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FINANCIAL MARKETS REPORT

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The attached note reports on developments in the foreign exchange and domestic financial markets during banking December and banking January (November 22 to January 16). The main developments were:

- Against a background of continued oil price weakness and an obstinately firm dollar, and some market concern about domestic financial conditions the pound came under considerable pressure in the early part of January, falling to new all-time lows of ERI 70.6, $ 1.1020 and DM 3.50¾ early on the 14th, before the one day reimposition of MLR at 12 per cent eventually helped to stabilise the exchange rate in the short term.

- Market interest rates were steady throughout banking December but climbed from late December, as sterling weakened. The clearers raised their base rates to 10½ per cent on 11 January. The situation deteriorated over that weekend and market rates opened sharply up on 14 January. The Bank announced a minimum rate of lending for that day of 12 per cent, and the clearers raised their base rates to the same level almost immediately.

- Gross gilt sales in the review period totalled £1¾ billion, against a target of £1½ billion. Buying in of next maturities reduced net sales to £610 million.

- The equity market reached record levels in early January, and though set back by the subsequent sharp rise in interest rates, ended the period back at close to these levels.

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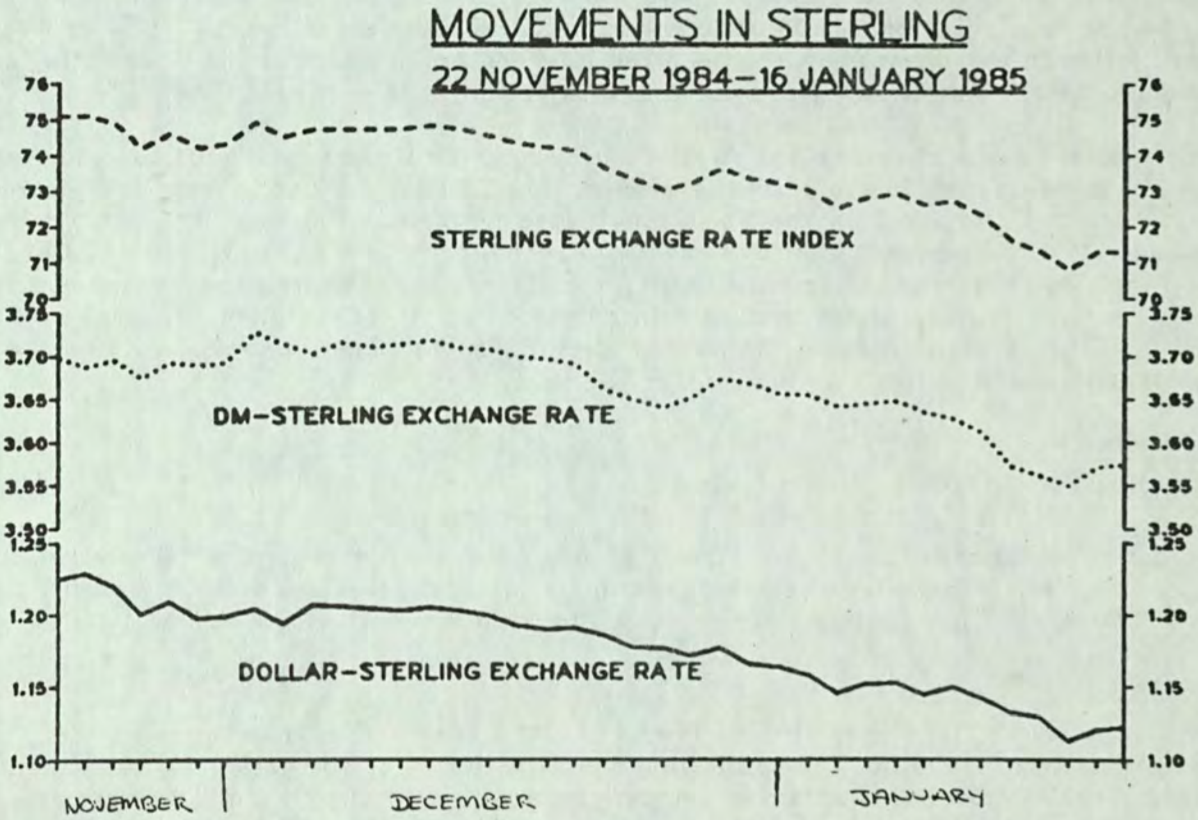
FOREIGN EXCHANGE MARKETS



Spot sterling

November

The pound dipped sharply in the latter part of November, touching lows of $1.1927 and ERI 74.1 on the 28th, reflecting a combination of a stronger dollar and renewed oil price sensitivities, before recovering to end the month little changed at ERI 74.9 (S1.2037 and DM 3.7269).

