Mancots Doss

FINANCIAL MARKETS (16 OCTOBER 1980 - 19 NOVEMBER 1980)

(i) Gilts

The continuing rise in US interest rates was an unsettling factor throughout the month. But the underlying tone remained resilient and the market reacted calmly to the rise in £M3 in banking October. In the latter part of the month a more consistently firm tendency was apparent amid better news on pay and prices, further evidence of recession and the strong external trade performance which together gave rise to renewed expectations of an early cut in MLR.

The issue of 11¾% Exchequer 1986 attracted a good response on the first day of the banking month. But the market quickly developed indigestion after previous heavy purchases of stock and displayed renewed concern about the outlook for US interest rates.

Early the following week some recovery was apparent, helped by the strength of sterling, and quite large amounts of the 1986 tap were later sold at 30 1/16 (30-paid). A further tranche of £400mn of 3% Treasury 1985 was announced on 24 October. Thereafter, enthusiasm was dampened during the rest of October by diminishing hopes of an early cut in MLR and by the behaviour of US interest rates; but the underlying tone remained resilient.

At the beginning of November, some nervousness was apparent ahead of the announcement of the October banking figures. In the event, although the estimated growth in £M3 was at the extreme upper end of the expected range, prices fell only slightly immediately after the announcement. Sharper falls were seen later in the week following news of a further rise in US prime rates (to 15½%). But the absence of a new long tap was a steadying influence after the official close on Friday, 7 November and conditions improved after the weekend.

The market took further heart from the October wholesale price figures and the moderate October CGBR and later in the week from the miners' and BL workers' proposed pay settlements. At the close on 14 November, the issue of a further tranche of £1bn of 11¾% Treasury 2003/07 was announced (the first over-20 year maturity to be issued since April). The announcement had little impact on prices.

After the weekend, the market initially weakened on news of the rise in the Federal Reserve discount rate. But prices rallied to close little changed on Monday and moved ahead in the last few days of the banking month, helped by the October trade surplus and in renewed anticipation of a cut in MLR. Large demand built up for the 1986 tap which was sold in fully paid form on 19 November at prices of 95⅞-96.

Over the banking month as a whole yields on shorts showed a mixed trend but were little changed on balance; yields on longs fell by around ⅛%.

(ii) Money

Market conditions fluctuated during the banking month in line with changes in the net Exchequer position and reflecting the periodic impact of sales of gilt-edged stock and calls on previously issued stocks. Conditions remained markedly tight up to 24 October before easing for most of the next two weeks as the net Exchequer position became favourable to the market. Renewed stringency then developed, partly due to the effects of gilt sales, but conditions in the last two days of the month were relaxed.

Regular market assistance by the Bank was necessary on every day up to 24 October. On the latter day help was predominantly in the form of outright purchases of commercial bills. Such assistance, unlike purchases of Treasury bills, does not automatically reduce the total amount of reserve assets in the system. A greater role for purchases of commercial bills in open market operations is also in line with the policy outlined in the Bank's background note of 24 November (see copy attached) of placing less emphasis on discount window (lender of last resort) lending. As part of the same approach, the Bank has introduced a little more flexibility in the rates at which it conducts operations in commercial bills, with the objective of reducing the emphasis on officially established rates.

During the periods of more relaxed conditions after 24 October small amounts of Treasury bills were sold to absorb surplus funds.

On the other days, however, regular assistance (including further outright purchases of commercial bills) was necessary.

The two facilities with the Bank for the purchase and resale of gilt-edged stocks which matured on 7 and 17 November were again extended on maturity, but for a reduced total of 2% of mid-October eligible liabilities and for periods of less than one month (to 24 November and 3 December).

Interest rates also fluctuated during the month. Short inter-bank rates moved erratically at the beginning, reflecting both the persistent extreme shortages and the high level of market assistance. Rates generally eased after 24 October in line with market conditions, only firming again towards the middle of November as pressures re-emerged; the one-week rate which had been at 17⅝% on 16 October finished at 16⅛%.

As mentioned in last month's note, the Bank had taken action following the competition for funds which developed on the October make-up day to remind banks of the need to maintain their reserve asset ratios at all times. The November make-up day passed without any of the excessive pressures on short-term rates which had been evident a month previously.

Longer rates tended to move up during the first three weeks, with the three-month inter-bank rate rising from 15 13/16% on 16 October to touch 16 15/16% in the first week of November. Rates at three months and over eased subsequently in response to more optimistic views about prospects for a MLR cut and by 19 November the three-month inter-bank had dropped to 15 1/2%.

The average rate of discount at the Treasury Bill tender rose from 14.2720 on 17 October to 14.3776 on 7 November, but eased to 14.3669 on 14 November.