.2
6	**Net recourse (=5-4)**	**26.1**	**25.1**	**5.2**	**4.0**	**14.4**	**1.5**
	of which:						
	Sterling	18.0	18.3	1.8	3.9	10.9	1.7
	Foreign currency	8.1	6.8	3.5	0.2	3.5	-0.3
	OFIs						
7	Deposits	11.8	19.3	3.9	5.1	5.8	4.6
	of which:						
	Sterling	9.5	13.5	2.5	3.7	5.2	2.2
	Foreign currency	2.4	5.8	1.4	1.4	0.6	2.4
8	Borrowing	11.1	20.1	7.5	3.2	4.4	5.0
	of which:						
	Sterling (a)	10.1	12.9	3.5	2.6	3.6	3.2
	Foreign currency	1.0	7.2	4.0	0.6	0.8	1.8
9	**Net recourse (=8-7)**	**-0.7**	**0.8**	**3.6**	**-1.8**	**-1.3**	**0.4**
	of which:						
	Sterling	0.6	-0.6	1.0	-1.1	-1.5	1.0
	Foreign currency	-1.4	1.4	2.6	-0.7	0.2	-0.6

(a) Includes Issue Department take-up of commercial bills.

Counterparts to money

The growth of sterling lending by banks and building societies declined significantly over the quarter, from 5.7% to 4.2%. The slowdown was more than accounted for by banks' business, as the growth rate of building society lending increased. The major change was the sharp slowdown in lending to ICCs, whose borrowing rose by 4.4% (over £5 billion), compared with 9.9% (£11 billion) in the previous quarter. By contrast, lending to the personal sector rose by 4.0%, a similar rate to that of the two previous quarters. As a result, the personal sector's net recourse to banks and building societies was positive again, reversing the unusual surplus of deposits over borrowings in the third quarter.

For the first time in a year, the public sector counterpart to M4 was negative (see Tables D and E). On this occasion it reflected primarily a large public sector debt repayment (of over £2.4 billion) and a substantially negative (£1.8 billion) external counterpart (the latter, in turn, due to changes in official reserves). These negative influences were partially offset by around £1 billion of debt purchases from the M4 private sector. It should be noted that the public sector counterpart (which includes sales or purchases of Treasury bills by the M4 private sector and the overseas sector) is no longer exactly equal to overfunding (which excludes all Treasury bill transactions): in the fourth quarter, however, the two were broadly equal in size.

Table D
Counterparts to changes in M4 and M5[(a)]

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

	Counterparts to M4			Counterparts to M5
	1989		12 months to end-Dec. 89	12 months to end-Dec. 89
	Q3	Q4		
1 PSDR (-)	-1.7	-2.4	-9.5	-9.5
2 Net purchases (-) of central government debt by the M4 private sector (b)	3.8	1.0	12.9	13.9
3 Net purchases (-) of other public sector debt by the M4 private sector (b)	0.2	—	0.3	0.5
4 External and foreign currency finance (-) of the public sector	-1.2	-1.8	-3.8	-3.8
5 Public sector contribution (= 1+2+3+4)	1.1	-3.2	-0.1	1.1
6 Sterling lending to the M4 private sector (b)(c)	26.2	20.5	88.1	88.6
7 Other counterparts (d)	-9.6	-1.3	-23.2	-23.2
8 Total (=5+6+7) = change in the aggregate	**17.6**	**16.0**	**64.8**	**66.5**

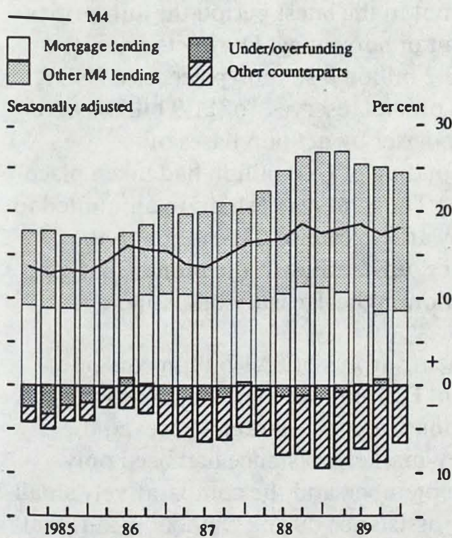
(a) See the statistical annex for definitions.

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

(c) Including changes in Issue Department's holdings of private sector commercial bills and of promissory notes relating to shipbuilding paper guaranteed by the Department of Trade and Industry. The M5 counterpart includes M4 private sector holdings of commercial bills.

(d) External and foreign currency transactions and increases (-) in net non-deposit liabilities.

Counterparts to annual growth of M4



Other counterparts were again negative. This reflected a combination of negative sterling net non-deposit liabilities and a positive external counterpart, though, as usual, the total external and foreign currency counterparts including the public sector externals were negative. The positive banking external contrasted with a strongly negative effect over the previous three quarters, which in total left a contractionary influence on money in 1989 of £11.4 billion, a similar rate to the previous year.

The positive M4 banking external in the fourth quarter probably reflected some combination of an improvement in the current account deficit, lower structural capital outflows and higher inflows to the M4 private sector. These may have stemmed from stock market uncertainties at the beginning of the quarter and from fluctuations in the levels of merger and acquisition activity.

Sectoral finances

The rate of growth of personal sector M4 borrowing remained at 4% (£11.9 billion) in the fourth quarter. The twelve-month growth rate of personal sector borrowing continued to decline (17.3% in the fourth quarter) but that of deposits was slightly higher at 15.6%.