December

Sterling took on a slightly better tone at the beginning of December, but renewed oil price sensitivities, coupled with chartist inspired selling, forced sterling lower in anticipation of the OPEC meeting beginning on the 19th. Pressure mounted on the 19th in the absence of conclusive news from OPEC, together with a strengthening of the dollar on better than expected GNP data. After falling to new lows of $1.1605 in the Far East and ERI 72.7 shortly after the London opening on the 20th, the pound remained depressed, but recovered slightly in the final days before Christmas. Continued oil prices uncertainties plus a strong dollar then saw the pound weaken further, touching $1.1560 on the 31st.

January

The pound began 1985 under strong downward pressure as news of post-tax losses by Midland Bank's subsidiary, Crocker National Bank, coupled with continued oil price sensitivities and a sharply stronger dollar, resulted in new lows for sterling of ERI 72.3 and $1.1395 on the 2nd. Thereafter, the pound generally reflected the fluctuations of the dollar, but began to loose ground on the 7th after a poor weekend press and nervousness about base rate increases began to mount in advance of the money supply figures. Following the release of the figures on the 8th (£M3:- ½ per cent), the pound was marked down, as the likelihood of a rise in interest rates faded, and touched $1.1370 and ERI 72.2 on the 9th. The slide continued on the 10th, with dealers concerned about weak oil prices and the Government's supposed indifference to the exchange rate. After opening at ERI 71.6 on the 11th, a 1 per cent increase in base rates proved insufficient to halt the pound's decline (ERI 71.1 and $1.1125 lows), although nervousness about concerted intervention and talk of the G5 meeting caused the dollar to weaken, allowing the pound to make a tentative recovery.

Poor weekend press coverage led to confusion about the Government's attitude to situation and the pound opened on the 14th at a new all time ERI low of 70.6, having hit record lows of $1.1020 and DM 3.50¼ in the Far East, before news that the Bank had set a minimum lending rate of 12 per cent that day enabled a recovery to ERI 71.7, $1.1310 and DM 3.5796 at 11 am. But a strengthening dollar during the afternoon and Statoil's announcement that it would be negotiating a more market related price for its oil in January, sparked further selling (ERI 70.8 at the close). The pound eventually stabilised at around 71.3 on the 15th, as attention began to focus on the G5 meeting.

The Dollar

November

The dollar established itself above the DM 3.0 level in the latter part of November, despite aggressive central bank intervention, cuts in US interest rates and weak US data (Q3 GNP revised from + 2.7 per cent to + 1.9 per cent), to end the month at DM 3.0962.

December

The dollar began December firmer, rising to DM 3.12½ in thin trading on the 3rd, before easing sharply to DM 3.0600 the following day in a technical correction to its earlier sharp gains. The US currency fluctuated erratically on the 6th and 7th amid reports of central bank intervention, before moving higher on news of an unexpected 0.2 per cent fall in the US unemployment rate in November. Thereafter, the dollar traded steadily at around the DM 3.09 level, in thin and featureless markets. The effects of cuts in US prime rates from 11¼ per cent to 10¾ per cent and inconclusive US data were short-lived, with the US currency moving up to DM 3.11 in thin trading on the 20th in response to the previous day's better than expected Q4 GNP 'flash' estimate (+2.8 per cent). The dollar continued to make gains, in a thin market, for the rest of the month on a growing belief that US interest rates had bottomed out. The ½ per cent cut in the discount rate - announced late on the 21st - had been widely expected and had little impact on the dollar.

January

After breaking through new heights against many currencies on 2 January, fears of possible central bank intervention caused the dollar to trade erratically within a range of DM 3.18 to DM 3.13 until the 14th when it surged to new highs, including DM 3.2005 in the Far East on the 15th. The dollar was unable to sustain its higher levels as dealers became nervous ahead of the G5 meeting and speculation mounted over rise in W Germany interest rates but failed to move significantly lower, despite cuts in US prime rates (10½ per cent to 10¾ per cent on the 15th) and weaker than expected US data.

