Operation of monetary policy

This article covers the two months November and December 1986.

Review

Financial sentiment, which had been disturbed in the preceding period, remained fragile throughout November, but became gradually less anxious towards the end of the year and into 1987. In consequence, market concerns about the possibility of higher interest rates, which had never been acute, eased as the period progressed. The authorities did not consider that the general structure of interest rates should move during the two months under review.

Monetary conditions remained difficult to interpret. M0 growth edged up during the period; while remaining within the 2%–6% target range, its twelve-month rate rose to 5.2%. £M3 growth moderated somewhat, but its rate of 18.2% in the year to December was still above its 11%–15% target range.

Table A
Growth rates of the monetary aggregates
Percentages

	Unadjusted		Seasonally adjusted(a)	
Calendar months	12months to Sept. 86	12 months to Dec. 86	July 86– Sept. 86	Oct. 86– Dec. 86
M0(b)	+ 4.8	+ 5.2	+1.6	+2.4
£M3	+19.2	+18.2	+4.5	+1.5
Non-interest-bearing M1	+17.3	+11.6	+9.3	–4.9
M1	+25.2	+21.3	+8.1	–0.6
M2(c)	+15.4	..	+4.4	..
	+15.4	..	*+4.4*	..
PSL1	+18.4	+17.4	+4.4	+1.4
PSL2(d)	+15.0	+14.8	+3.0	+2.2
M3	+21.8	+21.4	+6.8	+2.1

.. not available.
(a) Seasonal adjustments constrained over the financial year.
(b) Weekly average.
(c) Excluding the effect of changes in the terms of existing accounts. Figures including such effects are shown in *italics*.
(d) New definition: see June 1986 *Bulletin*, page 186.

On the other side of the balance sheet, bank lending was again high, partly fuelled by takeover activity, and with some evidence of an increase in the underlying trend. Lending for consumption remained strong but lending for house purchase decelerated, although this may have partly reflected increasing use of non-bank financing vehicles. Building society lending and commitments to lend have also been growing less fast. The effect of strong bank lending on broad money growth was muted by substantial overfunding of the PSBR during the period. Government receipts (including British Gas privatisation receipts) proved buoyant and there was an unexpectedly large surplus in the public sector's accounts.

Economic indicators released during the period added to the evidence of stronger economic growth, led by consumer spending, during the second half of 1986, and this was accompanied by upward revision to growth prospects for the economy in 1987. Despite ambiguities in the statistics, it was also clear that output growth did not keep pace with demand, with the result that the visible trade balance deteriorated. Recorded unemployment, meanwhile, fell on a seasonally adjusted basis in each of the last five months of the year, and the previous upward trend ceased even if allowance is made for special measures. Inflation, as measured by the twelve-month change in the RPI, rose further during the period, reaching 3.7% in December. Other indicators, however, suggested that the underlying rate of inflation, which had not been as low as the RPI, might not have risen. In particular, unit labour costs have hardly increased since March. This has mainly reflected cyclical productivity improvements. For the future, evidence is accumulating of a significant reining back in the size of wage settlements.

The most significant external event during the period was the changed situation in the oil market following the successful

Table B
Composition of changes in the money stock

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

Calendar months	July 86– Sept. 86	Oct. 86– Dec. 86	Level outstanding at end-Dec. 86
1 Non-interest-bearing M1	+3.6	−2.1	40.3
2 Interest-bearing sight deposits	+1.9	+1.7	33.6
3 M1 (= 1+2)	**+5.6**	**−0.4**	**73.9**
4 Private sector holdings of time deposits with banks and bank CDs	+0.9	+2.7	76.4
5 £M3 (= 3+4)	**+6.4**	**+2.2**	**150.3**
Non-bank private sector holdings of:			
6 Building society shares and deposits(a)	+1.4	+3.7	117.0
7 Building society wholesale liabilities(b)	+0.2	+0.5	2.5
8 Other	−0.3	−0.6	5.2
9 PSL2 (= 5+6+7+8)(c)	**+7.7**	**+5.9**	**275.0**

(a) Including term shares and interest credited.

(b) CDs and time deposits (excluding holdings by building societies themselves).

(c) See June 1986 *Bulletin*, page 186.

Table C
Changes in £M3 and its counterparts[a]

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

Calendar months	July 86– Sept. 86	Oct. 86– Dec. 86	Oct. 85– Dec. 85	Jan. 86– Dec. 86
1 Central government borrowing requirement	+3.2	− 2.4	+ 3.1	+ 9.7
of which:				
own account borrowing:	*+2.9*	*− 2.2*	*+ 1.1*	*+ 3.6*
on-lending to:				
local authorities	*+0.5*	*− 0.2*	*+ 1.3*	*+ 5.9*
public corporations	*−0.1*	*+ 0.1*	*+ 0.6*	*+ 0.3*
2 Other public sector borrowing	−0.7	+ 0.1	− 1.9	− 6.1
3 PSBR (= 1 + 2)	**+2.5**	**− 2.3**	**+ 1.2**	**+ 3.6**
4 Net purchases (−) of central government debt by the non-bank private sector	−1.6	− 1.9	− 1.4	− 6.0
of which:				
Gilt-edged stocks	*−0.9*	*− 1.8*	*− 1.0*	*− 3.6*
National savings	*−0.8*	*− 0.8*	*− 0.3*	*− 2.6*
CTDs	—	*+ 0.8*	*− 0.1*	*+ 0.3*
5 Net purchases (−) of local authorities' and public corporations' debt by the non-bank private sector	+0.2	− 0.4	+ 0.3	+ 2.0
6 External and foreign currency finance of the public sector(b)	−0.8	− 0.9	− 1.0	− 1.6
of which, gilt-edged stocks (purchases −)	*−0.4*	*− 0.6*	*− 0.6*	*− 1.8*
7 Overfunding (−) = (3 + 4 + 5 + 6)	+0.3	− 5.5	− 0.9	− 1.9
8 Sterling lending by the banking system to the UK private sector(c)	+6.8	+10.1	+ 5.4	+29.6
9 External and foreign currency finance of the monetary sector(d) / 10 Net non-deposit sterling liabilities (increase −)	−0.8	− 2.4	− 1.5	− 3.9
11 Change in £M3 = (7 + 8 + 9 + 10)	**+6.4**	**+ 2.2**	**+ 3.0**	**+23.8**

(a) Counterparts may not add up to the total change in £M3 because of rounding.

(b) Includes net overseas purchases of public sector debt *less* the public sector's net acquisition of claims on the overseas sector.

(c) Includes changes in Issue Department's holdings of commercial bills and of promissory notes relating to shipbuilding paper guaranteed by the Department of Trade and Industry.