Of the increase in personal sector borrowing, £8.8 billion was accounted for by mortgage lending (an increase of £1.3 billion on the third quarter). The strength of mortgage lending is somewhat surprising given the depressed state of the housing market since the middle of 1989. However, it appears that a rising proportion of mortgage lending has been for purposes other than house purchase (perhaps including a significant element of remortgaging). In addition, there have been a number of special incentives offered to first-time buyers. Building societies again accounted for the major share of new lending (£6.7 billion), which may be owing to their more competitive lending rate. Towards the end of the fourth quarter, however, there were indications from building society data on new commitments that mortgage lending may be slowing down again.

Lending for consumption to the personal sector rose by a fairly modest £0.9 billion (2.3%) in the fourth quarter, which is consistent with the slowdown in retail sales over most of the quarter and with the increase in mortgage borrowing for purposes other than house purchase. Borrowing by unincorporated businesses increased by £2.1 billion (5.4%) over the quarter, easing back a little from the fairly sharp 7.3% rise recorded in the previous quarter.

Overall, the personal sector's net recourse to banks and building societies was small but positive (£2.3 billion), in contrast with its net repayment in the third quarter (£0.7 billion).

Following the third quarter's erratically large rise (£11.0 billion, or 9.9%), the growth in sterling lending by banks and building societies to ICCs declined sharply in the fourth quarter (to £5.4 billion, 4.4%). The twelve-month growth rate thus eased somewhat but, at 30%, remains very rapid. ICCs' sterling deposits rose by £3.7 billion (5.9%), raising their twelve-month growth rate to 20.9%. ICCs' sterling net recourse to banks and building societies fell from £10.9 billion in the third quarter to £1.7 billion in the fourth.

The reduction in the growth of net borrowing is thought to be primarily due to the fall in takeover activity in the fourth quarter.

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

	1989 Q2	1989 Q3	1989 Q4	12 months to end-Dec. 89
1 Central government borrowing on own account	-0.6	-2.1	-2.8	- 9.7
2 Other public sector borrowing (a)	-0.5	+0.4	+0.4	+ 0.1
3 PSDR (-)(= 1+2)	-1.1	-1.7	-2.4	- 9.5
4 Net sales (-) of central government debt to the M4 private sector	+3.2	+3.8	+1.0	+12.9
of which: Gilt-edged stocks	*+3.8*	*+3.2*	*+0.7*	*+12.2*
Treasury bills	*-0.6*	*-0.1*	—	*-0.7*
National savings	*+0.1*	*+0.7*	*+0.4*	*+ 1.5*
CTDs	—	—	—	*- 0.2*
5 Sales (-) of local authorities' and public corporations' net debt to the M4 private sector	+0.1	+0.2	—	+ 0.3
6 External and foreign currency finance (-) of the public sector	-0.9	-1.2	-1.8	- 3.8
of which: Gilt-edged stocks	*+1.2*	*-0.5*	*+0.7*	*+ 1.6*
Treasury bills	*-0.2*	*-0.5*	*-0.4*	*-0.9*
7 Total financing (-) of the public sector from the M4 private and overseas sectors (=4+5+6)	+2.4	+2.8	**-0.8**	+ 9.4

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

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

	1988 Q4	1989 Q3	1989 Q4	12 months to end-Dec. 89
Factors affecting the market's cash position				
CGBR (+)	-2.2	+0.3	-3.0	- 5.0
of which, on-lending to local authorities and public corporations	*+1.4*	*+1.8*	*-0.1*	*+ 4.5*
Net sales (-) of central government debt (a)	+3.9	+4.9	+2.3	+19.7
of which: Gilt-edged	*+3.7*	*+4.3*	*+1.8*	*+18.3*
National savings	—	*+0.7*	*+0.6*	*+ 1.5*
CTDs	*+0.1*	*-0.1*	*-0.1*	*- 0.2*
Currency circulation (increase -)	-1.2	-0.3	-1.6	- 1.2
Reserves etc	+0.8	-0.7	-2.9	- 6.7
Other	+0.1	+0.5	+0.7	- 0.8
Total (A)	+1.4	+4.8	-4.5	+ 6.0
Official offsetting operations				
Net increase (+) in Bank's commercial bills (b)	+0.9	-1.1	+3.3	- 3.0
Net increase (-) in Treasury bills in market (c)	-2.1	-3.4	+1.0	- 3.1
Other	-0.4	-0.4	+0.2	—
Total (B)	-1.5	-4.9	+4.5	- 6.0
Changes in bankers' operational balances at the Bank (=A+B)	-0.1	-0.1	—	—

(a) Other than Treasury bills.
(b) By the Issue and Banking Departments of the Bank of England.
(c) Excluding repurchase transactions with the Bank.

Investment expenditure may also have eased, especially as the level of interest rates may be exerting considerable pressure on ICCs to reduce their financial deficit.

The foreign currency deposits of ICCs rose by £1.4 billion whereas their borrowing in foreign currency increased by only £1.2 billion, a substantial decline from the £3.4 billion increase in the third quarter. Capital issues by ICCs in the equity and bond markets eased further in the fourth quarter, and for the year as a whole were significantly lower than in 1988.

Sterling lending to financial institutions other than banks and building societies (OFIs) rose by £3.2 billion (5.1%), bringing the twelve-month growth rate down to 24.5%. In addition, OFIs raised £1.5 billion through sterling bond issues. The increase in their sterling deposits in the fourth quarter at £2.2 billion (3.8%) was significantly lower than in the third, which was partly the result of high takeover activity (to the extent that OFIs were net sellers to acquiring companies). OFIs were net sterling borrowers from banks and building societies by £1.0 billion, following two quarters in which they were net depositors. They were net foreign currency depositors of £0.6 billion.