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OTHER RELATED DEVELOPMENTS

	EMS Top	EMS Bottom	Spread %	Yen	Gold
21 November (close)	Dkr	Bfr	$1\,^1/_8$	245.90	340.30
2 December (close)	Dkr	Bfr	$1\,^1/_4$	248.02	329.50
20 December (close)	Dkr	Dfln	$1\,^9/_{16}$	247.77	307.50
31 December (close)	Dkr	Dfln	$1\,^{11}/_{16}$	251.55	309.00
7 January (close)	Dkr	Dfln	2	255.70	298.25
16 January (close)	Dkr	Dfln	$1\,^{11}/_{16}$	254.78	302.70

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GILT EDGED MARKET

Gross gilt sales in banking December totalled £319 million against a target of £500 million. Buying in of next maturities reduced net sales to £125 million. The second call on the 9¾ per cent Exchequer 1998, due on 10 December, contributed £335 million to the sales target but was partially offset by £134 million of buying of other than next maturities.

Gross gilt sales in banking January totalled £918 million, against a target of £1 billion. Buying in of next maturities reduced net sales to £487 million. The final call on the 9¾ per cent Exchequer 1998, on 14 January, contributed £335 million to the sales target.

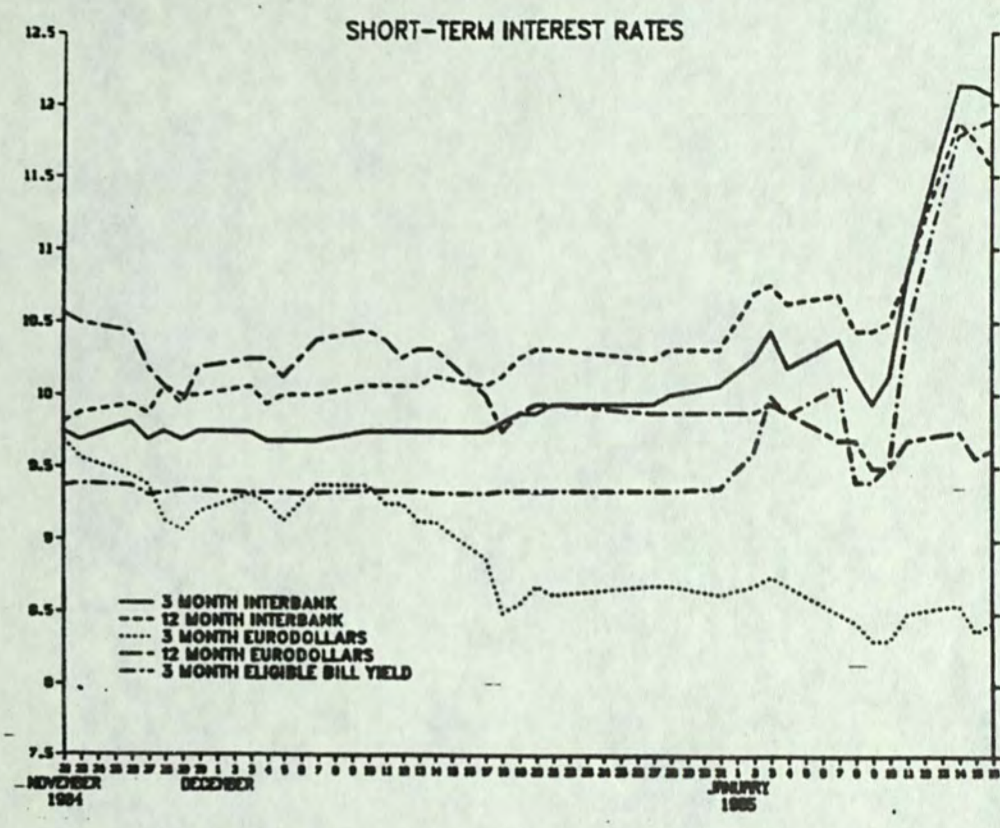
The 22 November cuts in base rates did little to attract new interest in the Gilts market with most operators distracted by the profit potential of the BT sale. On 10 December a set of heavily BT-distorted money supply figures increased market nervousness; with unfavourable press comment on the underlying PSBR arousing some concern, and, combined with a weaker trend in sterling, caused yields to rise steadily for the rest of December. At the year-end most yields were around ½ per cent higher than they were at the beginning of December and at the end of 1983.

