Operation of monetary policy

This article covers the three months from mid-May to mid-August 1985.

Review

With different indicators pointing in different directions, the interpretation of monetary conditions remained complicated in the three months under review.

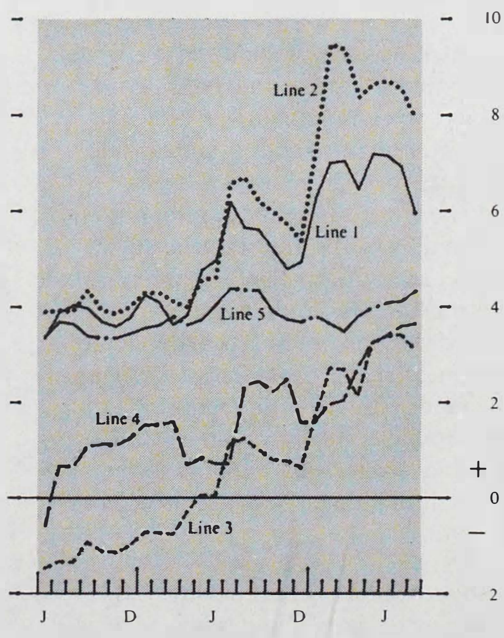
The background economic developments during the period are described in the commentary on page 349. In brief, the short-term prospect for retail prices improved, but the upward creep in pay settlements and earnings, notably in manufacturing, continued, despite the slower growth of productivity since 1983, so that the longer-term concern about unit labour costs remained. Economic activity and business confidence, as reflected in survey evidence, held up perhaps better than might have been expected, and the rise in unemployment slowed. But there is a risk of softening of demand into next year if world economic recovery slows down.

Monetary indicators were again affected by the spread of interest payments on sight accounts—both on wholesale and, increasingly since the spring, on retail deposits, under the impact of competition between and among banks and building societies. This factor explains the extremely rapid growth of interest-bearing M1 and total M1 at annual rates of 88½% and 27¾% respectively in the six months to mid-August. On the other hand, measures of narrow money that were less affected by this structural change continued to grow quite slowly. M0 over the same period increased at an annual rate of only 3¼% and at mid-August had grown by only 4½% over the previous twelve months, comfortably within its 3%–7% target range. And, unless the figures have been affected by further reporting errors as yet undiscovered, the twelve-month rate of growth of M2 declined from around 9½% in the spring to 7% in mid-August.

Broad money growth remained uncomfortably strong. £M3 in particular, having increased at an exceptional rate in the three months to mid-May (partly owing to the surge of leasing activity around the end of the 1984/85 financial year), grew only a little less strongly in the latest period; and its twelve-month rate of increase rose further, from something over 9% at mid-March to around 13½% by mid-August—far in excess of the 5%–9% target range for the current year set at the time of the Budget. If building society term shares are taken together with PSL2, the resulting aggregate has also accelerated in the past six months, though much more modestly, to show a similar twelve-month increase by mid-August. Among the counterparts of the growth in broad money there was a significant reduction in the pace of bank lending to the private and overseas sectors in the latest three months, which was none the less welcome for being expected (for the reasons given in the June *Bulletin*, pages 167–8).

Real interest rates

Monthly averages Per cent



Line 1 One year interbank deposit rate *minus* the expected rate of retail price inflation over the following year.

Line 2 The London clearing banks' base rate *plus* 1% *minus* the expected rate of inflation.

Line 3 The London clearing banks' base rate *plus* 1%, adjusted to allow for the deductibility of interest payments for corporation tax purposes, *minus* the expected rate of inflation.

Line 4 The building society ordinary share rate, net of basic-rate income tax, *minus* the expected rate of inflation.

Line 5 The gross real redemption yield on 2% Index-Linked Treasury Stock 1996.

Measures of real interest rates are discussed in the December 1982 *Bulletin*, page 483.

Among the other indicators of monetary conditions, the exchange rate remained firm, strengthening on balance over the period (despite a period of weakness beginning late in July), both against the generally weakening dollar and, more significantly, against the deutschemark.

In the face of this conflicting evidence, the Bank continued to take the view expressed in the June *Bulletin* (page 167), that, principally because of structural changes within the monetary system, the rate of broad money growth was understating the degree of monetary tightness. It was decided, therefore, that for the time being above-target growth of £M3 should be accommodated, provided that the other indicators of monetary conditions remained consistent with the achievement of the ultimate policy objectives of declining inflation and sustainable activity growth. In this context short-term interest rates were allowed to decline modestly further, in two stages by a total of 1% (leaving them still unusually high in real terms). And, in a period of heavy debt maturities, the authorities did not seek to restrain £M3 to within its target range by further overfunding of the PSBR through debt sales to the non-bank private sector and the overseas sector; and there was a modest decline over the period in government bond yields.

Monetary aggregates

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

During the three months under review the interpretation of the monetary aggregates continued to be complicated by structural developments in the financial system.