Official operations in financial markets

The figures in this section are not seasonally adjusted.

Money-market operations

There was a net drain of funds out of the money market during the period under review for the first time for seven quarters (see Table F). The main component of the market inflows in previous quarters had been the heavy borrowing by the local authorities from central government, but in the latest period the authorities made a small net repayment of borrowing. During the quarter, effective overfunding of £3.2 billion also took place, as a PSDR of £3.0 billion and a fall in official reserves[1] of £1.9 billion were not fully offset within the quarter by net purchases of government debt. (Underfunding of £6.0 billion had taken place in the first half of 1989/90.) The total net cash drain amounted to £4.5 billion and was met by an increase of £3.5 billion in the amount of official assistance outstanding to the money market and a reduction of £1.0 billion in the Treasury bill issue.[2]

October's central government surplus of £2.1 billion coincided with a fall in reserves also of £2.1 billion; over the month there was a net drain of £2.2 billion from the market. However, the outstanding stock of money-market assistance had been only £1.3 billion at the end of September, and the comparatively small daily amounts of maturing assistance during October meant that the average daily cash shortage, at £490 million, was no larger than it had been during the third quarter. The stock of assistance rose to £2.9 billion by the end of October, while the amount of Treasury bills in market hands fell by £0.7 billion to £8.6 billion.

During November a modest central government borrowing requirement was offset by a further fall, of £0.8 billion, in reserves, and money-market influences were in aggregate approximately neutral. The stock of assistance rose further to

(1) In the money-market operations section of this article, the figures on official reserves refer to the overall net foreign currency asset position of central government.
(2) Other than Treasury bills held by the Bank, Bank customers and government accounts.

£3.2 billion during the month, and the consequent larger amounts of maturing assistance led to a slight increase in the average daily cash shortage to £520 million.

The seasonal rise in currency circulation was the major component of the drain of £2.3 billion from the market in December, while substantial payments of corporation tax and central government receipts from the privatisation of the water authorities were also factors. The water privatisation led to very large shortages on 6 and 12 December, which were partly relieved by sale and repurchase agreements in bills due to mature in the period 27–29 December, when it was expected that much of the refunded money from only partially satisfied share applications would flow back into the market. The tighter conditions during the month, together with the further increase in amounts of maturing assistance resulting from the £1.6 billion rise in the stock of assistance to £4.8 billion by the end of December, raised the average daily cash shortage to £780 million.

The tighter market conditions in the quarter, which were partly seasonal, made a weekly Treasury bill tender as large as £800 million throughout the quarter unnecessary. Accordingly, on 10 November the £200 million 9-week bill tender (which had been introduced in late September in anticipation of heavy corporate tax payments in December and January) was discontinued, and on 24 November the 13-week tender was reduced from £500 million to £300 million. The 26-week tender, however, was left unchanged at £100 million. The stock of Treasury bills in market hands decreased by £1.0 billion to £9.0 billion during the quarter. On 2 February, the weekly tender was raised again, to £500 million of 13-week bills and £200 million of 26-week bills, to offset the net outflows to the market over the next few months that were expected to occur as a result of the seasonal pattern of Exchequer flows.

Quin Cope Ltd withdrew from its money-market dealing relationship with the Bank at the end of December, reducing the number of the Bank's money-market dealing counterparties to nine.

Gilt-edged operations

In his Mansion House speech in October the Chancellor of the Exchequer reaffirmed that the 'full fund' policy[1] did not mean that net foreign exchange market intervention would necessarily be sterilised within the financial year in which it took place. He also announced that the definition of public sector debt counting as funding would be adjusted to exclude all purchases or sales of Treasury bills. The foreign exchange reserves had fallen by £2.5 billion in the first half of 1989/90, while over the same period net sales of Treasury bills outside the bank and building society sectors amounted to £1.4 billion as the overall stock of bills outstanding increased sharply. Excluding Treasury bills, total public sector debt held outside the bank and building society sectors had fallen by £9.1 billion in the first half of the financial year. The PSDR for the whole of 1989/90 was forecast at the time of the Autumn Statement to be £12.6 billion, and in addition the funding programme had to take account of £2.2 billion of overfunding carried forward from earlier years.

(1) The 'full fund' policy is to fund the total of maturing public sector debt, the PSBR and any underlying change in the foreign exchange reserves by sales (or, if the total is negative, purchases) of debt outside the bank and building society sectors.

During the period under review the Bank continued to purchase gilt-edged stock, although on a more modest scale than earlier in the year as a rise in gilt prices during the quarter made market conditions less favourable for official purchases (see Table G). Purchases (net of sales) of stock with more than one year to maturity totalled £1.0 billion, including £0.5 billion bought at the reverse auction held on 29 September and settled on 2 October. Redemptions and net official purchases of stock with under one year to maturity amounted to £0.8 billion, and so the amount of stock outstanding in market hands declined by £1.8 billion.

During the quarter the gilt holdings of the private sector other than banks and building societies fell by £0.6 billion and those of the overseas sector by £0.7 billion, thus contributing £1.3 billion to the financial year's reduction in holdings of public sector debt outside the bank and building society sectors. Gilt holdings of banks and building societies fell by £0.5 billion.