(d) The net external sterling deposit liabilities of the monetary sector (increase −) *plus* the net foreign currency liabilities of the monetary sector to all sectors (increase −).

conclusion to the OPEC conference, with the oil price increasing by some 25% between the end of October and the end of December. This exerted an important influence on the exchange rate which, having declined during November, reaching a low point of 67.6 on the ERI, firmed by two points in December before settling back to 69.2 at the end of the period. This increase in the exchange rate was nonetheless insufficient to compensate for the rise in the oil price experienced during that time, with the result that, if sustained, there would be upward pressure on inflation in due course. The reassurance provided by the oil price increase nonetheless helped sterling to remain on the sidelines during the turbulence in the foreign exchange markets around the turn of the year, involving a sharp weakening in the dollar and pressure within the exchange rate mechanism of the EMS, leading to a realignment.

A particular policy concern in the early part of the period was the risk that market unease, never far below the surface, would develop into a break in confidence. In fact, despite continuing concern about the balance of payments, sentiment improved as the period progressed, reflecting developments in the oil market, the improved perception of economic prospects in 1987 and the strong financial position of the public sector. The emergent strength of the economy together with an increase in the exchange rate that was only moderate in relation to the oil price rise might have suggested the need for some tightening of policy. But the signs of output response were sufficiently encouraging to suggest that earlier market fears of inflation and balance of payment problems were exaggerated.

In view of the entry into force of the Building Societies Act on 1 January 1987, the authorities announced in December the ending of mortgage lending guidance with effect from the same date. Recent experience of strong credit growth was an uncomfortable background against which to make this change. Nonetheless, it was considered illogical to continue special restraint on this particular form of secured consumer lending when the building societies' freedom to lend was being widened. At the same time, the authorities took the opportunity to remind banks and building societies of the need to maintain prudential standards in this area, and announced a survey of banks' default experience on mortgage lending.

Monetary aggregates and credit

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

M0 grew by 1.0% in November and by 1.4% in December, bringing the twelve-month rate up to 5.2% from 4.9% at end-October, closer to the upper end of the 2%–6% target range. December's rise in M0 was similar to that seen at the same time last year, both reflecting unusually strong Christmas spending. The large rise in November may also have reflected Christmas spending, as there is some evidence from retail sales figures that the pattern of sales was a little different this year.

The behaviour of the wider monetary aggregates in November and December was affected by the British Gas privatisation.[1]

(1) The reclassification of British Gas as part of the non-bank private sector is reflected in the stock series for monetary aggregates at end-December. The recorded flows, however, and hence the growth rates of £M3 and PSL2, are unaffected by the reclassification.

Additional bank deposits, perhaps as much as £½–1 billion, sufficient to account for between 0.3 and 0.7 percentage points of the overall rise of 1.3% in £M3 in November, were built up by the end of that month in preparation for the sale. This distortion probably unwound by the end of December, and accounted in part for the December rise in £M3 being small, at only 0.2%. By the end of 1986 the twelve-month growth rate of £M3 had declined to 18.2%, down from 18.7% at the end of October, but still well above the target range of 11%–15%.

Among the components of £M3, non-interest-bearing M1 increased by 1.1% in November and by 0.6% in December. The path of non-interest-bearing M1 in recent months has been heavily influenced by the TSB and British Gas issues. Interest-bearing M1 rose by some £1.3 billion (3.8%) in November, then declined by an equivalent amount in December. This fall coincided with a rise of £1.5 billion in time deposits in December. This suggests that December saw a (probably temporary) set-back to the trend toward greater use of interest-bearing sight deposits.

The two main features of the asset counterparts of £M3 growth in November and December were overfunding of the PSBR and the strength of bank lending. Government receipts benefited during the period from stronger than expected non-oil tax revenues and from the British Gas privatisation. Net sales of central government debt to the non-bank private sector declined from £0.9 billion in November to almost zero in December, when there were large surrenders of certificates of tax deposit, and with external and foreign currency finance of the public sector totalling £0.4 billion, the PSBR was overfunded by £2.5 billion (not seasonally adjusted) in the two months added together. This brought cumulative overfunding in the first nine months of the financial year to £3.7 billion (£1.5 billion not seasonally adjusted), about 2¾% of the stock of £M3 at end-March. Given the policy of fully funding the PSBR over the financial year as a whole, this will be reversed over the first quarter of 1987.

Bank lending rose by £3.9 billion in November and £2.7 billion in December, giving a total increase in the fourth quarter of £10.1 billion, compared with £6.5 billion and £6.8 billion in the previous two quarters. The strength of the increase is largely attributable to takeover and merger activity and the impact of changes in the City. Some £1 billion of the increase in November alone is thought to have been associated directly with the financing of takeovers.

Provisional estimates of the changes in bank lending and bank deposits by sector in the fourth quarter are shown in Table D. The large movements in transit items in the third and fourth quarters largely reflect the timing of subscriptions to the TSB share issue, which spanned end-September. These items are attributed to industrial and commercial companies (ICCs) within the recorded statistics for bank deposits and bank lending, but, given their origin on this occasion, are probably more appropriately attributed to the personal sector. With this in mind, the underlying picture in the fourth quarter is one of a large net recourse to banks by both the personal sector and ICCs.

In underlying terms, persons' bank deposits fell, largely to finance purchases of British Gas shares. On this basis, their

Table D
UK monetary sector: sterling and foreign currency deposits and lending
£ billions, *seasonally adjusted* (a)

	1986 Year	Q1	Q2	Q3	Q4
Sterling deposits					
Other financial institutions	5.4	2.1	-0.1	1.5	1.9
Industrial and commercial companies	8.7	2.6	2.8	3.3	-0.1
Persons	8.4	3.2	3.5	1.4	0.3
Total	22.4	7.9	6.2	6.2	2.2
of which, transit items allocated to ICCs	—	*-0.4*	*0.2*	*1.2*	*-1.0*
Sterling lending					
Other financial institutions	9.8	2.0	2.1	3.0	2.7
Industrial and commercial companies(b)	9.1	2.3	1.1	0.9	4.9
Persons	10.8	1.9	3.4	2.9	2.6
Total	29.6	6.3	6.5	6.7	10.1
of which, transit items allocated to ICCs	—	*0.3*	*-0.2*	*-0.8*	*0.7*
Foreign currency deposits					
Other financial institutions	4.5	0.6	1.2	0.5	2.2
Industrial and commercial companies	2.7	0.1	1.1	2.1	-0.5
Persons	—	0.1	-0.1	0.1	—
Total	7.3	0.8	2.1	2.7	1.7
Foreign currency lending					
Other financial institutions	10.7	3.3	3.2	3.6	0.6
Industrial and commercial companies	-3.3	-1.4	-2.0	0.2	-0.1
Persons	0.8	0.4	0.3	-0.1	0.2
Total	8.8	2.4	1.6	3.7	0.6

(a) Seasonal adjustments constrained over the calendar year.
(b) Includes Issue Department take up of commercial bills and guaranteed shipbuilding paper.

borrowing probably rose faster than in the previous quarter. Within the total increase, lending for house purchase by the banks[1] slowed in the fourth quarter but still was substantially above the rate seen in the first half of the year and the equivalent period last year (perhaps a better comparison as there is some evidence that the seasonal pattern in mortgage lending is changing). Lending for consumption probably rose more quickly in the recent quarter, but this may have largely represented the financing of Christmas spending.