Among the narrow aggregates, M0 was probably least affected by these structural developments. It decelerated during the period under review but its twelve-month growth rate at mid-August, which was 4.5%, remained comfortably inside its target range. The other narrow aggregates were again affected, in particular, by the attraction of funds into interest-bearing sight deposits offered by banks. Interest-bearing M1 went up by £2.6 billion, or 13.2%, during the three months under review; about half of this increase was in the form of retail deposits. This did not, however, prevent M2 from decelerating (its twelve-month growth rate fell back from 8.3% to 7%), no doubt partly because the funds attracted into retail interest-bearing current accounts were drawn out of other accounts included in M2, but also because building society inflows have tended in recent months to be concentrated in accounts not included in M2.

The broad aggregates also presented a mixed picture. £M3 grew somewhat more slowly during the period under review than in the preceding three months, though its twelve-month growth rate increased to 13.6%, well above its target range. PSL2 increased faster than in the preceding three months, but the acceleration was largely illusory (see below).

The increase in £M3 was more than proportionately weighted towards sight deposits, so that the percentage ratio of M1 to £M3 advanced further from 46.4% to 47.2% (it was 45.4% in mid-August last year). £M3 was inflated in banking August

Table A
Growth rates of the monetary aggregates
Percentages: *seasonally adjusted*

Banking months	12 months to May 85	12 months to Aug. 85	Mar. 85–May 85	June 85–Aug. 85
M0(a)	5.4	4.5	1.0	0.6
£M3	11.6	13.6	4.3	3.5
Non-interest-bearing M1	4.1	2.6	0.8	0.6
M1	15.8	18.3	7.4	5.2
M2(b)	8.0	7.0		
	8.3	*7.0*		
PSL1	12.0	13.6	4.3	3.3
PSL2	14.7	15.2	3.3	3.5
M3	12.8	14.1	1.7	3.3

(a) Weekly average.

(b) Not seasonally adjusted: excluding the effect of changes in the terms of existing accounts. Figures including such effects are shown in *italics*

Table B
Composition of changes in the money stock
£ billions: *seasonally adjusted*

	Banking months	Mar. 85–May 85	June 85–Aug. 85	Level outstanding at mid-Aug. 85
1	Non-interest-bearing M1	+0.3	+0.2	34.0
2	Interest-bearing sight deposits	+3.4	+2.6	22.0
3	**M1** (= 1+2)	**+3.7**	**+2.8**	**56.0**
4	Private sector holdings of time deposits with banks and bank CDs	+1.1	+1.3	62.7
5	**£M3** (= 3+4)	**+4.7**	**+4.1**	**118.7**
	Non-bank private sector holdings of:			
6	Building society shares and deposits(a)	+1.3	+2.8	79.8
7	Building society wholesale liabilities(b)	+0.1	+0.2	1.6
8	Other	+0.3	—	7.9
9	**PSL2** (= 5+6+7+8)	**+6.4**	**+7.1**	**208.0**
10	Building society term shares(c)	+1.4	+0.6	19.3

(a) Other than term shares; including interest credited.

(b) CDs and time deposits.

(c) Including interest credited.

by heavy repayments by local authorities of temporary borrowings from the non-bank private sector (see below). Because the PSL aggregates include the private sector's holdings of local authority temporary debt, they were not affected by these repayments. The inflow of retail funds into building societies picked up, but far less went into term shares than in the preceding three months. This shift away from term shares probably had little monetary significance because most term shares offered recently have facilities for early withdrawal of funds by shareholders without significant interest penalty. Nevertheless it had the statistical consequence that PSL2 accelerated, though the growth rate of a broader aggregate arrived at by adding term shares to PSL2 actually fell a little.

Table C
Changes in £M3 and its counterparts

£ billions: *seasonally adjusted*

Banking months	3 months Mar. 85– May 85	3 months June 85– Aug. 85	12 months Sept 84– Aug. 85
CGBR			
own account	+1.6	+1.6	+4.4
on-lending	+1.0	+1.2	+4.4
of which, to local authorities	*+1.1*	*+1.5*	*+4.5*
Other public sector	+0.1	–0.7	+0.3
of which, local authorities	*–0.1*	*–0.2*	*–0.5*
Net sales of central government debt to the non-bank private sector	–3.2	–1.1	–11.2
of which:			
Gilt-edged stocks	*–2.1*	*–0.1*	*–6.9*
National savings	*–0.7*	*–1.1*	*–3.5*
CTD's	*–0.3*	—	*–1.1*
External finance of the public sector (a)	–0.4	–0.9	–2.8
of which, gilt-edged stocks	*–0.8*	*–1.1*	*–2.8*
Bank lending in sterling of the private sector (b)	+5.8	+4.7	+21.1
External sterling transactions of the banks (net) (c)	–0.7	–1.7	–1.7
of which:			
Deposits from non-banks (increase –) (c)	*–0.4*	*–1.1*	*–3.0*
Lending to non-banks (c)	*+0.7*	*–1.3*	*+2.0*
Banks' net foreign currency position (c)	+2.0	+1.3	+2.8
of which:			
Net deposit liabilities (c)	*+3.2*	*+4.4*	*+9.0*
Net non-deposit liabilities (c)	*–1.2*	*–3.0*	*–6.2*
Net sterling non-deposit liabilities	–1.6	–0.6	–3.4
Change in £M3	**+4.7**	**+4.1**	**+14.1**
Foreign currency deposits held by the private sector (d)	+0.4	+2.0	+3.8
Foreign currency lending to the private sector (d)	+1.2	–0.6	+6.2

(a) Net overseas purchases of public sector debt, *less* the public sector's net acquisition of claims on the overseas sector.

