Operation of monetary policy

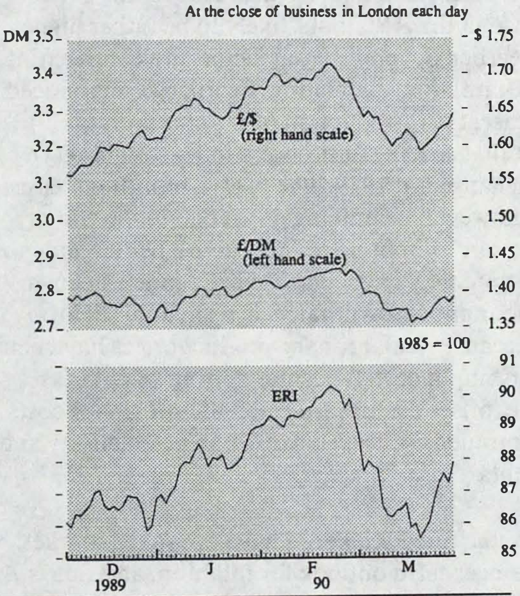
This article covers the three months from January to March 1990.

Review

The economic and financial indicators released during the first quarter suggested that the real economy was continuing to respond to tight monetary policy, with the slackening in domestic demand spreading into the corporate sector as well as the personal sector, and with output growth subdued. On the other hand, developments in costs and prices suggested that the adjustment in inflation might be more protracted than had been hoped earlier. Indeed, the twelve-month growth rate of the RPI increased, partly on account of mortgage interest rates, and the prospect for the near term is for further increases on account of special influences such as the introduction of the community charge. Market concerns about inflation were partly responsible for the sharp fall in gilt prices in the quarter, although the worldwide weakness in bond markets was perhaps a greater influence. In the light of all the evidence, the authorities maintained the general level of interest rates at 15% throughout the period.

Sterling exchange rates

At the close of business in London each day



The focus of international financial developments during the quarter was largely away from sterling, concentrating on prospects in Eastern Europe, particularly on German economic and monetary union and the effect that would have on the conduct of German monetary policy. Official German short-term interest rates remained unchanged during the period, though bond yields rose by 1⅛% at the 10-year maturity as worries about future inflation increased and as concerns grew about the likely fiscal costs of unification. In these circumstances, the deutschemark tended to weaken against other major currencies, including sterling. Weakness in the Japanese equity market and in the value of the yen had much less impact on the United Kingdom.

In the UK economy, the slowdown in domestic demand continued. It had formerly been concentrated in the personal sector, although there have been intermittent indications of some greater robustness in consumer spending recently. The slackening in demand has now spread to company behaviour, with the reduced investment intentions apparent in surveys conducted earlier last year being translated into a fall in investment (as well as stocks) in the fourth quarter of 1989. The softening in domestic demand components, while demand abroad was strong, provoked a shift of resources into net exports, with the underlying volume of non-oil imports in the first quarter up by only 3½% over a year earlier, as compared with a rise of 8% for underlying non-oil exports.

Developments in asset prices reflect the continuing tightness in monetary policy. House prices rose marginally in February and March, but the twelve-month change has subsided from 34% in

December 1988 to zero in March 1990. Equity prices were also weak during the period under review and at end-March were about 7% lower than three months earlier and 2% lower than six months earlier. Sterling strengthened against the generality of overseas currencies in January and February, as the deutschemark weakened. It then eased back as concerns about short-run inflation prospects added to political uncertainties. Over the period as a whole, sterling's exchange rate index appreciated by 2¼%, but remained 8% below its level of a year earlier.

Despite the slowing in the domestic economy, the growth of broad money has yet to show any significant easing. The twelve-month growth rate of M4 remains within the 16½%–18½% range of the last year and a half, though the growth of M4 lending has slowed from 24% in the year to March 1989 to just over 20% in the subsequent year. The recent weakness in domestic asset prices, if maintained, would point towards some future slowing in money growth and, perhaps, to a narrowing of the margin by which it has been exceeding the growth of nominal income. It seems that, in recent years, the share of sectoral wealth accounted for by broad money has remained fairly stable, although there has been some rise since 1988. As nominal wealth rose more quickly than nominal income during much of the 1980s, M4's velocity fell, and any future slowing in wealth may point to a change in this trend.

Table A
Growth rates of the monetary and credit aggregates[a]
Percentages; *seasonally adjusted (financial year constrained)*

	12 months to end-Dec. 89	12 months to end-Mar. 90	1989 Q4	1990 Q1
M0(b)	6.0	6.3	2.3	0.1
Non-interest-bearing M1	-5.5	-4.6	4.1	-4.1
M2	9.8	8.6	2.5	0.8
M4	18.2	17.5	4.0	3.7
M5	17.9	17.1	3.9	3.5
M4 lending	21.2	20.4	4.3	4.4

(a) See the statistical annex to the February 1990 *Bulletin* for definitions.
(b) Data are based on end-month figures, except M0, which is an average of Wednesdays in each month.