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

	1988	1989			
	Q4	Q1	Q2	Q3	Q4
Gross official sales (a)	-1.8	-3.8	-3.0	-1.2	-1.0
less					
Redemptions and net official purchases of stock within a year of maturity	-1.9	-2.9	-2.6	-3.1	-0.8
Equals net official sales (b)	-3.7	-6.6	-5.6	-4.3	-1.8
of which, net purchases by:					
Banks (b)	*-1.1*	*-0.5*	*-0.1*	*-0.8*	*-0.5*
Building societies	—	*-1.2*	*-0.6*	*-0.9*	*+0.1*
Overseas sector	*-0.1*	*-0.2*	*-1.2*	*+0.5*	*-0.7*
M4 private sector	*-2.4*	*-4.6*	*-3.8*	*-3.2*	*-0.7*

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

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

The total nominal amount of gilt-edged stock outstanding in market hands has fallen by 14% between end-March 1988 and end-December 1989. The authorities have therefore decided, in order to assist the liquidity of the market, to give investors opportunities to convert holdings of smaller stocks into larger, more liquid issues. Accordingly, in his Mansion House speech the Chancellor announced an experimental offer to holders of 9¾% Conversion Stock 2006 to convert their holdings into 9% Treasury Loan 2008 at the rate of £100.00 nominal of the 2006 stock to £105.00 nominal of the 2008 stock. (The terms of the conversion were set in line with the market price relationship between the two stocks at the time.) When the offer closed on 14 November, 98% of the £702 million of the 2006 stock outstanding before the offer had been converted, while the amount outstanding of the 2008 stock had increased from £1,800 million to £2,521 million. Following this successful experience, the Bank made a second offer, which closed on 17 January, to convert holdings of 12% Exchequer Stock 1999/2002 into 12% Exchequer Stock 1998 at the rate of £100.00 nominal of the 1999/2002 stock to £99.90 nominal of the 1998 stock. 92% of the £1,265 million of the 1999/2002 stock was converted, increasing the amount outstanding of the 1998 stock to £3,659 million. A third conversion offer was announced on 19 January, to convert holdings of 9¾% Conversion Stock 2001 into 10% Treasury Stock 2001 at the rate of £100.00 nominal of the 9¾% stock to £98.55 nominal of the 10% stock.

The large volume of official secondary market gilt purchases over the last two years led to a sharp increase in the amount of gilts held by the Issue Department of the Bank. The overall value of the Issue Department's assets is constrained by the size of the Bank note issue. In order to ease any consequent constraint on the future official purchase of securities, the government redeemed early and then cancelled £4.5 billion of the Issue Department's holdings on 6 December 1989. The cancellations were spread across a large number of issues, and included £0.9 billion of non-marketable (NILO) stock. The operation purely concerned the internal accounts of central government and the Bank of England, and does not affect holdings in the wider gilt-edged market.

One Stock Exchange money broker, Hoare Govett (Moneybroking) Limited, withdrew from the market during the

period under review, reducing the number of money brokers to nine. Chase Manhattan Gilts Limited, Credit Lyonnais Gilts Ltd and Merrill Lynch Government Securities Company had withdrawn as gilt-edged market makers during the third quarter, reducing the number of market makers to nineteen. The article 'The gilt-edged market: developments in market-making in 1989' on pages 62–70 reviews the performance of market makers over the last year.

Table H
Changes in UK official reserves
$ millions

	1989		
	Oct.	Nov.	Dec.
Changes in reserves	**-3,195**	**- 914**	**- 122**
of which:			
Net borrowing (+)/payment (-) of public debt	- 154	+ 17	- 460
Valuation change on roll-over of EMCF swap	- 146	—	—
Underlying change in reserves	-2,895	- 931	+ 338
Level of reserves (end of period)	39,681	38,767	38,645

Official reserves

The official reserves decreased by $5.0 billion over the three months to end-December, to stand $13.0 billion below their level at the end of 1988 (Table H). Some $3.5 billion of the decline over the year was accounted for by the annual revaluation of the reserves last March. The fall over the last three months was $3.5 billion in underlying terms, ie excluding changes arising from net foreign currency borrowing and debt repayment. The bulk of the decline in reserves occurred in October, when sterling depreciated against most currencies, while a further fall in reserves in November was partly offset by December's underlying rise.

ECU Treasury bills

At each of the latest three tenders of ECU Treasury bills on 14 November, 12 December and 9 January the Bank allotted ECU 900 million of bills to the market, equally split between one-month, three-month and six-month bills, and ECU 50 million of six-month bills directly to itself. This increased the amount of bills outstanding in the market to ECU 2,900 million as at 11 January.

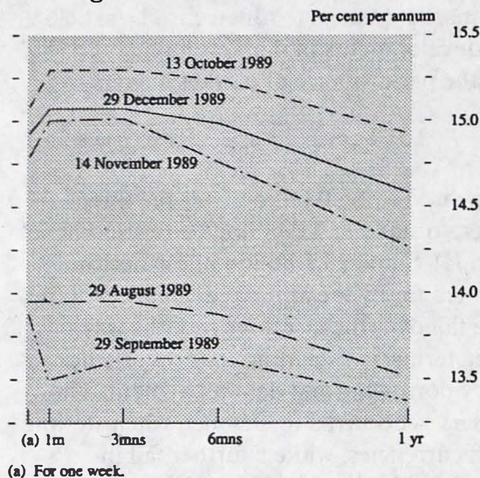
On average the latest three monthly tenders were covered 2.6 times, slightly above the rate of cover in the previous quarter, while the margin by which the average accepted yield has been below the bid rate for ECU-denominated bank deposits narrowed from $\frac{5}{16}$% to $\frac{7}{32}$%. Over 1989 as a whole, the monthly tenders were all covered between 2 and 4 times, while yields were on average $\frac{7}{32}$% below the ECU deposit bid rate. Monthly turnover in the fourth quarter averaged ECU 6,000 million, 34% above the previous quarter and 66% above the first quarter, while the amount of bills outstanding increased by 53% from ECU 1,900 million in the year to end-January.