Table E
Industrial and commercial companies: some sources of finance
£ billions, *not seasonally adjusted*

	1985 Year(a)	1986 Year(a)	Q1	Q2	Q3	Q4
Net equity issues:						
Listed companies	4.1	5.7	0.7	1.7	1.6	1.8
Unlisted market	0.2	0.2	—	—	0.1	0.1
Gross international bond issues:						
Sterling	0.5	1.2	0.2	0.8	0.2	0.1
Foreign currency	1.1	2.2	0.5	0.8	0.3	0.6
Net commercial paper issues:						
Sterling	—	0.4	—	0.1	0.2	0.1
US dollar(a)	..	..	..	..	0.3(b)	..
Borrowing from UK banks:						
Sterling(c)(d)	5.3	9.4	4.0	-0.1	0.4	5.2
Foreign currency	2.4	-3.3	-1.4	-2.0	-0.2	-0.1

— less than £50 million.
.. not available.

(a) Outstanding US commercial paper issued by ICCs increased from $1.7 billion at end-June 1984 to $2.2 billion at end-June 1985 and $3.6 billion at end-June 1986. These figures do not include euronotes or eurocommercial paper.
(b) Provisional.
(c) Includes Issue Department take-up of commercial bills and guaranteed shipbuilding paper.
(d) Includes changes in borrowing by some securities dealers up to 1986 Q3 (see the December 1986 *Bulletin*, page 478).

ICCs' sterling bank deposits grew by a modest amount in underlying terms, under half the rate of recent quarters. Their sterling bank borrowing on the other hand rose substantially. Some of the rise in borrowing and slowdown in sterling deposits probably reflected the payment of taxes, which have been notably buoyant over the last few months. ICCs' bank borrowing was also inflated by the financing of takeovers (particularly in November).

Sterling borrowing and bank deposits of other financial institutions (OFIs) are less affected by the treatment of transit items than those of the other sectors. Their bank deposits are provisionally estimated to have grown by almost £2 billion in the fourth quarter, following a rise of £1.5 billion in the third. Almost half of the rise in the second half of last year was due to building societies. OFIs' sterling bank borrowing grew by £2.7 billion, only a little less than the previous quarter. Lending was probably higher in both quarters owing to the impact of changes in the City, notably Big Bang. Building society recourse to banks also contributed to the rise in OFI borrowing. In the three months to end-November, wholesale borrowing by societies from banks rose by £0.6 billion.

Table D also shows estimates of sectoral borrowing and deposits in foreign currencies. One striking feature is the high rate of OFIs' borrowing in foreign currencies through the first three quarters of last year, which fell abruptly in the fourth quarter. The sharp rise may be to some extent overstated in the recorded statistics, which include prior to the fourth quarter estimates only of foreign currency lending to securities dealers, rather than figures reported directly by the banks (as is the case in the fourth quarter). Nevertheless, a sharp rise in lending to securities dealers is likely to have occurred in the period up to Big Bang as trading portfolios were built up.

Table F
Non bank financial institutions: some sources of finance
£ billions, *not seasonally adjusted*

	1985 Year	1986 Year	Q1	Q2	Q3	Q4
Net equity issues:						
Listed companies	0.3	2.2	—	0.9	1.1	0.2
Unlisted market	—	—	—	—	—	—
Gross international bond issues:						
Sterling	1.0	3.5	0.6	0.5	2.1	0.3
Foreign currency	0.2	0.1	—	0.1	—	—
Net commercial paper issues:						
Sterling	—	0.1	—	—	0.1	—
US dollar	—	—	—	—	—	—
Borrowing from UK banks:						
Sterling(a)	5.6	9.8	2.0	2.1	3.0	2.7
Foreign currency	1.5	10.7	3.3	3.2	3.6	0.6

— less than £5 million.

(a) Excludes changes in borrowing by some securities dealers prior to 1986 Q4 (see the December 1986 *Bulletin*, page 478).

To the extent that this buildup in OFIs' borrowing in foreign currencies is overstated, the decline in ICCs' currency borrowing in these quarters will have been less. Despite the statistical uncertainties, a pattern of declining foreign currency borrowing by ICCs in the first half of the year and a very modest rise in the second is consistent with their switching between direct borrowing on overseas markets to borrowing through UK banks. This is borne out by Table E, which shows that ICCs raised more in foreign currency in international markets in the first half of the year than in the second. A further influence on the pattern of foreign currency borrowing through the year was probably the pattern of trade, with imports having grown particularly strongly in the third quarter.

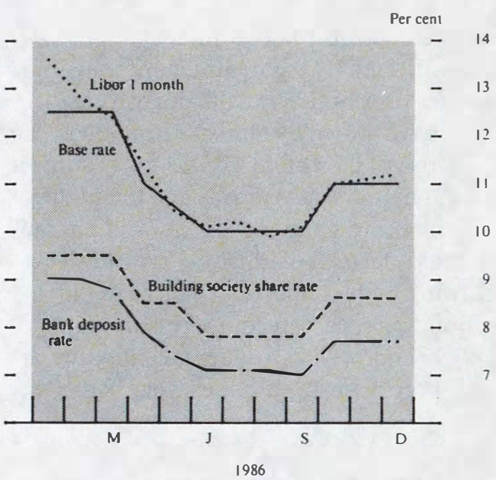
(1) After adjustment for some transfers of mortgages to mortgage finance subsidiaries outside the monetary sector. There is a corresponding adjustment to bank lending to other financial institutions.

Table G
Comparison of inflows to banks and building societies
£ billions; *seasonally adjusted (calendar year constrained)*

	1985 Year	1986 Year	Q1	Q2	Q3	Q4
Building society retail inflows (net, excluding interest credited)	13.4	12.5	4.2	3.1	1.4	3.7
Change in personal sector sterling deposits with banks(a)	4.9	8.4	3.2	3.5	1.4	0.3

(a) Includes changes in the deposits of some securities dealers up to 1986 Q3 (see the December 1986 *Bulletin*, page 478).