(b) Including Issue Department's holdings of commercial bills and of promissory notes related to shipbuilding paper guaranteed by the Department of Trade and Industry

(c) Not seasonally adjusted.

(d) Excluding changes in the sterling value of outstanding deposits and loans arising from exchange rate changes.

Among the counterparts to broad monetary growth (Table C), the CGBR was £2.8 billion. Of this, only £1.6 billion represented 'own-account' borrowing; the remainder was on-lent to the rest of the public sector. The latter was more than accounted for by £1.5 billion lent to local authorities, mostly on fixed-rate terms, much of which is likely to have been used, at least in the first instance, to repay temporary borrowing, some of it from banks but much of it, apparently, from the non-bank private sector.

As had been expected, the rise in bank lending in sterling to the private sector, at £4.7 billion, was smaller than in the preceding three months, when the total of £5.8 billion had been inflated by the surge in lending at the end of March to take advantage of the higher investment allowances of the 1984/85 financial year. In addition, there were net repayments by the private sector of foreign currency borrowings totalling £0.6 billion (not including the effects of changes in exchange rates on the value of outstanding loans), compared with net borrowings of £1.2 billion in the preceding three months. It is, however, not clear how much of the business recorded as foreign currency lending to the private sector simply reflects the booking of foreign currency lending to overseas borrowers through banks' non-monetary sector subsidiaries located in the Channel Islands.

Within the total of bank lending in sterling to the private sector, personal lending (including lending for house purchase) went up by £2 billion. This represented a sharp increase from the £1.2 billion lent in the preceding three months, and may in part have reflected greater marketing efforts by the banks. Building society mortgage lending continued to increase at around £1.1 billion a month; taking into account lending by banks, the rate of increase of total mortgage lending will have exceeded £1½ billion a month.

External sterling transactions with banks had a larger net contractionary effect during the three months under review (£1.7 billion) than in the preceding three months. This was partly the result of overseas non-banks' repaying sterling loans totalling £1.3 billion (in the preceding three months they had borrowed £0.7 billion); and partly of a further increase (of £1.1 billion) in sterling deposits held by overseas non-banks.

The banks' net foreign currency position was affected by their issues of foreign currency capital, which made a large contribution to the increase of £3.0 billion in their foreign currency non-deposit liabilities. The banks' net spot foreign currency deposit liabilities went up by £4.4 billion, but because it is unlikely that their overall currency exposure changed much, it seems probable that their forward foreign currency liabilities fell.

Official operations in financial markets

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

As shown in Table D, despite further heavy gross official sales of gilt-edged in the three months to mid-August, the pace of net funding was substantially reduced by a concentration of maturities. At the same time, the local authorities borrowed large amounts from the Public Works Loan Board in order to repay temporary debt: this raised the CGBR (without any consequential effect on the PSBR) and produced a corresponding flow of cash to the banking system. Largely as a result of these developments, about £2 billion of official assistance to the money market was withdrawn (Table E), although, even so, the daily cash shortages in the money market remained large.

Within the reduced total of net official gilt-edged sales, the main feature was the very heavy purchases of stock by the overseas sector, particularly early in the period under review. The limited statistical information available to the Bank does not give any clear idea of the distribution of these purchases by country. Net purchases by the non-bank private sector by contrast were exceptionally small. Sales of government debt to the overseas sector have a restraining effect on £M3, because the overseas sector may acquire from the non-bank private sector some of the sterling deposits they need in order to pay for the debt, but the effect is unlikely to be as great as in the case of debt sales to the non-bank private sector.

As noted above, the need for assistance to the money market was reduced by the heavy gilt-edged maturities. In addition, on-lending by the central government to the rest of the public sector was as much as £1.2 billion, reflecting principally the large borrowings by local authorities on fixed-rate terms from the Public Works Loan Board in August as the interest rates on the loans (which are linked to gilt-edged yields) fell.[1] This factor meant that the CGBR, before seasonal adjustment, was £3.8 billion, ie rather more than in the preceding period, despite receipts of £1.4 billion from asset sales. The stock of money market assistance outstanding fell during the period by about £2 billion to £15½ billion at mid-August; of the latter amount, £11½ billion consisted of bills held outright and £3½ billion of other securities held under purchase and resale agreements directly with the banks.