Table B
Composition of changes in the money stock[a]
£ billions; *seasonally adjusted (financial year constrained)*

		1989 Q4	1990 Q1	Level outstanding at end-Mar. 90
	M4 private sector holdings of:			
1	Notes and coin	0.5	-0.4	14.7
2	Non-interest-bearing bank deposits	1.4	-1.5	31.1
3	Interest-bearing retail bank deposits	1.8	4.5	98.4
4	Building society shares and deposits	3.8	4.0	145.9
5	Other interest-bearing bank deposits (including CDs)	7.3	7.5	142.6
6	Other building society deposits (including CDs)	1.4	1.6	6.0
7	**M4(=1+2+3+4+5+6)**	**16.2**	**15.7**	**438.7**
8	M4 private sector holdings of money-market instruments, CTDs and national savings in M5	0.2	-0.3	16.6
9	**M5(=7+8)**	**16.3**	**15.4**	**455.3**

(a) See the statistical annex to the February 1990 *Bulletin* for definitions. The M4 private sector comprises all UK residents other than the public sector, banks and building societies.

Despite the continued satisfactory adjustment of the real economy and distinct signs that the demand for labour is slackening, the underlying inflation indicators have not improved. In the short run inflation, as measured by the twelve-month change in the RPI, looks likely to be rather higher than was expected earlier. Several special factors are contributing to the rise in the RPI inflation—including February's announced mortgage rate increase, the introduction of the community charge, and the fact that specific duties were indexed this year having been left unchanged in 1989. The twelve-month increase in the RPI should, however, be moving down before the end of this year. Manufacturers' output prices may give a better guide to the underlying position: they have increased at a much steadier pace, and the twelve-month growth rate has risen only slightly above 5½%, partly because weak primary-product prices have held down manufacturers' input costs—despite sterling's weakness last year—and partly offset the upward creep of unit labour costs arising from the continued cyclical slowdown in productivity and higher pay settlements.

Pay settlements in the United Kingdom have provoked market concern about the longer-term outlook for inflation, and this is reflected in the wider gap between nominal yields on conventional gilt-edged stocks and real yields on index-linked. Capital market developments abroad also affected yields. Longer-term money-market rates have also risen, reflecting a market expectation that the current level of interest rates may need to be maintained for longer than was earlier hoped. However, upward pressures on shorter-term rates have been much less strong and, when present, have been resisted by official action, such as the non-allotment of three-month Treasury bills by the authorities at the tender on 23 March, when the rates bid by the market were unacceptably high.

Monetary aggregates and credit

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

Components of money

M0 increased by 6.3% in the year to March, compared with 6.0% in the year to December (see Table A), and the 1%–5% target range for the financial year. The twelve-month unadjusted rise of 5.0% was at the top of the target range, but was distorted as a result of the late timing of Easter this year. Although the annualised growth rate for the first quarter was only 0.5%, there was actually a slight fall in M0 in the first quarter of 1989. It is possible that in both years the Christmas surge was stronger than has been previously evident, leading to a larger than average unwinding. The twelve-month growth rate of M0 remained around 6% through most of the year to March 1990.

Among the other narrow aggregates, non-interest-bearing M1 (Nib M1) fell in the first quarter from its temporary peak in December, taking the twelve-month change to −4.7%. However, the fall in Nib M1 in itself does not indicate a tightening in monetary conditions since it reflects a continuing switch into interest-bearing current accounts. Perhaps more significantly, M2's twelve-month growth rate fell to 8.6% in March from 9.8% in December, while the growth in the retail deposit component of M4 also fell slightly, to 12.0%.

Growth in total M4 again fell slightly in the first quarter, from 4.0% to 3.7%—the lowest quarterly increase since end-1988; the twelve-month rate was also lower at 17.5%, but has remained in a narrow range around that figure for the past two years, so it is too early to detect a decelerating trend in the growth of M4. Personal sector holdings of M4 rose by 2.8% (£8.4 billion), down from 3.5% in the previous quarter. In contrast, M4 deposits held by industrial and commercial companies (ICCs) increased by 8.2% (£5.5 billion).

Since mid-1988 a growing proportion of M4 has consisted of wholesale rather than retail deposits. This has probably reflected, in part, the rise in wholesale deposit rates relative to retail deposit rates, as the chart opposite illustrates. As in three of the previous four quarters, over half of the increase in M4 (57%) in the three months to March consisted of wholesale deposits, although the stock of wholesale deposits still accounts for only just over a third of M4. Notwithstanding the rise in their deposit rates on 1 March, building societies, as in the previous quarter, relied heavily on wholesale borrowing to make up for the shortfall of retail deposits.