Bank/building society competitiveness(a)



(a) Building society share rate is an average of the best rates from five top building societies. Bank deposit rate is an average of the best rates from seven major banks.

Table H
Financing of the public sector
£ billions

Calendar months	Seasonally adjusted(a) July 86–Sept. 86	Oct. 86–Dec. 86	12 months to Dec. 86	Unadjusted Nov. 86–Dec. 86
Central government borrowing on own account	+2.9	−2.2	+3.6	−0.9
Other public sector borrowing(b)	−0.4	—	+0.1	−0.5
PSBR	**+2.5**	**−2.3**	**+3.6**	**−1.3**
Net sales of central government debt to the non-bank private sector	−1.6	−1.9	−6.0	−1.0
of which:				
Gilt-edged stocks	*−0.9*	*−1.8*	*−3.6*	*−0.6*
National savings	*−0.8*	*−0.8*	*−2.6*	*−0.5*
CTDs	—	*+0.8*	*+0.3*	*−0.2*
Net sales of local authorities' and public corporations' debt to the non-bank private sector	+0.2	−0.4	+2.0	+0.2
External and foreign currency finance of the public sector	−0.8	−0.9	−1.6	−0.4
of which, gilt-edged stocks	*−0.4*	*−0.6*	*−1.8*	*−0.4*
Total financing of the public sector from the non-bank private and overseas sectors	**−2.1**	**−3.2**	**−5.6**	**−1.1**

(a) Seasonal adjustments constrained over the financial year.
(b) Includes on-lending from central government to local authorities and public corporations.

Other sources of finance for ICCs in the fourth quarter included £1.8 billion worth of net new issues by ICCs listed on the main UK stock market and gross issues of international bonds raising £65 million in sterling and £590 million in other currencies.

Building societies issued few FRNs during the fourth quarter, as evidence emerged of an over-supply of such securities earlier in the year (the difficulties in the perpetual FRN market probably had very little impact). By early 1987, however, some larger building societies returned to the euromarket, this time with dollar-denominated issues linked with swaps into sterling following changes in regulations associated with the Building Societies Act.

Strong competition between banks and building societies for personal sector deposits and lending business has become an important feature of financial developments. The gains that banks made at the expense of building societies with respect to mortgage lending during the first three quarters of 1986 continued over the last quarter, but the banks' recent gains in the retail deposit market (Table G) came to an end. This probably reflected the relative impact of the British Gas share sale rather than a change in underlying competitiveness. The interest rates available on comparable deposits with banks and building societies are illustrated in the chart opposite. Net inflows to building societies were particularly weak in November and were only slightly higher in December. This, together with a fall in CTD holdings, gave the lowest monthly increase in PSL2 (+0.2%) for two years. The average increase in PSL2 in the last two months of the year was 0.7%, giving an increase of 14.8% during 1986 as a whole.

Under the Building Societies Act, which came into operation at the start of the year, societies have been allowed to undertake a variety of new activities, particularly in the areas of personal investment and banking. It is possible that most societies will diversify into these areas at quite a slow pace relative to that permitted by the Act, at least initially. However, as noted above, two have already used their new powers to issue bonds on the eurodollar market for the first time, with the receipts then being swapped back into sterling.

The entry into effect of the Building Societies Act provided the occasion for the withdrawal of mortgage lending guidance introduced in 1982. In circumstances in which the range of activities open to building societies was being extended, it was inappropriate to continue restraint on this particular form of secured consumer lending. The opportunity was taken at the same time to withdraw formally the qualitative guidance on lending priorities, first issued in 1972, which had effectively been in abeyance since the abolition of the supplementary special deposits scheme in 1980.

Official operations in financial markets

This and the succeeding section include commentary on the foreign exchange market as well as the money market. The figures are not seasonally adjusted unless otherwise stated.

In the two months covered, the central government's borrowing requirement was negative (ie there was a net repayment of debt). With, in addition, substantial net sales of central government debt and a large rise in the note circulation, the need for official assistance to the money markets increased by £2.1 billion.

The central government generated a financial surplus of £0.9 billion during the two months under review, most of which was accounted for by transactions on own account. The surplus arose principally because of receipt of the proceeds of the British Gas privatisation in December, supplemented by buoyant tax receipts.

Gross official sales of gilt-edged stocks totalled £2.3 billion during the period. Only one stock matured, but there were substantial official purchases of near maturities in anticipation of the heavy redemptions falling in the first quarter of 1987, with the result that net official sales totalled £1.1 billion. Of these, £0.6 billion were taken up by the non-bank private sector, £0.4 billion were sold overseas and £0.1 billion were taken up by the monetary sector.

Sales of other central government debt instruments came to £0.3 billion. This comprised an increase of £0.5 billion in national savings inflows on the one hand, and net surrenders of certificates of tax deposit, totalling £0.2 billion, on the other.

As usual at the end of the year, there was a sizable increase in the note circulation (£0.6 billion).

The net result of these financial flows was a substantial rise, of some £2.1 billion, in the need for money-market assistance during the period. This was more than met by an increase of £3.2 billion in the Bank's holdings of commercial bills, offset to some degree by an increase of £0.7 billion in the market's holdings of Treasury bills. By the end of the year, therefore, the total stock outstanding of official assistance (other than that provided through dealings in Treasury bills) totalled £13.0 billion, all in the form of eligible bill holdings.

In the first nine months of the current financial year (April-December), the stock of official assistance (excluding Treasury bills) fell by £0.4 billion. This occurred even though the PSBR was overfunded by some £1.5 billion (which would tend to drain cash from the money market) and reflected the continuing tendency for the central government borrowing requirement (which totalled £9.2 billion during that period) to exceed the PSBR (£4.4 billion). This in turn resulted from substantial central government on-lending to the rest of the public sector during the period (£3.7 billion, mainly to local authorities) and overall surpluses for the local authorities (£0.4 billion) and public corporations (£0.8 billion).

The average daily shortages of cash in the money market during November and December were £530 million, little higher than in the previous period.

Official reserves

Over the two months to end-November, the reserves fell by $69 million to $21,923 million. Net repayment of borrowing under the exchange cover scheme totalled $65 million. Repayments on long-term North American loans amounted to $124 million. The underlying change in reserves was an increase of $131 million.