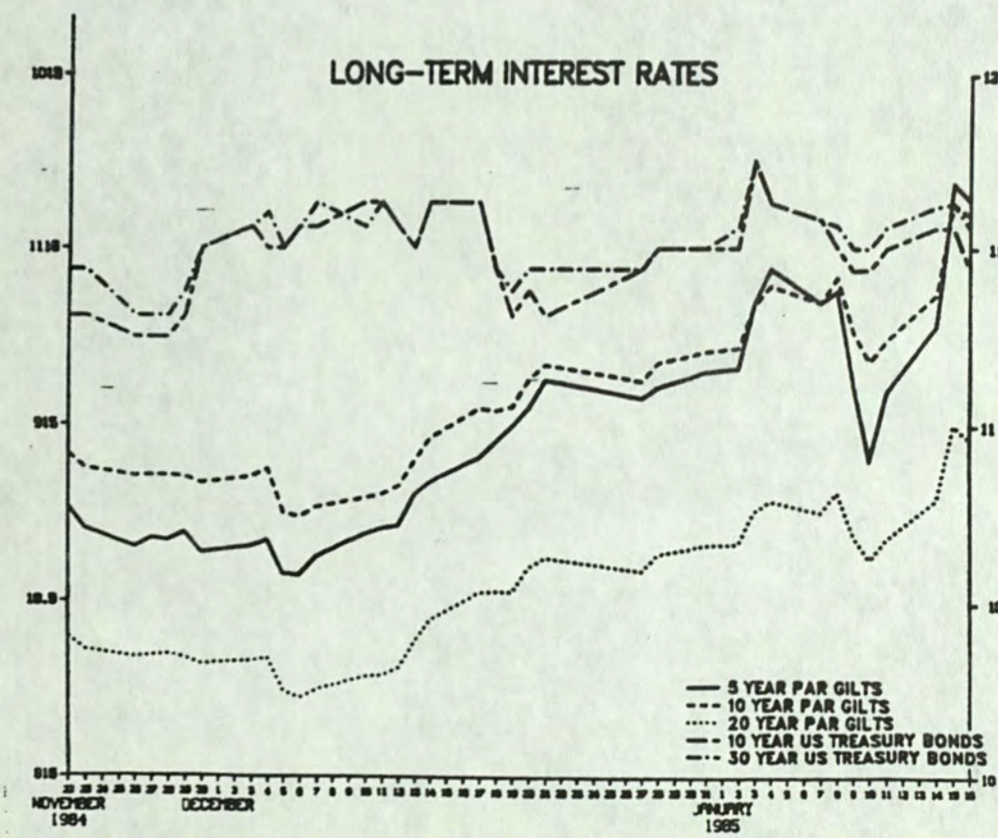
In early January nervousness on account of sterling weakness dominated the gilt market, and prices fell sharply from 10 to 14 January, as market interest rates, and subsequently basic rates, rose sharply. By the end of banking January yields were close to ½ per cent higher than at the turn of the year.

£168 m of 9¾ per cent Exchequer 1998 "A" issued on 7 November was still on Issue Department books at end-December but the tap was finally exhausted on 8 January. No new stock was issued in banking December, and £1.3 billion in banking January of which £85 million had been sold by 16 January. Though the 10½ per cent 2005 was put in the Issue Department on 14 January it did not become available for sale to the public until banking February.

Stock	Date Issued	Amount (£m)	Price	GRY(1)	Exhausted
2½% Exchequer 1987	17.12.84	250	87½	8.92	-
2½% Index-Linked Treasury 2001	17.12.84	150	101¼	-	-
2½% Index-Linked Treasury 2011	17.12.84	100	106	-	-
10½% Exchequer 2005	14. 1.85	800		10.73	

(1) GRY = Gross Redemption Yield


SHORT-TERM INTEREST RATES
3 MONTH INTERBANK
12 MONTH INTERBANK
3 MONTH EURODOLLARS
12 MONTH EURODOLLARS
3 MONTH ELIGIBLE BILL YIELD
NOVEMBER
1984
DECEMBER
JANUARY
1985


LONG-TERM INTEREST RATES
5 YEAR PAR GILTS
10 YEAR PAR GILTS
20 YEAR PAR GILTS
10 YEAR US TREASURY BONDS
30 YEAR US TREASURY BONDS
NOVEMBER
1984
DECEMBER
JANUARY
1985

SECRET

MONEY MARKETS

The ½ per cent cut in base rates on 22 November was well-discounted, Barclays having reduced theirs some days earlier by ¼ per cent (to 9¾ per cent), and with, all eyes on British Telecom, the market became very quiet. By the time attention had turned from BT, around 10 December, a set of distorted money supply figures together with weakening spot oil prices combined to counter-balance the decline in US interest rates, and the market remained quiet. 3 month interbank remained steady at around 9¾ per cent from the beginning of the review period until 17 December, while 3 month eurodollar eased ½ per cent over this period.