Counterparts to money

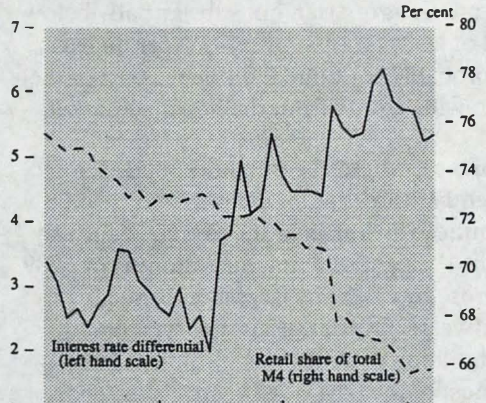
Lending by banks and building societies to the M4 private sector grew by 4.4% during the first quarter, a slightly faster rise than during the fourth quarter of 1989, although the increase over the six months as a whole was the lowest for nearly three years. On a sectoral basis, ICCs' borrowing from the banks and building societies grew by 4.5%. This was a little higher than the 4.0% growth of the previous quarter but, that apart, the lowest percentage increase since the second quarter of 1987. The growth of lending to the personal sector at 3.9% was little changed from the previous three quarters. All these factors taken together suggest that M4 lending is no longer accelerating.

Table C
Counterparts to changes in M4 and M5[(a)]
£ billions; *seasonally adjusted figures (financial year constrained)*

	Counterparts to M4			Counterparts to M5
	1989 Q4	1990 Q1	12 months to end-Mar. 90	12 months to end-Mar. 90
1 PSDR (-)	-2.2	-3.0	-8.0	-8.0
2 Net purchases (-) of central government debt by the M4 private sector (b)	0.9	1.2	9.0	10.2
3 Net purchases (-) of other public sector debt by the M4 private sector (b)	-0.2	-0.1	-0.1	-0.2
4 External and foreign currency finance(-)of the public sector	-1.8	1.6	-2.1	-2.1
5 Public sector contribution (= 1+2+3+4)	-3.3	-0.3	-1.2	-0.1
6 Sterling lending to the M4 private sector (b)(c)	20.8	22.1	89.3	89.4
7 Other counterparts(d)	-1.3	-6.1	-23.0	-23.0
8 Total (=5+6+7) = change in M4/M5	**16.2**	**15.7**	**65.1**	**66.3**

(a) See the statistical annex to the February 1990 *Bulletin* for definitions.
(b) Transactions in public sector debt instruments included in M5 are necessarily excluded from the M5 counterparts.
(c) Including changes in Issue Department's holdings of private sector commercial bills and of promissory notes relating to shipbuilding paper guaranteed by the Department of Trade and Industry. The M5 counterpart includes M4 private sector holdings of commercial bills.
(d) External and foreign currency transactions of banks and building societies and increases (-) in net non-deposit liabilities.

Wholesale minus retail deposit rate and retail share of total M4 stock



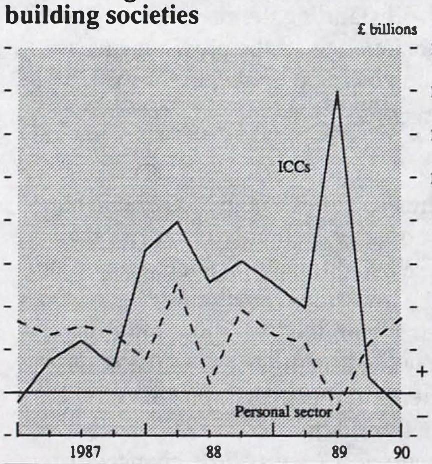
(a) Wholesale deposit rate is 3-month Libor, retail deposit rate is the average instant access deposit rate of the five largest banks and the five largest building societies.

Table D
Sectoral analysis of deposits with, and borrowing from, banks and building societies
£ billions; *seasonally adjusted (financial year constrained)*