Table J
Official transactions in gilt-edged stocks

£ billions; *not seasonally adjusted*

Calendar months	Jan. 86–Mar. 86	Apr. 86–June 86	July 86–Sept. 86	Oct. 86–Dec. 86	Nov. 86–Dec. 86
Gross official sales(a)	+2.0	+4.6	+3.0	+4.5	+2.3
less					
Redemptions and net official purchases of stock within a year of maturity	-1.7	-2.7	-0.9	-1.8	-1.2
Equals net official sales(b)	+0.3	+1.9	+2.0	+2.7	+1.1
of which, net purchases by:					
Monetary sector(b)	*+0.1*	*+0.2*	*+0.7*	*+0.2*	*+0.1*
Overseas sector	—	*+0.7*	*+0.4*	*+0.6*	*+0.4*
Non-bank private sector	*+0.1*	*+0.9*	*+0.9*	*+1.8*	*+0.6*

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

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

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

Table K
Influences on the cash position of the money market

£ billions; *not seasonally adjusted*
Increase in the market's cash +

Calendar months	July 86–Sept. 86	Oct. 86–Dec.. 86	Nov. 86–Dec. 86	Apr. 86–Dec. 86
Factors affecting the market's cash position				
CGBR (+)	+4.0	-1.1	-0.9	+9.2
of which, on-lending to local authorities and public corporations	*+0.3*	*+0.1*	*-0.1*	*+3.7*
Net sales (-) of central government debt(a)	-3.1	-3.0	-1.4	-9.2
of which:				
Gilt-edged	*-2.0*	*-2.7*	*-1.1*	*-6.5*
National savings	*-0.9*	*-0.8*	*-0.5*	*-2.2*
CTDs	*-0.2*	*+0.4*	*+0.2*	*-0.4*
Currency circulation (increase -)	-0.1	-1.0	-0.6	-0.7
Other	-0.7	+0.9	+0.8	+1.4
Total (A)	**+0.1**	**-4.2**	**-2.1**	**+0.7**
Official offsetting operations				
Net increase (+) in Bank's holdings of commercial bills(b)	-0.5	+5.0	+3.2	+2.4
Net increase (-) in Treasury bills in market	+0.3	-0.4	-0.7	-0.3
Securities(c) acquired (+) under purchase and resale agreements with banks	—	—	—	-2.3
Other	+0.2	-0.4	-0.5	-0.5
Total (B)	**—**	**+4.2**	**+2.1**	**-0.6**
Change in bankers' balances at the Bank (= A + B)	+0.1	-0.1	—	+0.1

(a) Other than Treasury bills.

(b) By the Issue and Banking Departments of the Bank of England.

(c) Gilt-edged stocks and promissory notes related to guaranteed export credit and shipbuilding paper.

Table L
Changes in UK official reserves

$ millions

	1986 Sept.	Oct.	Nov.	Dec.
Change in reserves	**+3,502**	**-434**	**+14**	**- 83**
of which:				
Net borrowing (+)/payment (-) of public debt	+3,874	+326	-21	-179
Valuation change on roll-over of EMCF swap	—	- 92	—	—
Underlying change in reserves	- 372	-668	+35	+ 96
Level of reserves (end of period)	**22,426**	**21,992**	**22,006**	**21,923**

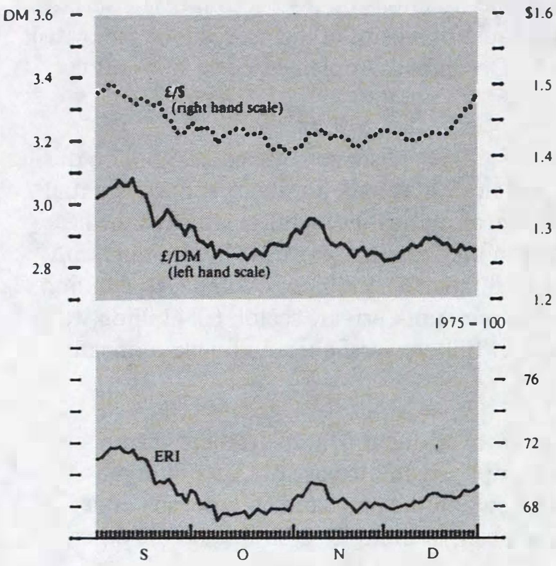
The money and foreign exchange markets

During November and December sterling on balance gained strongly against the weaker dollar but lost ground against Continental currencies. A major influence on sterling was the oil price, particularly in anticipation of and following the OPEC agreement. Some nervousness over electoral prospects was generated by opinion polls, and the exchange rate was depressed at times by considerations relating to economic prospects.

In the domestic money markets, the behaviour of the exchange rate was a dominant factor, with oil price prospects influencing sentiment at one remove. For much of the period the market was nervous that a base rate rise might be necessary, although upward pressure on rates was never acute. By the end of the period, market sentiment had become noticeably less nervous.

Sterling exchange rates

At the close of business in London each day

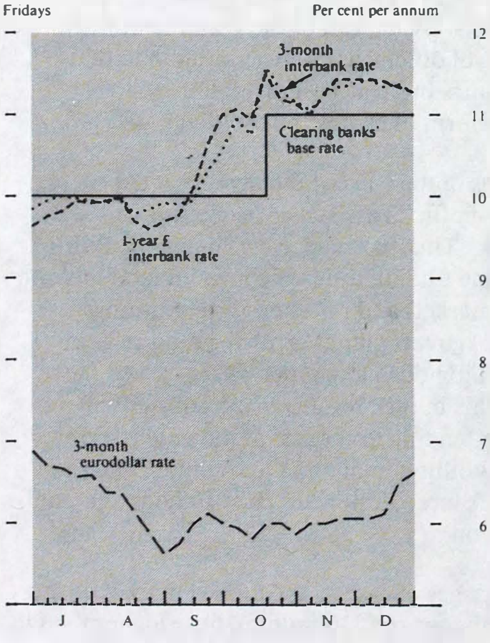


The ½% cut in the Japanese discount rate announced on 31 October (following the Baker-Miyazawa pact) and the dismissal of the Saudi Arabian Oil Minister reinforced the growing conviction in the market that the likelihood of a rise in base rates (in addition to the 1% increase on 14 October) had become remote. The exchange rate strengthened sharply on 3 November (the first day of the period under review) from its level of 68.4 on the ERI the previous Friday, and this was accompanied by an easing in money-market rates. Thus the period opened with a relatively flat yield curve, the one-month rate being at $10\frac{29}{32}$%, the three-month rate at 11% and the twelve-month rate at $10\frac{15}{16}$%. Banks' base rates were 11% and the ERI was 69.0 ($1.4160 and DM 2.9361).

Short-term interest rates in London

Fridays

Per cent per annum



In the next few days the pound rallied further following Saudi Arabia's request that OPEC meet to set a reference oil price of $18 per barrel, and the release of opinion polls favourable to the government. It reached 69.5 ($1.4340 and DM 2.9537) on 6 November. Period interbank rates had fallen to $10\frac{15}{16}$% at the one-month and twelve-month maturities on 5 November, but hardened the following day in anticipation of the Chancellor's Autumn Statement.