In late December the sterling index began to fall markedly, reflecting the strong dollar, oil prices weakness and concern about monetary conditions and the level of Government borrowing and expenditure. This forced market interest rates up; 3 month interbank rose steadily, reaching 10 per cent on 7 January. Publication of provisional December money supply figures on 8 January caused rates to ease temporarily, but by 11 January 3 month interbank had risen to $10^{15}/_{16}$ and all the major clearers raised their base rates to 10½ per cent. The situation deteriorated over that weekend, and market interest rates opened sharply up on January 14. (3 month interbank at $11^{13}/_{16}$). The Bank acted immediately, announcing its minimum rate for lending to the Discount Houses for that day would be 12 per cent. The clearers followed, raising their base rates to 12 per cent on the same day. Following the base rate rises market interest rates stabilised with the 3 month interbank rate settling around 12¼ per cent.

The average daily shortage during the review period was <u>£570m</u>, compared to an average of £460m over the calendar year as a whole. Maturing assistance accounted for most of this, but the British Telecom flotation was also a major factor. To deal with these pressures the Bank announced a further temporary facility for eligible banks to offer their gilts and export credit paper for repurchase. On 4 December £1,111m was taken up at an interest rate of $9^{21}/32$ per cent and the facility unwound on 31 December. With the prospect of major shortages in the money markets with the onset of the revenue season, a further repurchase facility was announced, under which £1.5 billion was taken up on 15 January. This facility unwinds on 14 February but money market pressures are likely to require further repurchase facilities.

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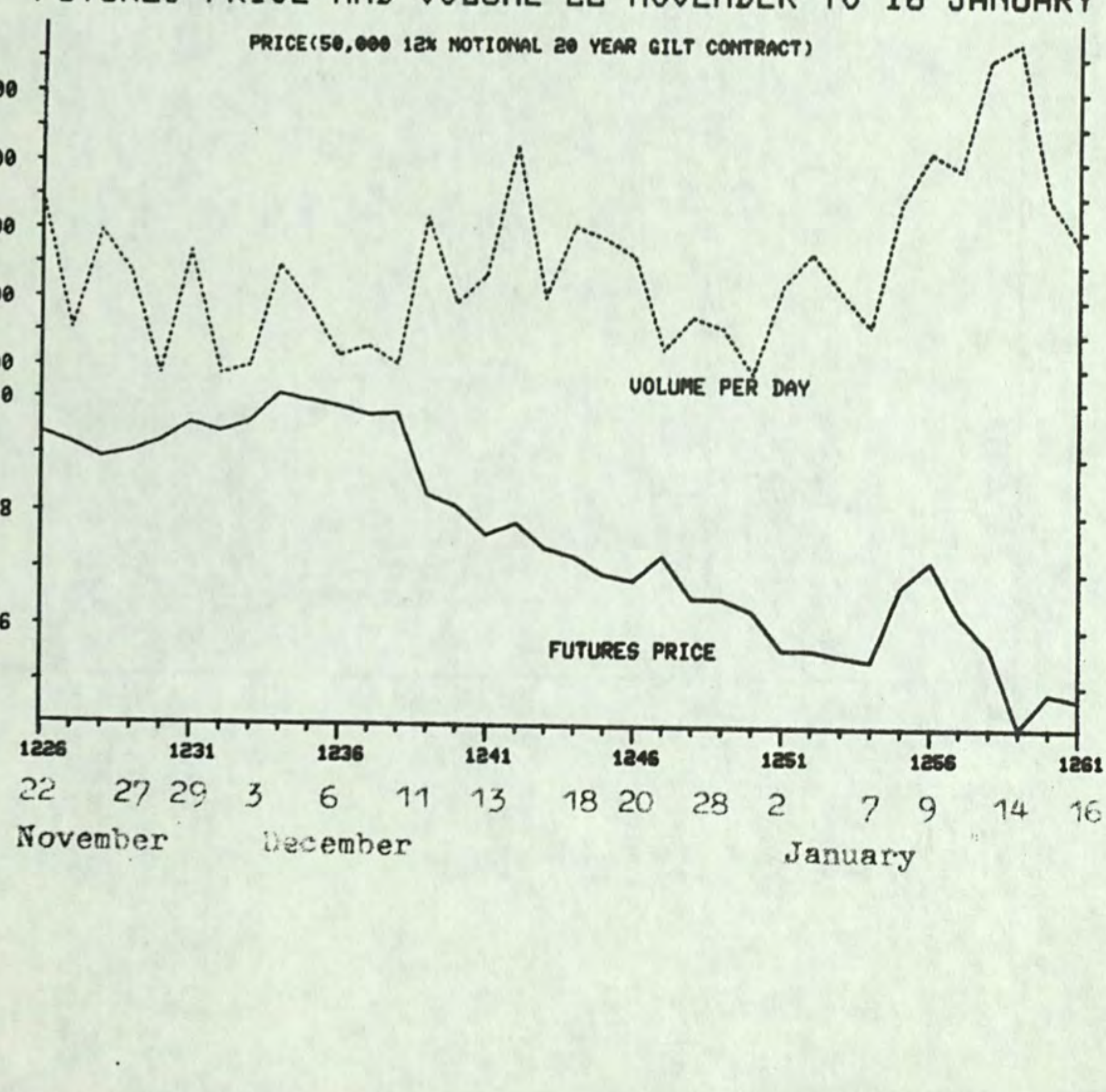
GILT-EDGED FUTURES