	1988 Year	1989 Year	1989 Q2	1989 Q3	1989 Q4	1990 Q1
Personal sector						
1 Deposits	36.9	39.4	8.5	12.2	9.6	8.8
of which:						
Banks	16.7	21.9	4.9	7.4	5.6	4.7
Building societies	20.2	17.5	3.5	4.8	4.0	4.1
2 Borrowing	47.9	45.9	10.7	11.4	11.9	12.2
of which:						
Mortgage	34.5	31.1	7.2	7.6	8.8	8.8
Consumption	5.8	5.4	1.7	1.3	0.9	0.9
Unincorporated businesses	7.6	9.4	1.9	2.6	2.2	2.5
3 **Net recourse (=2-1)(a)**	**11.0**	**6.5**	**2.2**	**-0.8**	**2.3**	**3.4**
ICCs						
4 Deposits	6.5	13.5	4.7	0.3	5.2	7.5
of which:						
Sterling	6.1	11.6	3.1	0.4	3.8	5.6
Foreign currency	0.3	2.0	1.6	-0.1	1.4	1.9
5 Borrowing	32.3	37.2	8.7	14.3	5.9	6.8
of which:						
Sterling (b)	24.0	28.6	6.9	10.9	4.9	5.7
Foreign currency	8.3	8.6	1.8	3.4	0.9	1.1
6 **Net recourse (=5-4)(a)**	**25.8**	**23.7**	**4.0**	**14.0**	**0.7**	**-0.7**
of which:						
Sterling	17.8	17.2	3.8	10.5	1.2	0.1
Foreign currency	8.0	6.6	0.2	3.5	-0.5	-0.8
OFIs						
7 Deposits	11.7	19.1	5.0	5.5	4.7	4.1
of which:						
Sterling	9.4	13.2	3.6	4.9	2.3	1.7
Foreign currency	2.4	5.9	1.4	0.6	2.4	2.4
8 Borrowing	11.2	21.2	3.2	4.6	5.8	3.1
of which:						
Sterling (b)	10.1	13.9	2.6	3.8	3.9	4.2
Foreign currency	1.0	7.3	0.6	0.8	1.9	-1.1
9 **Net recourse (=8-7)(a)**	**-0.5**	**2.1**	**-1.8**	**-0.9**	**1.1**	**-1.0**
of which:						
Sterling	0.7	0.7	-1.0	-1.1	1.6	2.5
Foreign currency	-1.4	1.4	-0.8	0.2	-0.5	-3.5

(a) Excludes notes and coin.
(b) Includes Issue Department take-up of commercial bills.

Net sterling recourse to banks and building societies



The public sector counterparts to the change in M4 had a contractionary effect of £0.3 billion (see Table C); the large public sector surplus of £3.0 billion was partially offset by net purchases of debt from the M4 private sector (around £1 billion) and the overseas sector (around £1.5 billion). The debt purchases from both sectors primarily consisted of gilts.

Other counterparts to broad money growth were again in total contractionary, indeed significantly more so than in the previous quarter. Bank and building society external and foreign currency transactions were strongly contractionary which is perhaps more to be expected bearing in mind the continuing large current account deficit, after the surprisingly positive banking external figure in the previous quarter. Sterling net non-deposit liabilities exerted a contractionary influence of £2.7 billion on M4, broadly in line with recent quarters.

Sectoral developments

The increase of £8.8 billion in deposits with banks and building societies held by the personal sector (including unincorporated businesses) was outweighed by their borrowing (£12.2 billion). The sector's net recourse to the banks and building societies of almost £3.5 billion was the largest since 1988.

Almost three quarters of the increase in personal sector borrowing was on mortgage: despite the depressed state of the housing market, mortgage lending rose by 3.8% (£8.8 billion), compared with a quarterly average of 3.7% (£7.8 billion) for 1989 as a whole. There is little indication from the building society data on new commitments that mortgage lending is likely to slow down in the near future. A large part of the funds recently borrowed on mortgage have probably been applied to purposes other than house purchase (perhaps including a significant amount of borrowing for consumption). It seems likely that the banks and building societies also continued to regain market share from other mortgagors, such as centralised mortgage lenders.

The increase in lending for consumption, at 2.3% (£0.9 billion), was the same as in the previous quarter, but substantially below the average for the rest of last year (just over 4.2% per quarter). However, individuals probably continued to finance part of their expenditures by withdrawing equity from the housing market.

Lending to industrial and commercial companies increased by 4.4% in the quarter, slightly more than in the previous three months (4.0%), but significantly less than the average quarterly growth rate witnessed in 1988 and the first nine months of 1989 (7.5%). ICCs' deposits rose by 8.5%, the largest percentage increase for almost four years. Overall, ICCs' net sterling recourse to banks and building societies was virtually zero, having been large for most of the past three years, as the chart opposite shows. The halt to the deterioration in ICCs' net liquidity position may partly be explained by the decline in takeover activity, but there is growing evidence that companies are also reducing their expenditures in reaction to the earlier tightening in monetary policy.

Foreign currency deposits of ICCs rose by a historically strong £1.9 billion. As in the previous quarter, this was slightly more than their foreign currency borrowing (£1.1 billion). Sterling and

Table E
Influences on the cash position of the money market

£ billions; *not seasonally adjusted*
Increases in bankers' balances (+)