Money-market rates increased further as the gilt market weakened in the immediate aftermath of the Autumn Statement, but the yield curve remained fairly flat at just above 11%. Sterling reached 69.6 ($1.4425 and DM 2.9457) early on 11 November but did not sustain these higher levels as the markets came to fear that the Autumn Statement meant that risks might be taken with fiscal policy. The continued debate over the United Kingdom's entry into the exchange rate mechanism of the EMS also unsettled the markets.

The fall in the exchange rate to 68.2 ($1.4227 and DM 2.8731) on 13 November caused the latent nervousness in the money market to come to the surface, and there was a steepening of the yield curve, with one, three and twelve-month rates at $10\frac{13}{16}$%, $11\frac{1}{4}$% and $11\frac{5}{16}$% respectively.

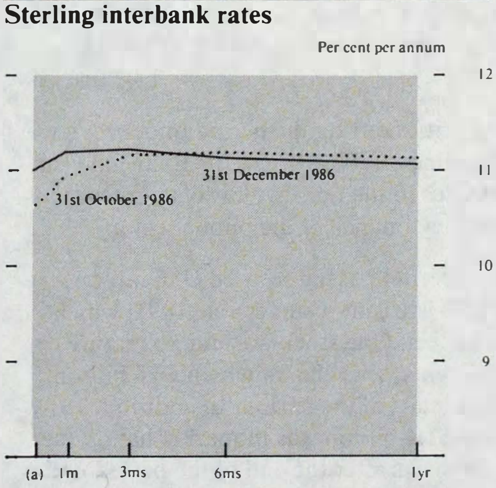
Over the course of the following week, sterling, influenced partly by publication of an opinion poll unfavourable to the government, fell further against Continental currencies, touching 67.5 ($1.4090 and DM 2.8311) on 20 November. At the same time interbank rates rose a little more, accentuating the positive slope of the yield curve, with the one-month maturity closing at $10\frac{13}{16}$%, three months at $11\frac{5}{16}$% and twelve months at $11\frac{7}{16}$%.

From 21 November onwards the sterling exchange rate benefited from the Chancellor's statement to the Select Committee on the Treasury and Civil Service that he did not want sterling to ease further, and strengthened to 68.3 ($1.4205 and DM 2.8732) on 24 November before easing somewhat. Although the ERI remained at around 68 until the end of November, this was the result of a firming against the dollar and a weakening against the Continental currencies. Following comments by King Fahd that Saudi Arabia would not cut oil production and the National Institute's pessimistic balance of payments forecast, sterling closed on 28 November at $1.4372 and DM 2.8379, giving an ERI of 68.1.

Meanwhile money-market interest rates remained relatively stable, with little reaction to the publication of the October money figures on 20 November or the October current account figures. By the end of November the yield curve had flattened somewhat, with rates of $11\frac{1}{16}$%, $11\frac{3}{8}$% and $11\frac{7}{16}$% at the one, three and twelve-month maturities respectively.

In sympathy with the weaker dollar, sterling eased further on 1 December, at one point touching a low of DM 2.8040. Thereafter, however, the exchange rate began to firm against the deutschemark and remained fairly steady against the dollar at around the $1.42–1.43 level. Sterling was helped by the strength of the dollar and by some good commercial demand, but the commencement of the OPEC conference on 11 December together with firmer oil prices (they rose by nearly $1.50, to about $16, between 10 and 15 December) were mainly responsible for the change in sentiment in the foreign exchange market. The new mood also began to be felt in the money markets, countering fears that there might be a possible 'sterling crisis' early in the New Year. In quiet trading, therefore, period interbank rates eased somewhat, and the yield curve flattened further. The pound reached 69.0 ($1.4360 and DM 2.9021) early on 16 December and, with publication of another very low PSBR figure, period interbank rates eased to $11\frac{1}{8}$% at three months and $11\frac{1}{4}$% at six and twelve months.

Sterling interbank rates



(a) For one week

Profit-taking in the wake of the OPEC production-sharing agreement reached on 20 December pushed sterling down against the deutschemark but, like other currencies, it improved against the dollar. The UK trade figures published on 23 December were close to expectations and had little effect but, helped by further firmness in oil prices and good demand, sterling continued to rise against the weakening dollar over the holiday period, moving up to finish the month at an ERI of 69.2 ($1.4837 and DM 2.8524).

Money-market activity was thin over the rest of the month. Rates moved little during a period when the November money and trade figures were published and the OPEC agreement was reached. By the end of the two months under review the undertone was cautiously hopeful and the interbank yield curve was again nearly flat, with the one and three-months' rates at $11\frac{3}{16}$%, and the twelve-month rate at $11\frac{1}{8}$%.

Over the period from 3 November to 31 December, the ERI rose slightly to 69.2 (+$\frac{1}{4}$%), with the sterling rate firming against the

Table M
Issues of gilt-edged stock

Stock	Amount issued (£ millions)	Date announced	Method of issue	Date issued	Price per £100 stock (£)	Payable per £100 stock: Initial payment(a) (£)	Payable per £100 stock: Further instalments (£)	Redemption yield (per cent)	Date exhausted
$2\frac{1}{2}$% Index-Linked Treasury 2001	50	18/11	Direct to Bank	18/11	$99\frac{1}{8}$			4.22(b)	27/11
$2\frac{1}{2}$% Index-Linked Treasury 2020	50	18/11	Direct to Bank	18/11	$90\frac{15}{16}$			3.59(b)	27/11
$10\frac{1}{2}$% Treasury Convertible 1992	200	28/11	Direct to Bank	28/11	$97\frac{3}{16}$			11.20	11/12
$9\frac{3}{4}$% Exchequer 1998	100	28/11	To National Debt Commissioners	28/11	91			11.17	—
9% Conversion 2000	100	28/11	Direct to Bank	28/11	87			10.87	5/12
$9\frac{3}{4}$% Treasury 2002	100	28/11	To National Debt Commissioners	28/11	$91\frac{13}{16}$			10.83	—
$8\frac{1}{2}$% Treasury 2007	100	28/11	Direct to Bank	28/11	$82\frac{7}{8}$			10.55	10/12
$10\frac{1}{4}$% Exchequer Convertible 1989(c)	100	22/12	Direct to Bank	22/12	$100\frac{3}{4}$			9.92	
$2\frac{1}{2}$% Index-Linked Treasury 2024(d)	600	19/12	Tender, no minimum price	30/12	78(e)	30.00	48.00 (10/2)	3.54(b)	19/1
10% Treasury 1994(f)	1250(g)	2/1	Minimum price tender	7/1	98	40.00	58.00 (24/2)	10.40	22/1

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

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

(c) Issued to assist market liquidity in this stock.

(d) The prospectus includes provision for exemption from UK taxation in favour of non-resident holders.