The futures market edged upwards until the beginning of December when with BT distractions it reached a plateau. The money supply numbers and the weaker trend in sterling unnerved operators and in moderate trading the March contract fell sharply. Contract price fell further on 11 and 14 January in heavy trading as a result of the rises in interest rates and sterlings' lack of response to the same. Trading became cautious as the banking month came to a close and expectations of further interest rate rises built up.

	Price*	Volume
Highest	110.02(4/12)	5709(14/1)
Lowest	104.09(31/12)	870(31/12)
Average	107.08	2464

* Figures after decimal represent 1/32 NDS.

FUTURES PRICE AND VOLUME 22 NOVEMBER TO 16 JANUARY



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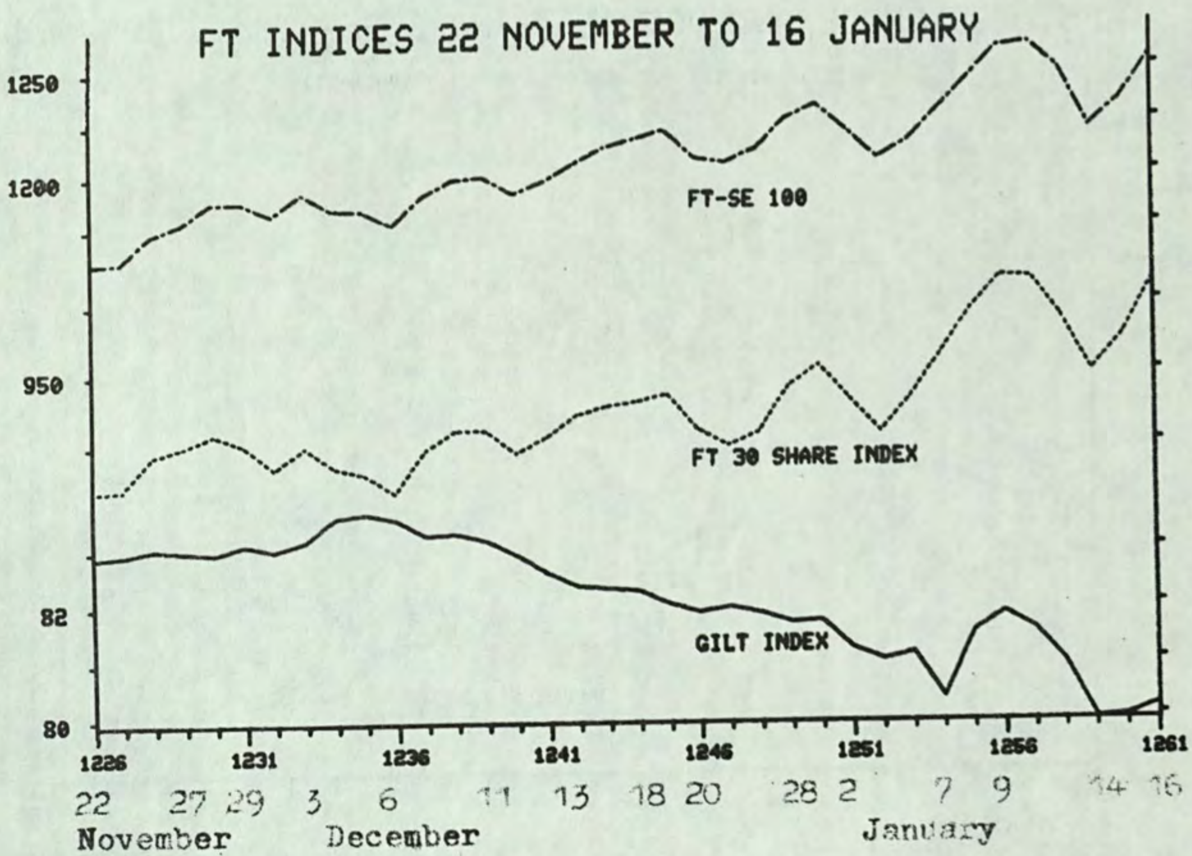
Equity Market