	1989 Q1	1989 Q4	1990 Q1	12 months to end-Mar. 90
Factors affecting the market's cash position				
CGBR (+)	-4.3	-3.0	-5.0	-5.6
of which, on-lending to local authorities and public corporations	*+1.8*	*-0.1*	*-3.1*	*-0.3*
Net sales (-) of central government debt (a)	+6.9	+2.3	+4.4	+17.2
of which: Gilt-edged	*+6.6*	*+1.8*	*+4.1*	*+15.8*
National savings	*+0.1*	*+0.5*	*+0.2*	*+ 1.7*
CTDs	*+0.2*	*-0.1*	—	*- 0.3*
Currency circulation (increase -)	+0.8	-1.6	+1.3	- 0.8
Reserves etc	-1.0	-2.9	-0.1	- 5.8
Other	-0.5	+0.7	-0.1	- 0.4
Total (A)	**+1.9**	**-4.5**	**+0.5**	**+ 4.5**
Official offsetting operations				
Net increase (+) in Bank's commercial bills (b)	-3.7	+3.3	+0.4	+ 1.1
Net increase (-) in Treasury bills in market (c)	+1.9	+1.2	-0.9	-5.7
Other	—	+0.2	-0.2	- 0.2
Total (B)	**-1.8**	**+4.5**	**-0.6**	**- 4.8**
Changes in bankers' operational balances at the Bank (=A+B)	+0.1	—	-0.1	- 0.3

(a) Other than Treasury bills.

(b) By the Issue and Banking Departments of the Bank of England.

(c) Excluding repurchase transactions with the Bank.

Table F
Average daily money-market statistics

£ millions; *not seasonally adjusted*
Increases in the market's cash (+)

	1989 Dec.	1990 Jan.	1990 Feb.	1990 Mar.
Average daily figures				
Influences (excluding maturing assistance)	-70	- 30	- 20	+ 100
Maturing assistance(a)	-660	- 610	- 850	- 860
Surplus (+)/shortage (-) before daily operations	-730	- 640	- 870	- 760
End-period levels				
Stock of assistance	4,820	5,000	6,820	4,970
Treasury bills outstanding(b)	8,070	6,930	8,440	9,410

(a) Including net issuance of Treasury bills and the level of bankers' balances above or below target carried over from the previous day.

(b) Other than those held by the Bank, Bank customers and government accounts.

foreign currency issues by ICCs in the bond and equity markets totalled £2.1 billion, similar to the previous quarter but below the quarterly average in 1989 (£2.5 billion).

Sterling lending to other financial institutions (OFIs) rose by £4.2 billion while their M4 deposits increased by an unusually weak £1.7 billion. OFIs' net sterling recourse to the banks and building societies of £2.5 billion was the largest on record, perhaps reflecting, in part, the fall in institutional receipts from takeovers.

Official operations in financial markets

The figures in this section are not seasonally adjusted.

Money-market operations

There was a net flow of funds into the money market during the first quarter of 1990, which was offset by an increase in the size of the Treasury bill issue (see Table E). Over the financial year 1989/90 as a whole the Treasury bill issue increased by £5.7 billion, while official assistance to the money market increased by £0.9 billion. Table H, which accounts for these increases in an alternative presentation,[1] shows that the main influence leading to the flow of funds into the market during the year was net sales of gilt-edged securities by banks and building societies, and that it was absorbed by an almost identical increase in that sector's holdings of Treasury bills. A fuller discussion of the material in Table H is contained in the section below on gilt-edged operations, in the context of the 'full-fund rule'.

Early in January there was a large net drain of funds from the market, as large corporate tax payments were only partly offset by net official purchases of gilts and the seasonal fall in currency circulation. The size of the weekly Treasury bill tender had been reduced in November in anticipation of this, and the consequent fall in the Treasury bill issue offset the drain of funds.

The recent annual inflow of funds to the market has tended to be particularly marked between February and September each year, reflecting the seasonal pattern of Exchequer flows. In early 1989, it was offset in the early stages by a reduction in the stock of assistance, before the Treasury bill tender was first raised in May. This year, the initial stock of assistance was lower, so it was necessary to increase the tender at an earlier stage. Accordingly, on 2 February the three-month tender reverted to £500 million per week, and the six-month tender was raised to £200 million per week. Money-market influences were in the event neutral during February, and the increase in the size of the Treasury bill issue was matched by a similar rise in outstanding assistance to the money market (see Table F). Central government borrowing was seasonally high in March and, despite the continuing increase in the size of the Treasury bill issue following the raising of the tender in February, the stock of assistance fell back again from its higher end-February level.

On average, the stock of assistance was larger in the first quarter than in the previous nine months and, once maturing assistance was taken into account, this led to higher daily cash shortages. Very-short-term money-market rates tended to be slightly softer

(1) The presentation of Table H broadly follows that of the note on recent developments in money-market assistance in the May 1989 *Bulletin* (pages 212–13).