Four new firms were added to the list of market makers in the period under review, while two withdrew from the market, bringing the total number of market makers to twenty-seven. A three-month ECU deposit futures contract was launched on LIFFE in October, and lending charges for ECU bills have recently been lowered by settlement agents Cedel and Euroclear. These developments have further enhanced what has already proved to be a very liquid market.

Market developments

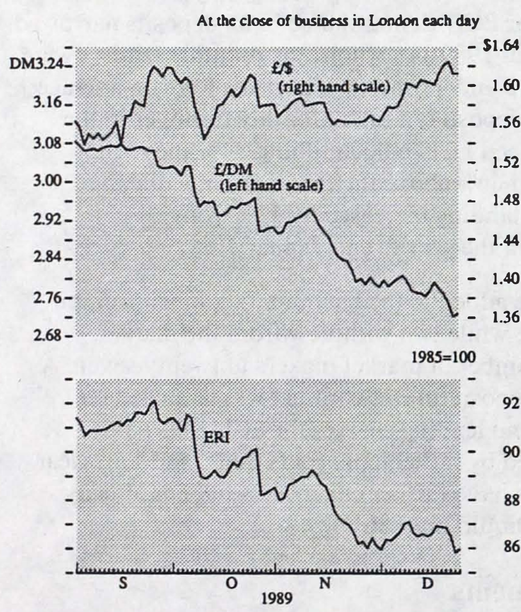
At the beginning of the period under review, there were widespread market expectations of an imminent rise in UK interest rates from 14%, which were fulfilled on 5 October when rates went up to 15% immediately following a rise in German rates. Market conditions remained volatile during the first half of the period as sterling weakened, and at one stage money-market interest rates rose significantly above 15%, implying some market expectation of a further rise in base rates. The authorities resisted

Sterling interbank rates



(a) For one week.

Sterling exchange rates



this pressure, however, and domestic markets were much calmer in the second half of the period. Sterling weakened against the generally stronger deutschemark during November and December but firmed against the dollar, and interbank rates remained fully consistent with 15% base rates.

The circumstances surrounding the rise in interest rates on 5 October were described in the November 1989 *Bulletin* (page 502). Sterling had fallen sharply, particularly against the deutschemark, over the last few days of September in response to the larger than expected August current account deficit announced on 26 September. The money-market pressure was evident from one-month to twelve-month interbank interest rates around 14½%, and very-short-maturity rates well below 14%, indicating investors' reluctance to hold assets of longer maturity. Conventional gilt yields had risen also, by as much as ¼% at the shorter maturities.

Money-market rates were somewhat easier at the opening on 2 October, as the authorities' resistance to higher base rates was noted. However, speculation about a German tightening built up again as the Bundesbank Council meeting on 5 October approached. Sterling fell further on 4 October, to DM 3.01 and by 0.3 on the exchange rate index, and interbank rates climbed back to the levels reached at the end of September. After the Bundesbank meeting, the German Lombard and discount rates were raised by 1%. The Bank immediately signalled a 1% rise in base rates by announcing at 2.00 pm on 5 October that the day's shortage would be relieved by 2.30 pm lending at 15%.

Interbank rates rose immediately after the Bank's action was announced. With one-month to six-month rates settling just above 14¾% and the twelve-month rate 14 9/16%, it appeared that the market thought base rates might now be at their peak. Sterling rebounded somewhat, conventional gilt yields steadied, and index-linked yields edged up. However, by 9 October downward pressure on the pound resumed, as the market continued to show disappointment at the speed of adjustment of the economy.

Sterling's exchange rate index fell below 90, breaching the year's previous low-point set in late June, and the pound also dropped through DM 3 and $1.60. Over the next few days the pound remained weak, particularly against the dollar, the renewed strength of which was reported to have led to co-ordinated official intervention. One-month to six-month interbank rates rose above 15%, although no further rise in base rates was expected, and conventional gilt yields rose by ⅛%–¼%. Interbank rates edged up further after the announcement of an unexpected rise in the twelve-month growth rate of the RPI in September.

The sharp drop in US equity prices on Friday 13 October abruptly changed sentiment in world markets as comparisons were made with the stock market crash of two years earlier. The dollar fell, and US Treasury bond yields declined by ¼% in a 'flight to quality'. When UK markets opened after the weekend, the path of equity prices mirrored that in the United States, although the scale of the fall was smaller; and money-market rates and bond yields fell sharply, especially at shorter maturities, as markets recalled the accommodative stance taken by the authorities after the 1987 crash. Sterling's ERI was little affected

Table J
Sterling interest rates, gilt yields and exchange rates

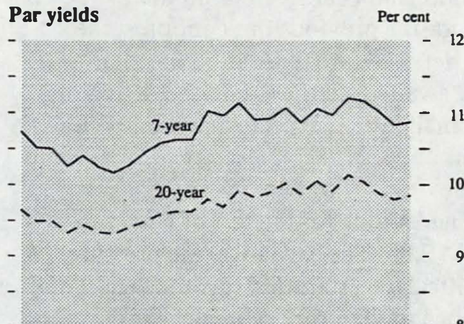
Date	Interbank interest rates (per cent per annum)				Gilt yields (per cent per annum)				Exchange rates		
					Conventionals			Index-linked			
	1 month	3 months	6 months	12 months	Short	Medium	Long	Long	ERI	£/$	£/DM
29 September (close)	14 9/16	14 11/16	14 21/32	14 7/16	11 5/32	10 19/32	9 5/8	3 1/2	91.4	1.6190	3.0291
5 October (close)	14 29/32	14 29/32	14 13/16	14 9/16	11 7/32	10 11/16	9 5/8	3 9/16	91.6	1.6195	3.0325
9 October (close)	14 31/32	14 31/32	14 15/16	14 11/16	11 5/32	10 5/8	9 5/8	3 9/16	89.8	1.5780	2.9769
13 October (close)	15 1/4	15 5/16	15 3/16	14 15/16	11 7/32	10 21/32	9 23/32	3 19/32	89.3	1.5625	2.9602
16 October (close)	14 31/32	14 31/32	14 3/4	14 1/2	10 27/32	10 13/32	9 19/32	3 1/2	89.0	1.5795	2.9327
26 October (close)	15 3/32	15 3/32	14 7/8	14 9/16	10 25/32	10 5/16	9 1/2	3 15/32	90.1	1.6075	2.9674
27 October (close)	15 1/2	15 9/16	15 5/16	14 13/16	11 1/32	10 1/2	9 23/32	3 1/2	88.2	1.5775	2.8979