The successful launch of British Telecom at the beginning of December buoyed the market and market prices in general moved ahead. Towards the end of December, the apparent halt in declining US interest rates, a worsening sterling and some associated worries about domestic interest rates caused the market to falter. However by the end of December sentiment had recovered and the FT 30 shares index closed 176.6 points up on the year at 952.3 a new record and up 42.1 points since the beginning of banking December.

As sterling fell further in the first ten days of January, the equity market continued to rise, and the FT 30 shares index reached yet another new record level, of 983.1 on 9 January. The sharp rise in market interest rates, and the 2½ per cent rise in base rates up to 14 January set back the market,(the 30 share index lost 34 points in two days), but by the end of banking January the equity market was back at close to record levels.



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INTEREST RATES SUMMARY

INTERBANK RATES (X)

DATE	7 Days	1 Month	3 Months	12 Months
25 November	9.44	9.69	9.75	9.88
30 November	9.69	9.69	9.75	10.00
7 December	-	-	-	-
14 December	9.25	9.56	9.75	10.13
21 December	9.0	9.56	9.94	10.31
28 December	9.38	9.56	10.00	10.31
4 January	9.19	9.81	10.19	10.63
11 January	10.44	10.69	10.81	10.81
18 January	12.25	12.25	12.00	11.50

EURODOLLAR RATES (Y)

23 November	8.75	8.94	9.25	10.13
30 November	8.81	8.94	9.19	10.19
7 December	-	-	-	-
14 December	8.69	8.84	9.13	10.31
21 December	8.56	8.31	8.63	9.94
28 December	8.50	8.50	8.68	9.88
4 January	8.38	8.38	8.69	9.88
11 January	8.06	8.06	8.50	9.69
18 January	8.19	8.19	8.38	9.63

UNCOVERED DIFFERENTIAL (X-Y)

23 November	+0.69	+0.75	+0.50	0.25
30 November	+0.88	+0.63	+0.56	-0.19
7 December	-	-	-	-
14 December	+0.56	+0.63	+0.63	-0.19
21 December	+0.44	+1.25	+1.31	+0.38
28 December	+0.88	+1.06	+1.31	+0.44
4 January	+0.81	+1.44	+1.50	+0.75
11 January	+2.38	+2.63	+2.31	+1.13
18 January	+4.06	+4.06	+3.62	+1.88

Par Gilts Yields	5 year	10 year	20 year
23 November	10.705	10.876	10.363
30 November	10.637	10.836	10.324
7 December	-	-	-
14 December	10.839	10.966	10.450
21 December	11.127	11.171	10.624
28 December	11.108	11.176	10.634
4 January	11.440	11.394	10.787
11 January	11.097	11.244	10.683
18 January	11.631	11.709	11.102