Despite this reduction in the total of assistance outstanding, the daily cash shortages in the money market remained large, averaging some £890 million during the period under review. This was largely because the persistent expectation of lower interest rates to come made the discount houses reluctant to sell longer-dated bills to the Bank outright, so that the average

Table D
Official transactions in gilt-edged stocks

£ billions: *not seasonally adjusted*

Banking months	Sept. 84–Nov. 84	Dec. 84–Feb. 85	Mar. 85–May 85	June 85–Aug. 85
Gross official sales(a)	+3.4	+3.5	+4.0	+3.9
less				
Redemptions and net official purchases of stock within a year of maturity	-0.7	-0.7	-0.6	-2.5
Equals net official sales(b)	+2.7	+2.9	+3.4	+1.4
of which, net purchases by:				
Monetary sector(b)	*+0.4*	*-0.4*	*+0.5*	*+0.2*
Overseas sector	*+0.3*	*+0.6*	*+0.8*	*+1.1*
Non-bank private sector	*+2.0*	*+2.7*	*+2.1*	*+0.1*

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 E
Influences on the cash position of the money market

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

Banking months	Mar. 85–May 85	June 85–Aug. 85	Sept. 84–Aug. 85
Factors affecting the market's cash position			
CGBR (+)	+3.6	+3.8	+ 9.3
Net sales (–) of central government debt(a)	-4.4	-2.5	-14.8
of which:			
Gilt-edged	*-3.4*	*-1.4*	*-10.4*
National savings	*-0.7*	*-0.7*	*- 3.4*
CTDs	*-0.2*	*-0.4*	*- 1.0*
Currency circulation (increase –)	-0.3	-0.4	- 0.6
Other	+0.5	+0.9	+ 1.9
Total (A)	**-0.5**	**+1.9**	**- 4.3**
Official offsetting operations			
Net increase (+) in Bank's holdings of commercial bills(b)	+0.7	-2.2	+ 0.8
Net increase (–) in Treasury bills in market	—	-0.2	- 0.1
Securities(c) acquired (+) under purchase and resale agreements with banks	+0.2	+0.1	+ 3.5
Other	-0.3	+0.4	+ 0.2
Total (B)	**+0.7**	**-1.9**	**+ 4.4**
Change in bankers' balances at the Bank (= A + B)	+0.1	-0.1	+ 0.1

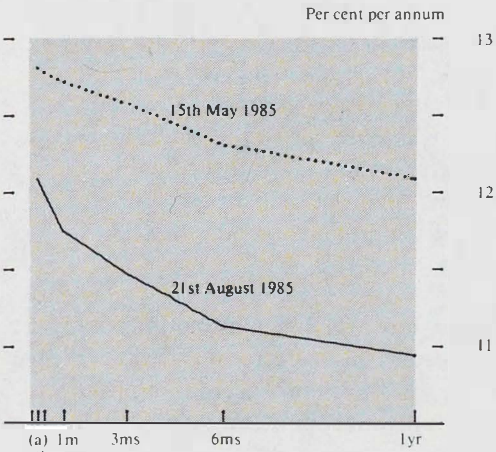
(a) Other than Treasury bills.

(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.

(1) The Board's variable rate facilities for local authorities and nationalised industries were made more attractive by the introduction of a revised interest rate formula and some reduced margins.

Sterling interbank rates



(a) Overnight.
(b) For one week.

maturity of outstanding assistance was thereby kept short. As the following section relates, in August the Bank became more restrictive than hitherto in offering sale and repurchase facilities in bills to the discount houses.

The money market

Given the conflicting indications of monetary conditions described in the review, and in particular the difficulties of interpreting the monetary aggregates, market sentiment was influenced during this period predominantly by fluctuations in the exchange rate.

At the beginning of the period under review, clearing bank base rates stood at $12\frac{1}{2}$%–$12\frac{3}{4}$%. In the interbank deposit market the yield curve was downward sloping (see chart); the Bank was buying bills in the four maturity bands[1] at discount rates of $12\frac{3}{8}$%, $12\frac{1}{4}$%, $12\frac{1}{8}$% and 12% respectively. Sterling's exchange rate index (ERI) stood at 78.9.

On Friday 17 May, the Federal Reserve discount rate was cut by $\frac{1}{2}$% to $7\frac{1}{2}$%; as a result, sterling was sharply higher against the dollar at the opening on 20 May (when the ERI was 80.0), and sterling interbank rates fell a little. Sterling fell back later that week, however, and conditions were quiet until near the end of the month, when sterling began to appreciate against the generality of foreign currencies: the ERI reached a peak of 80.7 at the opening on 3 June and the three-month interbank rate fell to $12\frac{5}{16}$%. Despite market expectations of lower short-term interest rates, which created technical difficulties in the handling of the daily money market shortages, the Bank declined to buy bills at lower rates, on the basis that the pace of broad money growth still called for caution in interest rate policy notwithstanding the firmness of the exchange rate.

These market hopes of a fall in interest rates were not sustained in the first week of June, when the exchange rate again fell back, partly on oil price worries, against a generally strengthening dollar. On 12 June, Barclays and Midland banks announced that they were reducing their base rates by $\frac{1}{4}$% to $12\frac{1}{2}$%, thus bringing them into line with Lloyds and National Westminster.