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

(f) The prospectus includes provision for exemption from UK taxation in favour of non-resident holders and for the loan to be available in bearer form.

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

dollar by $4\frac{3}{4}$% to \$1.4837 and falling against the deutschemark by $2\frac{7}{8}$% to DM 2.8524. Interbank rates rose by $\frac{9}{32}$% to $11\frac{3}{16}$% at the one-month maturity, by $\frac{3}{16}$% to $11\frac{3}{16}$% at three months, and by $\frac{3}{16}$% to $11\frac{1}{8}$% at twelve months. Banks' base rates and building society rates were unchanged.

The gilt-edged market

The market began the period, which immediately followed Big Bang, with a confident undertone, but was set back early on by concerns about fiscal and monetary policy. Another, partly related, factor was the weakness of the exchange rate. By the end of November, therefore, yields had reached levels similar to those at the end of September. A more optimistic tone became apparent through December, largely in response to hopes surrounding the OPEC conference and the expected consequences for the exchange rate. By the end of the period, yields had fallen back by about $\frac{5}{16}$% throughout the yield curve from their levels at the beginning of November.

The objective of the authorities during the period under review remained that of fully funding the PSBR over the financial year as a whole through debt sales to the non-bank private sector and external and foreign currency finance of the public sector.

The authorities began the period having secured £0.6 billion through earlier sales of 10% Treasury Convertible 1991, which had been issued on 29 October. One stock was due to mature during the period—$2\frac{1}{2}$% Exchequer 1986, of which £0.6 billion was in market hands at the start of the period. In addition, $13\frac{1}{4}$% Exchequer 1987, of which £1.1 billion was in market hands, was due to be redeemed three weeks after the end of the period under review. Within the Bank's portfolio, there were still supplies of 3% Treasury 1991 available for sale.

The period opened with the market in good heart following the cut in the Japanese discount rate announced on 31 October and the call by the new Saudi Arabian Oil Minister for an OPEC conference. The authorities had taken the opportunity on the same day to announce the issue of tranchettes of £250 million of 10% Conversion 1996 and £50 million each of 9½% Conversion 2004, 8½% Treasury 2007 and 2½% Index-Linked Treasury 2009.

With the sterling exchange rate continuing to improve after the weekend, the 1996 tranchette was exhausted early on 3 November following operation for the first time of the mini-tender procedure.[1] Sales of 3% Treasury 1991 were also made by this method, and the 2007 tranchette was sold out shortly afterwards.

Market expectations now began to be focussed on the Chancellor's Autumn Statement, due on 6 November. This was not well received by the market, which feared that risks might be taken with fiscal policy in what was perceived as a pre-election period. With no encouragement available from overseas bond markets, conventional gilt-edged prices fell fairly consistently over most of the ensuing fortnight. This was so despite the RPI figures published on 14 November (the annual rate of increase in October remaining unchanged at 3%) and the negligible PSBR for October published on 18 November.

The index-linked sector recovered rather earlier than the conventional sector despite continuing low recorded inflation, reflecting some switching out of equities. Substantial official sales of indexed stock were made on 17 November, and the authorities took the opportunity on the following day to replenish their supplies by announcing the issue of tranchettes of £50 million each of 2½% Index-Linked Treasury 2001 and 2½% Index-Linked Treasury 2020.

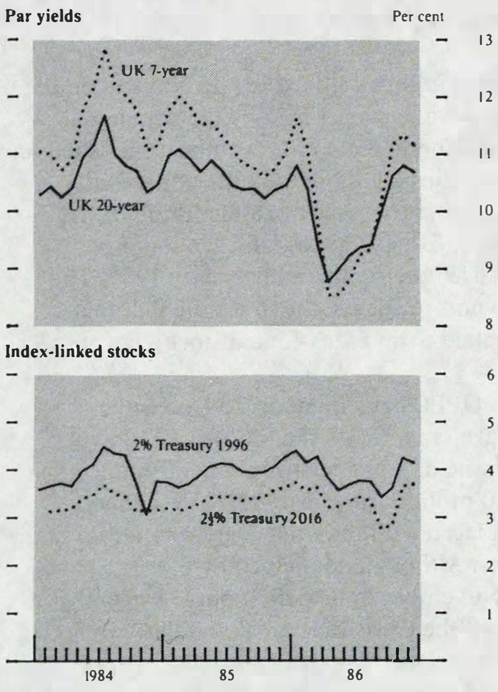
The weakening of the exchange rate on 19 November set the market back, but despite greater pressure on sterling the following day the market made gains as a result of a favourable reaction to the October money figures. This proved to be short-lived, however, and the market failed to move ahead on publication of current account figures for October which were better than expected.

Meanwhile demand for index-linked had remained firm following the issue of the tranchettes, and this led to their exhaustion on 27 November. With the conventional market also having recovered somewhat, the authorities announced on 28 November the issue of a tranchette package comprising £200 million of 10½% Treasury Convertible 1992 and £100 million each of 9% Conversion 2000 and 8½% Treasury 2007.

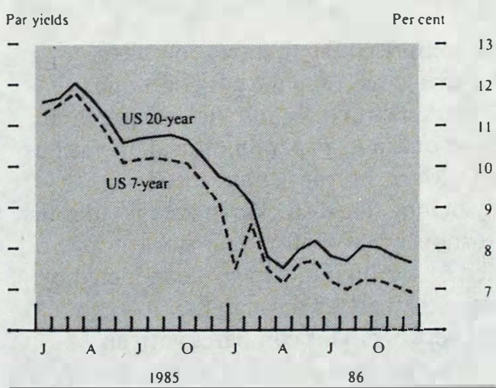
The market fell back early in the following week as the exchange rate weakened, but then recovered along with sterling, helped by the reserves figures for November. Official sales of two of the new tranchettes were made on 3 December, and the 2000 stock was sold out two days later. There was no follow-through, however, and, in the absence of retail demand, prices fell back.

Helped by the strength of the US bond market early in the following week, and by expectations surrounding the visit of the US Treasury Secretary to Europe, demand revived, enabling the 2007 tranchette to be sold out. By this time the main factor

Gross redemption yields on UK government securities



Gross redemption yields on US government securities



(1) See the Bank's paper on official operations in the gilt-edged market in the December 1986 *Bulletin*, pages 569–74.

