BANKS

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FINANCIAL MARKETS (17 September - 21 October)

Introduction

Short-term interest rates continued to rise during the second half of calendar September as the exchange rate came under renewed pressure after a temporary respite. Gilt-edged prices fell back sharply in the last week of the month to their lowest level since January 1977.

From early October, external influences became more favourable. The realignment of EMS currencies on 4 October led to calmer conditions generally in the foreign exchange market. Interest rates abroad also began to fall, first in the United States and later in West Germany and France. Sterling picked up sharply in the first full week of October and this encouraged longer money market rates to ease and buyers to return to the gilt-edged market on the largest scale since mid-March. These conditions permitted a ½% fall in base rates, but then market rates again moved up, on fears of higher interest rates in the United States and of a major strike at BL. Prices fell back again in the gilt-edged market which was digesting the previous heavy sales.

The monetary aggregates in banking October remained heavily distorted by the effects of the Civil Service dispute, but there was further evidence of a continuing rapid growth in bank lending to the private sector. £M_3 rose by 1.7% during the month. The CGBR is estimated to have been inflated by about £750-1,000mn as government payments delayed by the dispute outweighed delayed receipts.

Gilts

The authorities began banking October with no funds assured for the month and the market was apprehensive that an early funding initiative would be necessary. Some temporary encouragement was taken from the full money supply figures for August (published on 17 September) and prices rallied on 22 September following a 1% reduction in the US Federal Reserve's discount rate surcharge and a further ½% cut (to 19½%) in several US banks' prime rates.

Sentiment improved sufficiently for moderate official (non-tap) sales to be made. Later in the same week, however, sterling came under renewed pressure and confidence was also undermined by Wall Street's adverse reaction on 25 September to President Reagan's package of spending cuts and by Federal Reserve intervention apparently aimed at halting the fall in US short-term interest rates. Against a background of rising domestic interest rates, prices of gilt-edged stock fell back sharply and by 28 September yields on some medium-dated issues had risen to almost 16¾%.

The underlying tone remained nervous for the rest of the week, with the index-linked stocks coming under particular pressure on 30 September on fears that the authorities would launch a new initiative in this area. However, the market reacted calmly to the rise in clearing bank base rates to 16% on 1 October and there was renewed optimism after the weekend - encouraged by the latest US money supply figures and further prime rate cuts (to 19%) - that US interest rates might finally be on the way down. There were also hopes that sterling would be more stable, following the realignment of the EMS currencies. There was widespread demand for stock on 5 October and the 1985 tap was reactivated at £86¾ (almost £5 lower than its previous price) and then at £86⅞; large amounts were sold, along with other stocks in the Issue Department portfolio. On 6 October, the 1985 tap was exhausted (at £87) and, although the market was unsettled later in the day by the provisional estimate of a 2% rise in £M_3 in September and by the news of President Sadat's assassination, the underlying tone remained firm. Additional tranches of £250 million each of two medium-dated (1987 and 1992) and one long-dated stock (1998-2001) were therefore issued to the Bank (for sale to the market from 8 October onwards) to take advantage of this recovery in sentiment. In the next two days, falling US and domestic interest rates encouraged further strong demand and heavy official sales of stock were made (including, on 8 October, large amounts of the longer-dated tranches).

With the market, particularly for longer-dated stocks, continuing to move ahead despite these sales, but with no evident demand for the two existing index-linked stocks, it was decided to announce a new conventional long-dated stock - the first since January 1981 - on 9 October. The stock (15% Exchequer 1997) was priced to give a yield modestly below those on similar stocks already in the market, on the view that gilt-edged prices in the near future would depend primarily upon developments in the United States and that the recent rise in prices should not be halted by the authorities' pricing of the new stock. Given the funding already achieved in banking October, only £25 was payable on tender, with the balance in banking November. Response to the issue in after-hours' trading on 9 October and in initial dealings on 12 October, when substantial amounts of the recently issued tranche of 1987 stock were sold, was encouraging. However, an abrupt fall in sterling during 12 October, together with renewed pessimism about the outlook for US interest rates, brought the rally to a sudden halt and there were few subscriptions at the tender on 14 October.

During the following week prices fell back as the market digested the recent heavy sales. Confidence was affected by further weakness in sterling on 16 and 20 October and by the renewed upward pressure on short-term interest rates; doubts about the prospects for public expenditure in 1982/83 and the situation at BL were also unsettling influences.

Over the banking month as a whole, yields on short-dated stocks rose on balance by about 1 1/4% to 16 1/4-16 1/2%; those on mediums by 1/2% to 16-16 5/8%; and those on longs by about 5/16% to 16-16 1/4%.

Money market

Following the Bank's move to raise very short-term interest rates on 14 September sterling strengthened briefly, but it then fell back and by 18 September, as operators began to anticipate the need for further action to support sterling, three-month inter-bank rates had edged further up to 15%. The following week saw continuing pressure on sterling, halted only momentarily when some American banks cut their prime rates below 20%. Interest rates again moved up and by 28 September the one-week inter-bank rate had reached 15% and the three-month rate 16 3/4%.

On 29 September, £400 million special Treasury bills maturing on 21 October were offered for tender. These had been announced a week earlier; they were intended to help offset cash flows to the market expected to arise during banking October as the result of VAT refunds (of up to £2 billion) delayed by the dispute. With market confidence weak, the top rate of discount paid for these bills, 15 3/4%, was about 1/2% above previous comparable market rates*. On 30 September, when the discount houses faced a large prospective cash shortage they offered bills to the Bank at rates 1/2%-1% higher than previously, in their eagerness to obtain cash. With sterling still weak, the money market clearly looking for higher short-term rates and with opportunities for round-tripping opening up, the authorities did not seek to resist a further rise of this magnitude in very short rates. The clearing banks' base rates rose a further 2%, to 16% on 1 October.

For the next few days markets continued very nervous with three-month rates around 17%. However, the Bank provided assistance (which was necessary on most days) at rates not significantly higher than on 30 September and this reassurance, together with further falls in short-term interest rates abroad (first in the United States and then in West Germany) and a recovery in sterling, brought an improvement in sentiment. On 6 October, when a further £100 million special Treasury bills (maturing on 2 November) were auctioned, the average rate of discount approached 16 1/8%; at the weekly tender three days later, for the usually higher yielding 91-day bills, the average rate had fallen below 15%.

Conditions then became briefly more stable and the clearing banks judged, by 13 and 14 October, that a 1/2% reduction in base rates would be appropriate given ruling market rates. The Bank provided cash to the market every day on terms intended to encourage a period of consolidation. However, sterling weakened again and, with at least a temporary halt to the decline in American interest rates and growing fears of a strike at BL, longer rates edged back and by 21 October three-month inter-bank rate had risen to 16 5/16% (from 15 7/16% on 12 October).

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*An approximate calculation.