Expectations of lower short-term interest rates revived in mid-June when US prime rates fell by $\frac{1}{2}$%, and sterling responded by rising not only against the dollar but also (although by less) against the deutschemark. The ERI rose to a peak of 81.2 and the three-month interbank rate fell to $12\frac{3}{16}$%. But the 'flash' estimate that second quarter GNP growth in the US would be 3.1%, which was more than had been expected, prompted a sharp dollar recovery and dampened UK interest rate optimism.

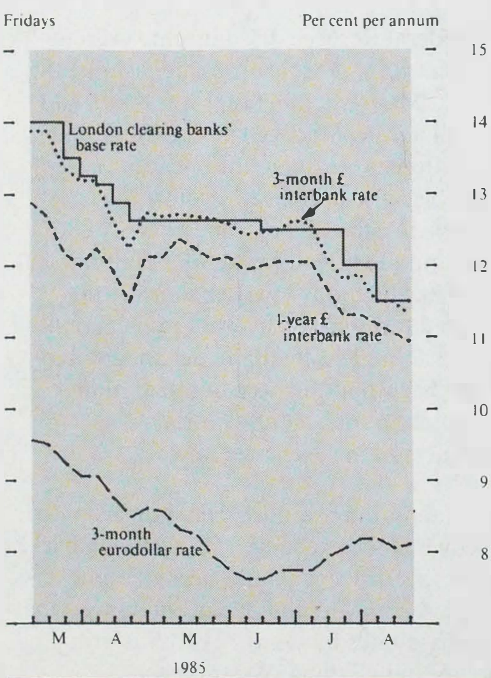
After this sharp fall, the pound gradually appreciated over the following three weeks against both the dollar and the deutschemark: the ERI reached 84.4 on 10 July. In the light particularly of the strength of the exchange rate, and against the economic background described above, the authorities judged that the monetary situation justified a modest reduction in short-term interest rates, notwithstanding the pace of broad

(1) Band 1: up to 14 days to maturity; band 2: 15–33 days; band 3: 34–63 days; band 4: 64–91 days.

money growth. The £M3 figure for banking June which had been published two days earlier (showing a rise of 2%) was judged to have been too seriously distorted by the effects of the Abbey Life share issue to support any conclusion that underlying £M3 growth had accelerated.

Accordingly, on 11 July the Bank accepted offers of bills at rates up to ½% below its earlier rates.[1] The exchange rate fell back modestly on this development, but soon steadied. The clearing banks reduced their base rates by ½% to 12% on 15 July, and the three-month interbank rate fell below 12% as market expectations of a further interest rate cut quickly developed. These expectations were heightened on 17 July after the Federal Reserve Chairman's Congressional testimony had led to a weakening of the dollar, and, in order to dampen them, the Bank lent that day to the discount houses under the 2.30 arrangements.

Short-term interest rates in London



The pound continued firm, however, and expectations of lower interest rates persisted. Against this background, given evidence of an improvement in the short-term prospect for inflation, increasing concern about industrial confidence, and indications of better money figures to come, on 26 July the Bank accepted offers of bills at rates a further ½% down. It followed this up on the same day with lending to the discount houses under the 2.30 arrangements to made it clear that no immediate further reduction in rates was to be expected. Bank base rates were cut from 12% to 11½% on 29 July.

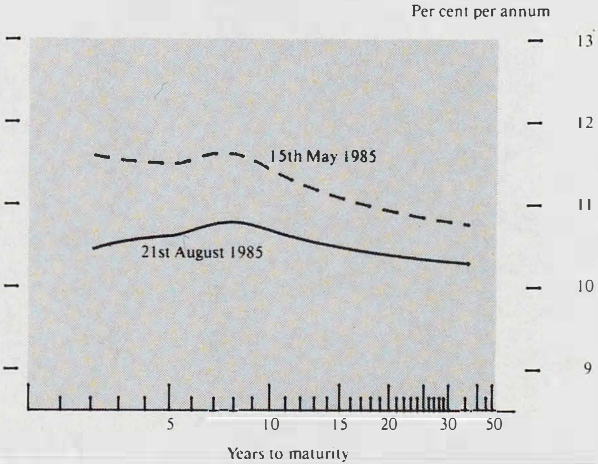
Immediately after this second reduction in interest rates, sterling remained firm: indeed, the ERI reached a peak of 84.7 at the close on 29 July. But from 30 July the pound weakened sharply against the generality of currencies, and this led to a modest firming in money-market interest rates. Following the publication of the money figures for banking July, there was some concern in the foreign exchange market that interest rates might be pushed further down in the near future, and sterling's ERI reached a low point of 79.5 on 7 August. When it became clear that the authorities were adopting a cautious approach to interest rates, sterling recovered against a weakening dollar. This in turn began to rekindle hopes of lower interest rates in the domestic money market.

Market interest rates for bills fell below the Bank's 'stop rates' during August, reflecting continuing hopes of lower interest rates. The Bank became concerned that discount houses might hold back from offering bills to the Bank for outright sale purely in the hope that the Bank would thereby be induced later in the day to invite bids for purchase and resale agreements in bills, which might provide cheaper money to the houses. In order to discourage this practice the Bank became less ready to enter into purchase and resale agreements even when there were large cash shortages (it entered into no such agreements between 6 and 27 August), so that when the houses were left with a residual need for cash after the Bank's outright bill operations, they were forced to meet it by relatively expensive borrowing from the Bank.