as the pound's gains against the dollar were balanced by losses against other currencies.

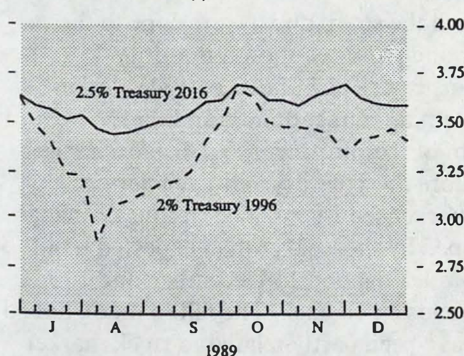
In the event, equity prices stabilised at only moderately lower levels without there being any easing of monetary policy, and money-market rates and bond yields retraced part of their fall. The market mood was not helped by news on 19 October of a £10 billion rise in M4 lending in September and on 24 October of a £1.6 billion trade deficit for the same month, but sterling benefited from continued dollar weakness, and gilt yields eased down again as the Chancellor's Mansion House prediction of a slowing economy was matched by similar private-sector forecasts.

Gross redemption yields on UK government securities

Par yields



Index-linked stocks (a)



(a) Real yields assuming 5% inflation.

The resignation of the Chancellor of the Exchequer late on 26 October provoked a sharp overnight fall in sterling. Market speculation that the authorities might raise interest rates to support the currency caused three-month interbank rates to open above 15½% on the next day, and gilt yields rose by up to ¼%. The authorities resisted this pressure by conducting 2.30 pm lending on 27 October at an unchanged rate of 15% and by declining to allot Treasury bills at that day's tender at the prices bid, which if accepted would have implied endorsement of a sharply higher level of bill yields. Interbank rates and gilt yields fell back again over the next few days and the foreign exchange market regained its composure as the new Chancellor emphasised that the government's economic policy would be unchanged.

The High Court judgment on 1 November that Hammersmith and Fulham Council's interest rate swap transactions had been *ultra vires* caused a setback to the gilt market on speculation that, in the light of the judgment, financial institutions exposed in swaps to local authorities would partially cover their resulting open positions by selling gilts, and sterling weakened further on the following day. Interbank rates and conventional gilt yields firmed in response to this further weakening of the pound, but UK markets calmed down considerably over the next few days, as the new Chancellor was favourably received and analysts reviewed the options for monetary and economic policy. Sterling rebounded, and one-month to six-month interbank rates fell back to 15% or below as market nervousness about a possible imminent rise in base rates dissipated.

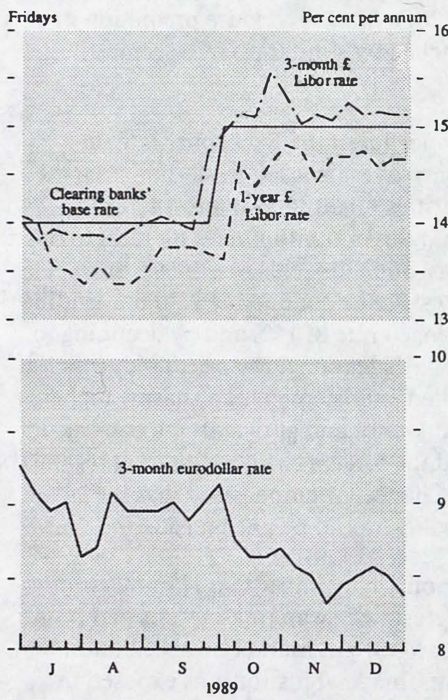
UK markets then remained calm until the middle of November, although in foreign exchange markets the deutschemark began to strengthen, apparently in response to political developments in

Table K
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			
	1 month	3 months	6 months	12 months	Short	Medium	Long	Long	ERI	£/$	£/DM
2 November (close)	15 5/32	15 5/16	15 3/16	14 3/4	11 3/16	10 5/8	9 13/16	3 15/32	88.0	1.5677	2.8940
14 November (close)	14 29/32	14 31/32	14 3/4	14 5/16	11	10 17/32	9 11/16	3 15/32	89.1	1.5815	2.9308
20 November (close)	15 1/16	15 1/8	15	14 21/32	11 5/16	10 23/32	9 29/32	3 9/16	87.5	1.5595	2.8651
4 December (close)	15 1/16	15 3/16	15 1/16	14 11/16	11 13/32	10 7/8	9 31/32	3 17/32	86.0	1.5627	2.7827
11 December (close)	15 1/32	15 1/32	14 15/16	14 5/8	11 1/4	10 11/16	9 25/32	3 15/32	87.0	1.5882	2.8071
20 December (close)	15 3/32	15 3/32	14 15/16	14 9/16	11 1/16	10 1/2	9 5/8	3 7/16	86.9	1.6010	2.7937
29 December (close)	15 3/32	15 3/32	14 31/32	14 5/8	11 1/16	10 15/32	9 21/32	3 15/32	86.0	1.6125	2.7275