Table G
Financing of the public sector

£ billions; *seasonally adjusted (financial year constrained)*

	1989 Q3	1989 Q4	1990 Q1	12 months to end-Mar. 1990
1 Central government borrowing on own account	-2.1	-2.8	+0.3	- 5.3
2 Other public sector borrowing (a)	+0.4	+0.7	-3.3	-2.7
3 PSDR (-)(= 1+2)	-1.7	-2.2	-3.0	- 8.0
4 Net sales (-) of central government debt to the M4 private sector	+3.8	+0.9	+1.2	+9.0
of which: Gilt-edged stocks	*+3.2*	*+0.6*	*+0.8*	*+8.3*
Treasury bills	*-0.1*	—	*+0.1*	*-0.7*
National savings	*+0.7*	*+0.4*	*+0.5*	*+ 1.7*
CTDs	—	—	*-0.2*	*- 0.2*
5 Sales (-) of local authorities' and public corporations' net debt to the M4 private sector	+0.1	-0.2	-0.1	-0.1
6 External and foreign currency finance (-) of the public sector	-1.2	-1.8	+1.6	- 2.1
of which: Gilt-edged stocks	*-0.6*	*+0.8*	*+1.5*	*+ 3.0*
Treasury bills	*-0.4*	*-0.1*	*+0.2*	*-1.1*
7 Total financing (-) of the public sector from the M4 private and overseas sectors (=4+5+6)	**+2.8**	**-1.0**	**+2.7**	**+ 6.8**

(a) Includes on-lending from central government to local authorities and public corporations.

Table H
Influences on the cash position; alternative presentation

£ billions; *not seasonally adjusted*
Increases in bankers' balances (+)

	Financial years 1987/88	1988/89	1989/90
Factors affecting the market's cash position			
Under/overfunding (+/-)(a)	—	-2.5	+0.4
Central government net debt sales to banks and building societies(b) (-)	+0.4	+4.5	+4.5
Other public sector net borrowing from banks and building societies (-)	+1.2	+4.8	+1.2
of which, local authorities' deposits with banks and building societies	*+1.1*	*+2.8*	*+0.1*
Currency circulation (-)	-1.9	-0.8	-0.8
Other	-0.1	-0.4	-0.2
Total (A)	**-0.5**	**+5.6**	**+5.1**
Official offsetting operations			
Net increase (+) in Bank's commercial bills	+2.5	-5.7	+1.1
Net increase (-) in Treasury bills held by banks and building societies	+0.3	+0.2	-4.7
Net increase (-) in Treasury bills held by M4 private and overseas sectors(c)	..	..	-1.6
Other	-2.5	+0.1	-0.2
Total (B)	**+0.2**	**-5.4**	**-5.4**
Changes in bankers' balances at the Bank (=A+B)	-0.3	+0.1	-0.3

.. not applicable.

(a) Based on funding definition in use at the time. From 1988/89 onwards, funding is defined in terms of debt sales to the non-bank and non-building-society private sector, whereas previously it was defined in terms of the non-bank private sector. For 1987/88, all lines in the table referring to banks and building societies comprise only banks, and the M4 private sector includes building societies.

(b) Other than Treasury bills.

(c) Prior to 1989/90, included in definition of under/overfunding instead.

than in the previous three months, and the Bank continued the policy it had been following since August of relieving market shortages later in the day than was customary previously.

The increase in the size of the weekly Treasury bill tender over the last year has, in general, been matched by an increase in the volume of bids, both from discount houses (which are committed collectively to underwrite each tender) and from other institutions. The average yield at each tender has normally been at a level consistent with the general level of market interest rates indicated by the rates at which the Bank's own money-market operations have been conducted. There have however been occasions when the prices bid at a given weekly tender fell short of that level. This was the case on 23 March, when the Bank decided not to allot any three-month Treasury bills, though it did fully allot the bills on offer at the six-month tender.

Gilt-edged operations

Over the financial year 1989/90, the PSDR was £8.0 billion and foreign exchange reserves fell by £5.9 billion. Net purchases of debt[1] outside the bank and building society sectors totalled £14.3 billion (including £11.3 billion of gilts), and the public sector was underfunded by £0.4 billion over the year (Table H), so that the cumulative £2.2 billion of overfunding in earlier financial years was not fully offset. The PSDR for 1990/91 was forecast at the time of the Budget at £7.0 billion. Table K shows the sectoral breakdown of official transactions in gilt-edged stocks in recent quarters.

In his Budget speech on 20 March the Chancellor of the Exchequer reiterated that the objectives of funding policy were to manage the public debt in a way that supports monetary policy in bearing down on inflation, while causing the minimum distortion to the financial markets. The 'full fund rule'[2] would be operated taking into account the situation in the money markets. Table H sets out the relationships. It reveals that the modest underfunding in 1989/90 made no more than a small contribution to the expansionary influences on bankers' cash balances; the dominant influence was the sale of central government debt by banks and building societies. The official absorption of those sales was financed by an almost identical increase in bank and building society holdings of Treasury bills. The effect of these operations was therefore to change the maturity composition of bank and building society liquidity held in the form of central government debt, but not to change its total amount.

Over a longer period, a significant influence on flows in the money market has come from the transactions with the banking system of public sector bodies other than central government — public corporations and, especially, local authorities. Prior to 1982, local authorities had accumulated substantial borrowings from banks. Central government had an increasingly positive cash flow, attributable in part to overfunding, and this led to the build-up of the 'bill mountain', the form in which the cash was recycled to the banking system. In 1982, more favourable terms were introduced for local authorities to draw central government funds through the Public Works Loan Board. The objective was

(1) Excluding all purchases or sales of Treasury bills.