(1) The new rates (which were not all established until the next day) were down by ½% for band 1 bills, $\frac{7}{16}$% for band 2, ⅜% for band 3 and $\frac{5}{16}$% for band 4. The Bank established an upward sloping yield curve in its 'stop rates' by these differential reductions, although the slope of the discount rate curve remained downward-sloping.

Over the period as a whole short-term interest rates fell by about 1%. Clearing bank base rates fell by 1%–1¼% to 11½%. Building society interest rates were largely unchanged until, at the end of July, two large societies announced a ¾% cut in mortgage rates charged to new borrowers. The Building Societies Association council stated on 15 August that a 1¼% cut in both share and mortgage rates was appropriate: this brought the general level of base annuity mortgage rates down to 12¾% with effect from 1 September.

Time/yield curves of British government stocks



The gilt-edged market

At the beginning of the period under review no gilt-edged receipts had been secured through earlier sales of partly-paid stocks. The Bank had available for sale the residue of the low coupon tap stock (3% Treasury 1989) that had been issued in April. Market holdings of stocks maturing during the period totalled £2.2 billion; in addition there were market holdings of £0.8 billion of 8¾% Treasury Convertible 1985, which was due to mature shortly after the end of the period.

There was demand for index-linked stock at the beginning of the period and the tranche of 2009 stock which had been issued on 1 March was exhausted on 16 May. The announcement on 17 May that the retail price index had risen by 6.9% over the year to April caused the prices of index-linked stocks to rise a little further, and the Bank announced three further index-linked tranches—£100 million of the 1990 stock and £150 million each of the 2001 and 2011 stocks.

Following the reduction in the Federal Reserve discount rate (late on Friday, 17 May), there was substantial demand for conventional stocks, and on 21 May the Bank announced two new tranches of stock—£150 million of 10% Treasury 1992 and £250 million of 10½% Exchequer 2005.

The strength of the exchange rate and of the US bond market provoked heavy demand for gilt-edged at the end of May and early in June. The 1992 and 2005 tranches were sold out on 30 May, and on Friday 31 May the Bank announced new tranches of £200 million each of 11% Exchequer 1990, 10¼% Conversion 1999 and 11¾% Treasury 2003–07.(1) These three tranches were all exhausted on the morning of Monday 3 June as the pound strengthened further, and on 4 June the Bank announced the issue (direct to itself) of a new stock—£800 million of 10% Treasury 2004(2)—in partly paid form for dealing as from 6 June. At the price at which it was issued to the Bank the stock yielded 10.40%.

After this issue, the mainstream market became quieter. There was demand for low coupon conventional and index-linked stocks, however, so that supplies of the 1989 low coupon tap were exhausted on 6 June, followed by the tranches of the 1990 and 2011 index-linked stocks on 13 June.

The following day the Bank announced a new low-coupon conventional stock—£400 million of 3% Treasury 1990—to meet reinvestment demand following the maturity (on 21 May)

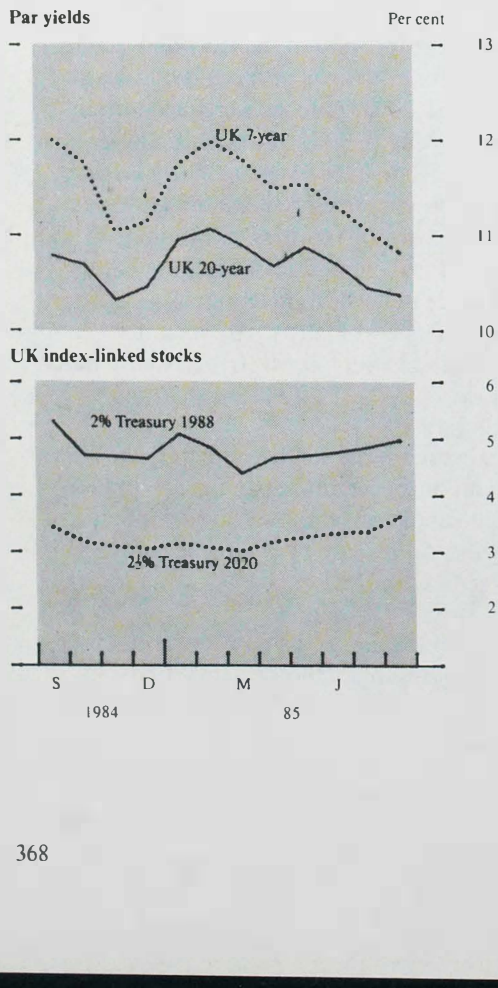
(1) In addition £150 million of 10% Treasury Convertible 1990 was issued direct to the National Debt Commissioners.
(2) A further £100 million was reserved for the National Debt Commissioners.

