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FINANCIAL MARKETS (19 FEBRUARY - 18 MARCH 1981)

(i) Gilts

Events during the month were dominated by the Budget. This was well received by the market and very heavy sales of stock were achieved thereafter.

The market was firm at the start of the banking month amid hopes of a large cut in MLR in the Budget. Activity was concentrated initially in shorts and substantial sales were made of the short tap, 12% Treasury 1986, leading to its exhaustion at a price of 20 1/4 (20-paid) on 24 February. Some of the firmness then spread to mediums and longs which had hitherto been very quiet.

The market then settled into its normal pre-Budget lull. An issue of £500mn of low coupon stock, 3% Treasury 1986, was announced on 27 February; this attracted only a small response at the tender on the following Wednesday.

Conditions were firm immediately ahead of the Budget speech, though some profit-taking was apparent after the announcement of the February banking figures and the indicated rise in £M_3. This tendency proved short-lived, however, as the market reacted with enthusiasm to the Budget measures, including the announcement of the first index-linked gilt-edged stock, 2% Index-Linked Treasury 1996, restricted to pension funds and to insurance companies and friendly societies in respect of their pension business.

The market was very firm at the opening on 11 March and the long tap (12 1/4% Exchequer 1999 B) was immediately exhausted at a price of 90 3/4; sizeable sales were also made of the low coupon tap. Prices rose sharply during the day with gains at one stage of up to 2 points in longs. In the light of market demand, it was announced at the official close that £1bn of 12 1/2% Exchequer 1990 had been issued direct to the Bank to be operated as a tap stock from the following day. Large amounts of this stock were sold on Thursday at prices of 15 1/16-15 3/16 (15-paid) and gains of up to a further point were recorded in longs. Friday morning saw renewed demand for the 1990 tap, but some profit-taking developed later in the afternoon.

Conditions remained generally firm in the last few days of the banking month with the February trade figures a further favourable influence. More sales of the 1990 tap were made at prices up to 15 5/16.

Over the banking month as a whole, yields on shorts and mediums fell by about 1/4% and those on longs by up to 3/8%.

(ii) Money

The fairly easy market conditions which prevailed at the beginning of the month were followed by three weeks of unusual difficulty.

There was little pressure on funds in the first week of the period, next-maturity gilt purchases by the Bank being a substantial favourable factor. Conditions then, however, tightened sharply, and the following week was dominated by the massive shortage of 2 March, due to PRT payment. This was preceded on 27 February by another day of extreme stringency, which was chiefly due to the final call on 12% Exchequer Convertible Stock 1985.

Despite forecast surpluses immediately after 2 March some difficulty in obtaining funds persisted, and by 6 March stringency was again evident with the market faced by a substantial increase in the note circulation and a further final stock call. 9 and 10 March saw intense competition for funds in the interbank market as banks sought to restore their reserve asset ratios to 10%, following the temporary 2% reduction which had been granted in order to ease rate pressures in advance of the shortage on 2 March.

By early on 11 March it was clear that further days of extreme difficulty lay ahead chiefly as a result of heavy gilt sales following the Budget, and it was announced that a further 2% reduction in the reserve asset ratio would be granted, to extend this time from 12 March to 30 April. This action relieved the worst of the pressure but the market remained extremely short of funds until Monday of the following week. Conditions were easier by make-up day, chiefly due to a favourable net Exchequer position.

As well as the reduction in the reserve asset ratio mentioned above, the Bank also gave regular assistance to the market, predominantly by outright bill purchases, on most days during the month. 27 February saw the first use of a new sale and repurchase technique, involving the discount houses bidding a money rate for funds generated by the sale of bills to the Bank on a repurchase basis; this technique was called into occasional service thereafter on days of especial difficulty. Lending to the discount market took place on four occasions, twice at MLR and twice at a rate above. There were three days on which no intervention was necessary.

Short interbank rates were steady in the first week of the period and generally firm in the difficult conditions of the following fortnight, though some relief of pressure was achieved by the Bank's large-scale assistance and the first reserve asset ratio reduction. There was no immediate reaction to the 2% Budget MLR cut, but following further Bank help and the extended ratio relaxation these rates declined quickly to a more suitable level; the seven day rate dropped from 15 3/4% on 11 March to 12 7/8% two days later. This softer tendency was evident up to the end of the period, and the seven day rate finished at 12 3/16%.

Longer rates were sharply affected in the first week by Press speculation about a possible 3-4% MLR cut in the Budget, the three month rate dropping by 13/16% to 12 5/16% between 19 and 25 February. The Budget MLR reduction was thus fully discounted in advance at the longer end, and up to the end of the period the general tendency in these rates was steady to firm. The three month rate finished at 12 5/8%.

Dollar interest rates continued to ease during the banking month; the US three month CD rate fell from 15 3/4% to 13% and the three month Eurodollar rate from 17 1/4% to 14 1/4%. The differential between the three month interbank rate (adjusted for cost of forward cover) and the three month Eurodollar rate was mostly against sterling but changed from -5/16% to +1/8% over the period, having at one point been -1/2%.

The average rate of discount at the Treasury Bill tender fell from 12.0575 on 20 February to 11.3912 on 6 March, then rose (for the first time since December) to 11.6357 on 13 March.