East Germany. Sterling came under more broadly-based downward pressure after the Chancellor's Autumn Statement on 15 November, which forecast low growth and only a modest reduction in the RPI inflation rate excluding mortgage payments during 1990. A higher than expected RPI figure for October announced on 17 November accelerated the currency's fall, but the increase in interbank rates was comparatively modest, as few observers expected the authorities to respond by tightening monetary policy, given the slowdown in the domestic economy already taking place. Gilt yields rose sharply on more pessimistic long-run forecasts of inflation as well as sterling's decline. In the more nervous market mood, and bearing in mind the disappointing trade data for the previous three months, the October current account deficit figure to be announced on 23 November was keenly awaited. In the event, the deficit of £1.5 billion was slightly smaller than expected, and market interest rates edged down.

Short-term interest rates in London

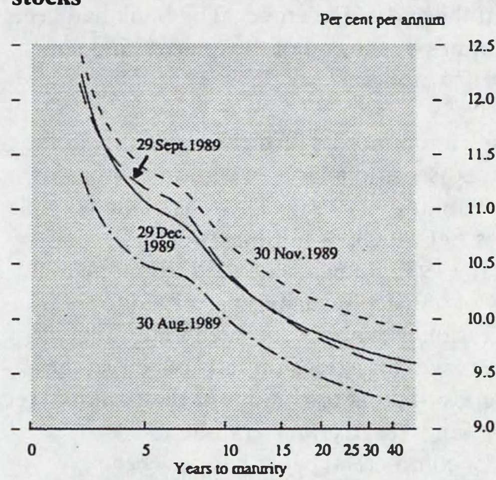


The deutschemark remained strong for the rest of November, and sterling fell below DM 2.80. The exchange rate pressure, together with further political uncertainties, this time caused by the possibility of a challenge to the Prime Minister for the Conservative Party leadership, caused a further rise in interbank rates and gilt yields, though the sharp downward slope to the interbank yield curve beyond the three-month maturity persisted. The Prime Minister's re-election as party leader on 5 December removed one market uncertainty, and the Chancellor's reiteration of his commitment to a firm exchange rate at his appearance before the Treasury and Civil Service Committee also helped market sentiment. The sterling exchange rate index recovered, helped by the weaker than expected retail sales and producer price index data on 11 December, and interbank rates and gilt yields eased back. The fall in index-linked yields at this time may have been partly related to stock market strength. In foreign exchange markets, the deutschemark continued to rise, reflecting the market view that German interest rates might rise in coming months, partly in response to inflationary pressures in West Germany arising from immigration from the East and possible eastward capital flows from West Germany. Sterling's firmness against the dollar helped to offset the effect on the exchange rate index of the deutschemark's strength.

Conventional gilt yields fell by $\frac{1}{8}$%–$\frac{1}{4}$% in the period up to Christmas, as weaker than expected November indicators, for the

RPI announced on 15 December and for M4 lending on 20 December, provided further indications of the slowdown in the economy. However, the market view was that interest rates would have to remain high for some time, and interbank rates remained very stable, with the three-month rate at about 15⅛%. In foreign exchange markets trading in sterling was also quiet, but Eastern European developments continued to provide support for the deutschemark, and in thin post-Christmas trading sterling surrendered some of its recent gains against the dollar, while falling to a record low of DM 2.7025 (the previous low point having been DM 2.7349 in January 1987). It recovered a little on 29 December as the November current account deficit of £1.4 billion was a little smaller than the market had expected; interbank rates and gilt yields eased also.

Time/yield curves of British government stocks



Interbank rates ended the three months under review about ½% higher at the one-month maturity, but only $\frac{3}{16}$% higher at twelve months. The much more pronounced downward slope to the interbank interest rate curve beyond three months indicated that a decline in short-term interest rates as the UK economy slowed down was seen by the market as being closer at hand. The March 1990 and June 1990 short sterling futures were priced at 85.52 and 86.40 respectively, implying an expected fall of about 1½% in interest rates in the six months to June. Conventional gilt yields were almost ⅛% lower at the short end, and little changed at the long end, from their levels at the end of September so that the downward slope of the yield curve had flattened slightly. The decline at the shorter end perhaps also reflected a greater degree of confidence in the pace of economic adjustment.

The deutschemark's worldwide strength led to a 10.0% fall in sterling against that currency over the quarter to DM 2.7275. The pound ended the period only 0.4% down against the dollar, at $1.6125, having spent virtually the whole quarter at slightly lower levels and reached a low point of $1.5372 during the period of dollar strength before the stock market slump on 13 October. The 5.9% fall in sterling's exchange rate index to 86.0 was therefore more a reflection of deutschemark strength than of widespread sterling weakness.

Market turnover

Transactions in eligible bills by discount houses,[1] including sales to the Bank, averaged £1.5 billion daily over the period under review, up from £1.3 billion in the third quarter. Within the total, average daily transactions in Treasury bills continued to rise, by £60 million to £300 million. Discount house transactions in certificates of deposit rebounded to an average £0.6 billion in the period, having fallen to £0.5 billion in the third quarter. Average daily turnover in the short sterling futures contract on the London International Financial Futures Exchange rose to a record 33,900 contracts in the fourth quarter from 26,300 in the previous three months, despite quiet pre-Christmas trading which resulted in a December average of 18,000. October's exceptional average of 47,800 came in a month of particular uncertainty in the money markets and illustrated the growing tendency for the futures contract to be used by financial institutions as the most convenient and liquid instrument for quickly adjusting short-term interest rate exposure.