Table F
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 (£)	Payable per £100 stock: Further instalments (£)	Redemption yield (per cent)	Date exhausted
2% Index-Linked Treasury 1990	100	17/5	Direct to Bank	17/5	—	—	Fully paid	—	13/6
2½% Index-Linked Treasury 2001	150	17/5	Direct to Bank	17/5	—	—	Fully paid	—	17/7
2½% Index-Linked Treasury 2011	150	17/5	Direct to Bank	17/5	—	—	Fully paid	—	13/6
10% Treasury 1992	150	21/5	Direct to Bank	21/5	—	—	Fully paid	—	30/5
10½% Exchequer 2005	250	21/5	Direct to Bank	21/5	—	—	Fully paid	—	30/5
11% Exchequer 1990	200	31/5	Direct to Bank	31/5	—	—	Fully paid	—	3/6
10¼% Conversion 1999	200	31/5	Direct to Bank	31/5	—	—	Fully paid	—	3/6
11¾% Treasury 2003-7	200	31/5	Direct to Bank	31/5	—	—	Fully paid	—	3/6
10% Treasury Convertible 1990	150	31/5	Direct to National Debt Commissioners	31/5	—	—	Fully paid	—	
10% Treasury 2004	900(a)	4/6	Direct to Bank	4/6	96.75	30.00	66.75 (15/7)	10.40	15/7
3% Treasury 1990	400	14/6	Minimum price tender	20/6	75.75	—	Fully paid	9.29	29/7
2½% Index-Linked Treasury 2013	200	14/6	Direct to Bank	14/6	—	—	Fully paid	—	24/7
11% Exchequer 1989	200	17/7	Direct to Bank	17/7	—	—	Fully paid	—	19/7
9¾% Exchequer 1998	200	17/7	Direct to Bank	17/7	—	—	Fully paid	—	12/8
11½% Treasury 2001–4	200	17/7	Direct to Bank	17/7	—	—	Fully paid	—	26/7
10½% Exchequer 1997	200	17/7	Direct to National Debt Commissioners	17/7	—	—	Fully paid	—	
9¾% Exchequer 1998	100	17/7	Direct to National Debt Commissioners	17/7	—	—	Fully paid	—	
9¾% Treasury 2002	900(a)	12/8	Minimum price tender	15/8	96.00	25.00	71.00 (9/9)	10.25	—
3% Treasury 1989	100	30/8	Direct to Bank	30/8	—	—	Fully paid	—	—
3% Treasury 1990	150	30/8	Direct to Bank	30/8	—	—	Fully paid	—	—

(a) Of which £100 million was reserved for the National Debt Commissioners.

Gross redemption yields on government stocks



of 3% Treasury 1985, together with a further £200 million of the 2013 index-linked stock.

On 2 July, the Government announced that it had decided to abolish capital gains tax on gilt-edged stocks and qualifying corporate bonds. The initial market reaction was to mark up slightly the prices of low-coupon and index-linked stocks.

The gilt market was generally subdued until mid-July, when the appreciation of sterling and the fall in short-term interest rates provoked demand for stock. The 2004 tap stock was exhausted on 15 July, followed by the 2001 index-linked tranche on 17 July. On the latter date, the Bank announced a package of new tranches: £200 million each of 11% Exchequer 1989, 9¾% Exchequer 1998 and 11½% Treasury 2001–04.[1] The market again became quieter, although the 1989 tranche was sold out on the first day of dealing. Demand revived in all sectors, however, as sterling continued firm, so that the 2013 index-linked tranche was exhausted on 24 July, followed by the 2001–04 conventional tranche on 26 July, after the further fall of ½% in short-term interest rates, and the 1990 low coupon tap on 29 July.

The sharp fall in the exchange rate that began at the end of July caused prices to soften, though trading continued to be active. But as the pound steadied the tranche of 9¾% Exchequer 1998 was sold out on 12 August, and on the same day the Bank announced a new partly paid stock—£800 million of 9¾% Treasury 2002[2]—for sale by tender on 15 August, with a minimum price implying a yield of 10.25%.

(1) In addition, £200 million of 10½% Exchequer 1997 and £100 million of 9¾% Exchequer 1998 were issued direct to the National Debt Commissioners.
(2) A further £100 million was reserved for the National Debt Commissioners.

Over the period as a whole, conventional yields fell on 5-year stocks by a full percentage point to $10\frac{11}{16}$%, on 10-year stocks by $\frac{3}{4}$% to $10\frac{7}{8}$% and on 20-year stocks by $\frac{7}{16}$% to $10\frac{7}{16}$%. Index-linked yields rose: the real yield on the 1988 stock rose by just over $\frac{3}{8}$% to $4\frac{11}{16}$% but the real yield on the 2020 stock rose by only $\frac{1}{16}$% to $3\frac{5}{16}$%.[1]

Other capital markets

In the *equity market*, prices remained firm in the early part of the period under review but drifted lower during most of June and July before recovering strongly in the final weeks. Measured by the FT-Actuaries all-share index, share prices fell overall during the period by 1.2%.