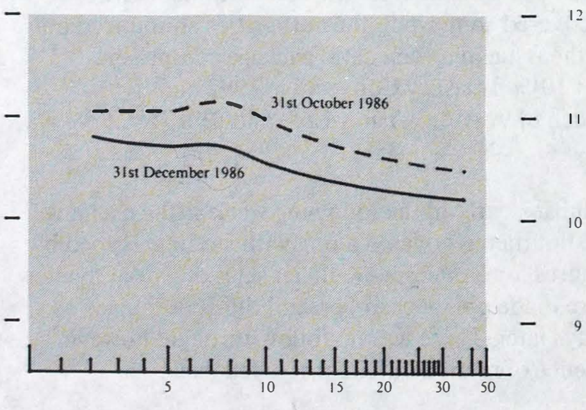
influencing the market was the OPEC conference which was due to begin on 11 December, and expectations of a successful outcome were becoming firmer. The price of the long gilt futures contract consequently moved sharply ahead on the afternoon of 11 December, and the authorities were able to sell out the 1992 tranchette.

Supplies of 3% Treasury 1991 were exhausted on 15 December largely as a result of switching. There were further gains in the wake of the stronger exchange rate on 16 December and the November PSBR announcement on the following day. The gains were extended despite publication of the November money figures on 18 December, with sentiment buoyed by renewed hopes of an OPEC production-sharing agreement.

Since the flurry of interest in index-linked in late November, the sector had been quietly advancing, assisted by the rise in recorded retail price inflation to 3.5% in November, published on 12 December. The authorities therefore took the opportunity to announce on 19 December the issue of £600 million of 2½% Index-linked Treasury 2024, £30-paid, for tender on 30 December. The balance was payable in February 1987. The stock was free of tax to non-residents, the first time that this provision had been applied to an index-linked stock.

The achievement of an OPEC agreement on 20 December strengthened the gilt-edged market on the following Monday, 22 December. On the same day, in a technical operation to assist market liquidity, a £100 million tranche of 10¼% Exchequer Convertible 1989 was placed with the Issue Department, for dealing on 24 December. Although not helped by the announcement of the November trade deficit on 23 December, the market emerged from the Christmas break in relatively buoyant mood following reports that OPEC producers were planning to activate their new pricing levels from February. All applications for the 2024 index-linked stock were allotted in full at the tender on 30 December at a price of 78, giving a real yield of 3.54% (calculated on the assumption of 5% inflation).

Time/yield curves of British government stocks



The period under review comprised the first two complete months since Big Bang. During that time the gilt-edged market adapted well to the new market structure, and the changes in the Bank's dealing practices set out in its paper on official operations were initiated successfully. Market turnover increased significantly, particularly in long-dated stocks. In the two months together, daily average turnover in over-five-year stocks was £2 billion, which included £1.1 billion of bargains conducted by the market makers between themselves through the inter-dealer-broker (IDB) network. This compares with an average daily turnover for the jobbers of £0.7 billion in the first ten months of 1986. It is legitimate to include IDB turnover in the comparison because many of the present market makers were classified as outside-market customers before 27 October and therefore figured within pre-Big Bang customer turnover. The increase in turnover in short-dated stocks was less marked: from £0.6 billion in the old market to £1.1 billion since Big Bang including £0.6 billion through the IDBs.

Turnover in gilts futures contracts, traded on the London International Financial Futures Exchange, also rose significantly.

In the first ten months of 1986, daily turnover in the long gilt contract averaged about 7,000 contracts, increasing to 12,000 contracts after Big Bang.

Over the period from the beginning of November to the end of December, yields on conventional 5-year stocks fell by $\frac{5}{16}$% to $10\frac{7}{8}$%, those on 10-year stocks by $\frac{3}{8}$% to $10\frac{5}{8}$%, and those on 20-year stocks by $\frac{5}{16}$% to $10\frac{3}{16}$%. The real yield on 2% Index-Linked Treasury 1990 fell by $\frac{1}{4}$% to $3\frac{11}{16}$%, whilst that on $2\frac{1}{2}$% Index-Linked Treasury 2020 remained unchanged at $3\frac{9}{16}$% (both calculated on the assumption of 5% inflation).

Other capital markets

The *equity market* moved ahead early in November on hopes that an OPEC agreement on production cutbacks would lead to firmer oil prices, and the FT-Actuaries all-share index, which stood at 807.27 at the end of October, advanced to 822.52 on 11 November. However, the announcement of official action on cases of insider dealing in both New York and London unsettled the market, and the index fell back sharply to reach a low point of 798.35 on 19 November. The market recovered a measure of stability thereafter, but trading remained thin in the run up to the £5.4 billion flotation of British Gas in the first week of December. The success of the flotation, which resulted in the 50p partly-paid shares moving quickly to a premium of around 12p amid record turnover on the first day of trading (8 December), helped to consolidate a more optimistic tone. With fears of a sterling crisis and higher interest rates in the New Year receding, the market moved ahead again in the last two weeks of December and the index ended the year at 835.48, up 3.5% over the two months. The all-share yield fell by 0.01% over the period to 4.04%.

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

Banking months	Mar. 86– May 86	June 86– Aug. 86	Sept. 86– end-Oct. 86	Nov. 86– Dec. 86
UK private sector				
Loan capital and preference shares	+ 385	+ 429	+ 261	– 14
Equity capital(a)	+ 675	+2,725	+2,658	+1,053
Unit trusts(b)	+1,200	+1,447	+ 859	+1,119
Issues on the unlisted securities market	+ 33	+ 83	+ 35	+ 106
Local authorities				
Stocks	+ 3	– 7	—	—
Negotiable bonds	– 9	– 54	– 54	– 24
Overseas	+ 189	+ 37	+ 134	—

(a) Net issues by listed UK public companies.
(b) Calendar months.

New equity issues were dominated by the British Gas flotation. There were, however, a number of other issues including offers for sale by Virgin (£60 million), London & Metropolitan Estates (£34 million), Geest Holdings (£32 million) and placings by Associated British Foods (£148 million), British Land (£95 million), Britannia Arrow (£41 million) and Albert Fisher (£45 million).

In the *eurosterling market* there was one straight issue for £75 million by the EIB together with three equity-linked issues by Next (£48 million), Dixons (£68 million) and Thorn EMI (£60 million). There were no domestic fixed-interest issues during the period.

During November and December UK borrowers made issues of £1 billion in the *international bond markets* in currencies other than sterling (including issues by foreign subsidiaries with a parental guarantee). Almost £700 million of these issues were for banks, including two perpetual FRN issues, made before this market encountered difficulties in December. Other issues included a $250 million Yankee bond issue for ICI North America in New York and $100 million issues for Heron International Finance and Lonrho Finance.

Sterling commercial paper

New issues of sterling commercial paper increased further during the early part of the period, with the total value of paper outstanding reaching £700 million at the end of November. The level of activity fell off slightly thereafter and the total of outstandings declined to £527 million by the end of December. Over the period as a whole, gross issues totalled £988 million against redemptions of £993 million. By the end of 1986, 37 programmes had been notified to the Bank and paper had been issued under 25 of those programmes.