(1) Figures for discount houses cover only those money-market dealing counterparties of the Bank of England which are authorised under the Banking Act 1987.

Total turnover in gilts fell to an average of £3.5 billion per day in the fourth quarter from a revised figure of £3.8 billion per day in the third quarter. Within the quarter, the volume of transactions was lowest in November.

Average daily turnover in the long gilt futures contract rose to 14,800 contracts from 14,600 in the third quarter, but was still well below the 17,800 figure a year earlier. There were no call or put warrants exerciseable into gilt-edged stock outstanding at the end of 1989, £150 million of call warrants having expired during the period under review.

Commercial paper and medium-term notes

Gross issues of sterling commercial paper during the fourth quarter totalled £11,699 million, down from a revised £12,130 million in the previous three months. There were redemptions of £12,379 million, and the total paper outstanding fell to £3,497 million at the end of December. The Bank had been notified of 211 programmes by the end of the quarter, and paper had been issued under 174 of these.

On 11 January, the Bank announced a further broadening in the range of short-term paper issues available to certain companies without infringing the Banking Act 1987. This was made possible by the 1989 Companies Act which, in fulfilment of a commitment made in the 1989 Budget, extended from one to five years the maturity of unlisted securities permitted to be issued onshore to professionals without the need for a prospectus. In order to make this extension fully effective, the exemption from the deposit-taking provisions of the Banking Act provided under the Banking Act (Exempt Transactions) Regulations for issues of commercial paper has now been similarly amended. However, whereas paper up to and including one year will continue to take the form of 'commercial paper', issues of over one year and up to five years will be referred to as 'medium-term' notes. The Bank has also taken the opportunity to broaden the terms of the exemption to include paper issues in currencies other than sterling, including ECU. Although there is already a thriving secondary market in London in eurocommercial paper and euro medium-term notes, and the Bank intends that this should continue undisturbed, issuers may find it convenient to have available this alternative route for issuing these forms of paper. A Bank notice[1] of 11 January on Commercial Paper, Medium-Term Notes and Other Financial Instruments sets out the newly revised arrangements for these instruments and replaces the Bank's notice of 14 March 1989 on Sterling Issues.

Other capital markets

The FT-SE 100 share index ended the period under review at 2,422.7, a rise of 5.4%. Equity prices had dropped sharply during October, particularly on Monday 16 October when the FT-SE index fell by 70 points in the wake of the steep fall on Wall Street on the previous Friday evening. This had been precipitated by the breakdown of the proposed $6.8 billion management buyout of United Airlines. The rise in base rates, sterling's decline and the Chancellor's resignation were other factors behind the 6.8%

(1) The notice is available from the Bank's Gilt-Edged and Money Markets Division (telephone 01-601 3100).

fall in the index over the month as a whole. Over the next two months, market confidence returned and equities recovered strongly, boosted by the growing signs of economic adjustment, takeover activity and gains on overseas stock markets. The FT-SE 100 share index reached 2,463.7 at the close on 3 January, surpassing its previous record high of 2,443.4 set before the 1987 crash, before falling back.

The sale by the government of water shares took place on 6 December and met with strong demand at £2.40 per share. It raised £5.24 billion for the ten water companies. Excluding water privatisation, the volume of sterling capital issues was significantly lower than in the previous quarter (see Table L). Announcements of new equity issues were down by around £0.5 billion, with volume being particularly low in November. Activity in the sterling debt markets was also depressed. It is notable that over half the volume of fixed-rate issues during the period was accounted for by non-UK borrowers, predominantly in the public sector.

Table L
Sterling capital issues: amounts announced
£ millions

	Equities(a)	Fixed rate(b)			FRNs
		Domestic issues (including preference shares) (c)	Sterling eurobonds		
			UK borrowers	Overseas borrowers	
1988	5,954	3,192	4,080	3,219	6,132
Q1	894	320	1,890	1,340	1,129
Q2	1,686	1,047	1,080	1,669	2,067
Q3	2,027	533	135	—	2,017
Q4	1,347	1,292	975	210	919
1989	6,967	5,337	3,292	3,303	4,300
Q1	640	1,749	1,713	922	600
Q2	2,527	1,519	514	961	1,625
Q3	2,159	1,137	825	995	1,325
Oct.	471	351	-	200	325
Nov.	286	552	200	125	250
Dec.	884	29	40	100	175
Q4	1,641	932	240	425	750

(a) Excludes privatisation issues.

(b) Of which £167 million was equity-related in the fourth quarter of 1989 and £2,654 million in 1989 as a whole.

(c) All UK borrowers except for:
Two preference share issues in 1988 Q2 for £218 million.
Two 'bulldog' issues in 1988 Q4 for £200 million.
Two 'bulldog' issues in 1989 Q1 for £225 million.
Two 'bulldog' issues in 1989 Q2 for £100 million.
Two 'bulldog' issues in 1989 Q3 for £275 million.
Three 'bulldog' issues in 1989 Q4 for £385 million.
Excludes local authority issues.

Total issues by UK borrowers in currencies other than sterling declined from $3.0 billion in the third quarter to $1.6 billion in the fourth. The proportion of the total accounted for by fixed-rate bonds increased from 52% to 94%. The yen replaced the US dollar as the foreign currency most actively used by UK international borrowers, accounting for 38% of the volume, followed by the US dollar (36%) and the Australian dollar (14%).

Foreign currency bond issues for UK banks and other financial institutions declined from $1.9 billion in the third quarter to $0.9 billion in the fourth. Issues by the corporate sector also fell, from £1.1 billion to £0.7 billion.