During late May, prices were steady despite fears of an oil price cut; trading was thin with most interest focussing on potential take-over situations. At the beginning of June, however, investors were encouraged by the strength of Wall Street and the improvement of sterling; an encouraging CBI survey and the money supply figures for May gave further impetus, and on 5 June the FT-Actuaries all-share index closed at a new record high of 644.21.

This stronger tone was soon dispelled by the re-emergence of concern about possible lower oil prices. Share prices eased further in the wake of the £519 million rights issue announced by Hanson Trust and the cash shortage arising from the oversubscription of the offer for Abbey Life Assurance. In the face of continuing oil price fears the market continued to retreat, while the electrical sector was particularly hit by reports of reduced profits from a number of companies. On 26 June, the FT-Actuaries all-share index closed below 600 for the first time since January. In early July, the market continued to drift: while most attention focussed on the troubled electrical sector, the shares of leading exporters suffered from the strength of sterling, and the absence of interest rate reductions further discouraged investors. Towards the end of the month the bearish trend was aggravated by a pessimistic CBI survey and disappointing trade figures for June. On 25 July, the FT-Actuaries all-share index closed at 591.23, representing a fall of 8% since the beginning of the period.

Towards the end of July, sentiment changed following the reduction in interest rates, while the weakening of sterling early in August gave further encouragement to investors. Although cash was absorbed by subscriptions to the Britoil sale, share prices continued to move upwards. After mid-month there was a strong recovery in electrical shares which spread to other sectors, while the publication of the National Institute forecast on 21 August improved inflationary expectations and led to further advances. The FT-Actuaries all-share index closed the period at 635.21.

Companies continued to raise large amounts in the domestic capital market (Table G). Although the amount of equity raised was lower than the record level achieved in the previous period, it was still extremely large; and there was a substantial increase in issues of convertible loan stock and preference shares,

(1) These real yields are based on the assumption of a future rate of increase of the retail price index of 5% a year.

Table G
Amounts raised in the capital market

£ millions: *not seasonally adjusted*
Net cash raised +

Banking months	Sept. 84–Nov. 84	Dec. 84–Feb. 85	Mar. 85–May 85	June 85–Aug. 85
UK private sector				
Loan capital and preference shares	+ 69	+ 84	+ 159	+ 485
Equity capital(a)	+535	+322	+1,916	+1,119
Unit trusts(b)	+294	+503	+ 456	+ 285(c)
Issues on the unlisted securities market	+ 48	+ 10	+ 67	+ 48
Local authorities				
Stocks	− 11	− 47	− 14	− 3
Negotiable bonds	− 88	−116	− 122	− 88
Overseas	+296	+159	+ 164	+ 175

(a) Net issues by listed UK public companies.
(b) Calendar months.
(c) June and July only.

principally by way of rights. As in the previous quarter, several leading companies raised substantial amounts in this way: these included Woolworth (£146 million) and European Ferries (£72 million) in the latter half of May, English China Clay (£86 million) and Hanson Trust (£519 million) during June and Siebe (£75 million) in July. There were also two very large offers for sale of shares by Abbey Life and Christian Salvesen, which raised £243 million and £66 million respectively. During the first week of August, the government's residual holding of 242.6 million shares in Britoil was offered for sale to the public. With one fifth of the offered shares earmarked for overseas institutions and two fifths for UK institutions, the sale was four times oversubscribed; gross proceeds totalled £449 million of which £243 million was payable immediately, with the balance due in November this year.

In the *domestic fixed-interest market*, six UK issuers raised a total of £53 million (Table H). These included one local authority which issued stock under a droplock arrangement; droplock arrangements currently outstanding for local authorities and other borrowers are now estimated at some £40 million. There were also three issues by overseas borrowers.

The *euro-sterling market* was less active than during the previous quarter. Eight fixed rate issues were made, totalling £380 million and including two by domestic borrowers: Royal Insurance (£60 million) and ICI (£75 million). There were also four issues of floating-rate notes for a total amount of £375 million. During the first week of September, two building societies entered the eurosterling market for the first time when the Halifax (£150 million) and the Nationwide (£200 million) issued floating-rate notes.

Table H
Debt issues announced on the London capital market, mid-May to mid-August 1985[(a)]

Date of Announcement	Issuer	Nominal amount (£ millions)	Coupon (per cent)	Maturity
Domestic borrowers				
18 June	Mansfield Brewery	20	$11\frac{1}{2}$	2010
4 July	Oldham	7	$12\frac{1}{2}$	2022
9 July	Sunderland and South Shields Water Company	5	$11\frac{3}{8}$	1995/7
9 July	The York Waterworks Company	3	$11\frac{3}{8}$	1995/7
17 July	Keystone Investment	3	$11\frac{3}{8}$	2010/5
20 August	Brixton Estates	15	$10\frac{3}{4}$	2025
Overseas borrowers				
25 June	Credit Foncier	100	$10\frac{1}{4}$	2011/14
15 July	International Bank for Reconstruction and Development	100	$9\frac{1}{2}$	2010
5 August	Australia	100	$9\frac{1}{2}$	2012

(a) All these issues, except those by the IBRD and Australia, were placed. Issues of convertible loan stock and issues of less than £3 million are not included.