(2) The 'full fund rule' is to fund the total of maturing public sector debt, the PSBR and any underlying change in the foreign exchange reserves by sales (or, if the total is negative, purchases) of debt outside the bank and building society sectors. As the Chancellor announced last October, purchases and sales of Treasury bills are now excluded from the measure of debt.

Table J
Conversions of gilt-edged stock
Amounts of stock are quoted in £ million nominal

Date of conversion	Stock to be converted from	Amounts outstanding before conversion	Amounts outstanding after conversion	Percentage of stock converted	Stock to be converted into	Amounts outstanding before conversion	Amounts outstanding after conversion	Rate of conversion (a)
15/11/1989	9 3/4% Conversion 2006	702	15	98	9% Treasury 2008	1,800	2,521	£105.00
22/1/1990	12% Exchequer 1999-2002	1,265	105	92	12% Exchequer 1998	2,500	3,659	£99.90
10/2/1990	9 3/4% Conversion 2001	802	35	96	10% Treasury 2001	1,050	1,806	£98.55
11/4/1990	10% Conversion 2002	591	21	96	9 3/4% Treasury 2002	1,450	2,030	£101.80
19/5/1990	9% Exchequer 2002	1,190	(b)	(b)	9 3/4% Treasury 2002	2,030	(b)	£94.55

(a) The nominal amount received of the stock being converted into per £100 nominal of the stock from which the conversion is being made.
(b) This conversion is due to take place after the publication of the *Bulletin*.

Table K
Official transactions in gilt-edged stocks
£ billions; *not seasonally adjusted*

	1989 Q1	Q2	Q3	Q4	1990 Q1
Gross official sales (a)	-3.8	-3.0	-1.2	-1.0	-0.6
less					
Redemptions and net official purchases of stock within a year of maturity	-2.9	-2.6	-3.1	-0.8	-3.4
Equals net official sales (b)	-6.6	-5.6	-4.3	-1.8	-4.1
of which, net purchases by:					
Banks (b)	*-0.5*	*-0.1*	*-0.8*	*-0.5*	*-1.3*
Building societies	*-1.2*	*-0.6*	*-0.9*	*+0.1*	*-0.5*
Overseas sector	*-0.2*	*-1.3*	*+0.5*	*-0.8*	*-1.5*
M4 private sector	*-4.7*	*-3.6*	*-3.2*	*-0.6*	*-0.8*

(a) Gross official sales of gilt-edged stocks are defined as net official sales of stock with over one year to maturity apart from transactions under purchase and resale agreements.
(b) Apart from transactions under purchase and resale agreements.

Table L
Changes in UK official reserves
$ millions

	1990 Jan.	Feb.	Mar.
Change in reserves	**-197**	**+89**	**-447**
of which:			
Net borrowing (+)/payment (-) of public debt	-19	-25	-18
Valuation change on roll-over of EMCF swap	-258	—	—
Underlying change in reserves	+80	+114	-429
Annual revaluation of reserves	-	—	+1,205
Level of reserves (end of period)	**38,448**	**38,537**	**39,295(a)**

(a) After the annual revaluation.

to bring about matching reductions in local authority borrowing from the banks, and in the Bank of England's bill mountain. This has been progressively accomplished, and local authority gross borrowing from banks has fallen to £2.0 billion at the end of March from £10.8 billion at the same point in 1982. More recently, local authorities have begun to accumulate deposits of significant size with banks and building societies, while continuing to borrow heavily from central government through the PWLB. As can be seen from Table H, this has contributed some £4 billion of the cash injection into the market over the past three years, as the level of their bank deposits has almost doubled, and its continuation would have required central government to increase yet further its reliance on Treasury bills as a means of financing it.

Against this background, the government in February announced measures to limit the extent to which local authorities can simultaneously borrow at fine rates from the PWLB and build up deposits with banks and building societies. Over time, these measures should contain this source of flows into the money market, and so ease money-market management. Meanwhile, funding operations will be adjusted if necessary, increasing gilt sales or reducing gilt purchases, to take account of the overall situation in the money market.

The series of offers to convert holdings of smaller gilt-edged stocks into larger, more liquid issues which began last October continued during the period under review. Details of all the conversions to date are shown in Table J. On each occasion the terms were set in line with those prevailing in the market and over 90% of the stock in question was converted.

Official reserves

Table L gives details of the changes in the official reserves during the period under review. Over the first quarter as a whole, the level of reserves rose by $0.7 billion, as the increase which resulted from the annual revaluation more than offset the modest fall in underlying terms which took place in March.