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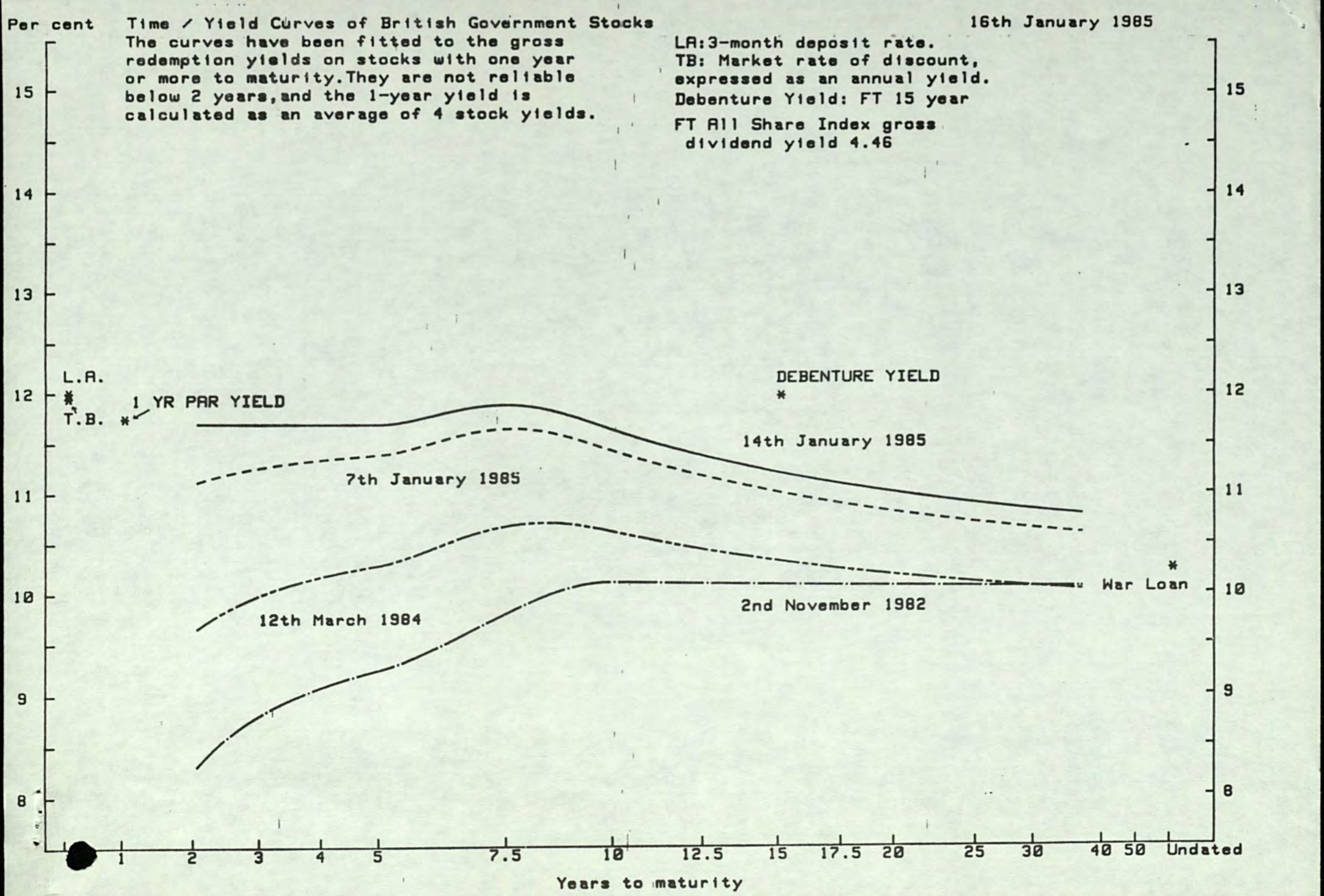
International Comparisons

	USA	FRG	World Basket	UK/World Basket Differential
17 November	9.20	5.98	9.07	+0.96
23 November	9.33	5.93	9.13	+0.59
7 December	9.00	5.85	9.00	0.78
14 December	8.97	5.90	8.96	0.77
21 December	8.48	5.83	8.79	0.93
28 December	8.35	5.80	8.72	1.18
6 January	8.35	5.78	8.69	1.40
13 January	8.25	5.73	8.53	1.78


Per cent
Time / Yield Curves of British Government Stocks
16th January 1985
The curves have been fitted to the gross redemption yields on stocks with one year or more to maturity. They are not reliable below 2 years, and the 1-year yield is calculated as an average of 4 stock yields.
LA: 3-month deposit rate.
TB: Market rate of discount, expressed as an annual yield.
Debenture Yield: FT 15 year
FT All Share Index gross dividend yield 4.46
15
14
13
12
11
10
9
8
L.A.
T.B.
1 YR PAR YIELD
DEBENTURE YIELD
14th January 1985
7th January 1985
12th March 1984
2nd November 1982
War Loan
1
2
3
4
5
7.5
10
12.5
15
17.5
20
25
30
40
50
Undated
Years to maturity