ECU Treasury bills

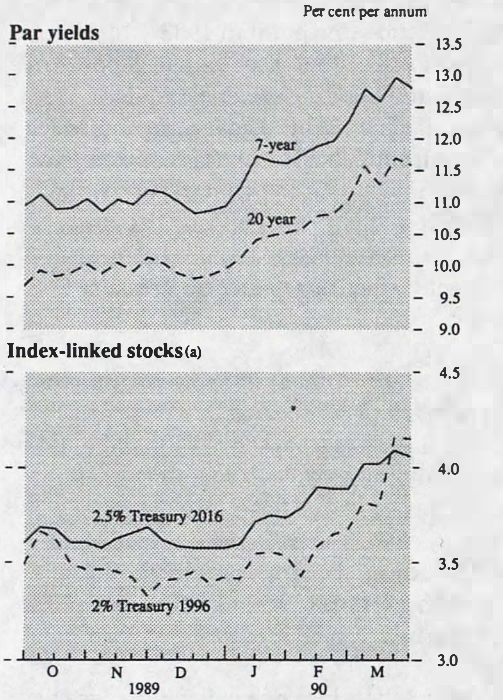
At each of the latest three tenders of ECU Treasury bills on 13 February, 13 March and 10 April the Bank allotted ECU 300 million of both one-month and three-month bills, while the amount of six-month bills was raised from ECU 300 million to ECU 400 million on the last of these dates. The amount of bills outstanding rose to ECU 3,100 million as at 12 April. On average the three tenders were covered 2.7 times, with the largest cover each time being at the three-month maturity. The margin by which the average accepted yield has been below the bid rate for

Table M
Sterling interest rates, gilt yields and exchange rates[a]

Date	Interbank interest rates (per cent per annum)				Gilt yields (per cent per annum)				Exchange rates		
					Conventionals			Index-linked			
	1 month	3 months	6 months	12 months	Short	Medium	Long	Long	ERI	£/$	£/DM
29 December	15 3/32	15 3/32	14 31/32	14 5/8	11.12	10.68	9.65	3.46	86.0	1.6125	2.7275
8 January	15 1/16	15 3/32	14 15/16	14 21/32	11.32	10.88	9.89	3.50	87.2	1.6515	2.7550
15 January	15 3/32	15 1/4	15 1/4	15 1/16	11.71	11.23	10.09	3.53	88.5	1.6657	2.8159
17 January	15 3/16	15 3/8	15 7/16	15 1/4	11.85	11.34	10.18	3.58	87.8	1.6540	2.7915
26 January	15 1/32	15 3/32	15 3/32	15	11.78	11.39	10.25	3.64	88.1	1.6605	2.8057
7 February	15 3/32	15 1/8	15 1/8	15 3/32	12.00	11.58	10.50	3.69	89.2	1.6995	2.8135
16 February	14 15/16	15 3/32	15 5/32	15 3/16	12.03	11.58	10.50	3.78	89.7	1.6925	2.8485

(a) The rates quoted are for the close of business on each day.

Gross redemption yields on UK government securities



(a) Real yields assuming 5% inflation.

ECU-denominated bank deposits rose from $\frac{7}{32}$% to $\frac{1}{4}$%. Monthly turnover in the first quarter averaged ECU 5,000 million, 17% below the previous quarter but still 39% above the level in the first quarter of 1989.

Market developments

In the early part of the first quarter, sterling gradually appreciated in generally quiet trading, and day-to-day movements in UK interest rates became less sensitive to exchange rate changes than they had earlier tended to be. Gilt yields, like yields in some overseas bond markets, rose sharply and money-market rates were, as last year, subject at times to bouts of market nervousness. Later on, when inflation worries and political factors led to a partial retreat by the pound, the influence of its daily movements on domestic markets strengthened once more. Over the period as a whole, the money-market yield curve became upward-sloping as market expectations of an early cut in base rates diminished, and gilt-edged yields rose substantially.

Domestic markets began the first quarter in fairly stable conditions, though the pound had fallen sharply against the deutschemark (despite rising somewhat against the dollar) since mid-November. The downward-sloping interbank interest rate curve beyond three months indicated that the market expected a fall in interest rates during 1990.

As the new year opened, gilt-edged yields began to rise in sympathy with bond yields overseas (see Table M), stimulated primarily by anticipated demand for capital arising from developments in Eastern Europe. But domestic concerns about inflation (including the pay negotiations at Ford) played a part, and longer-term interbank interest rates also increased as expectations of a fall in base rates were deferred. Meanwhile the pound quietly firmed, as the deutschemark's rise came to a halt and investors were attracted by the interest rate differential in sterling's favour.

The sharp rise in December retail sales announced on 15 January provoked market fears that consumer demand had been stronger than previously thought, and longer money-market rates moved up further, though no further tightening of policy seemed to be expected in the near term. Both conventional and index-linked gilt yields rose further during this period with overseas bond markets weak and market forecasts of the PSDR for 1989/90 diminishing.

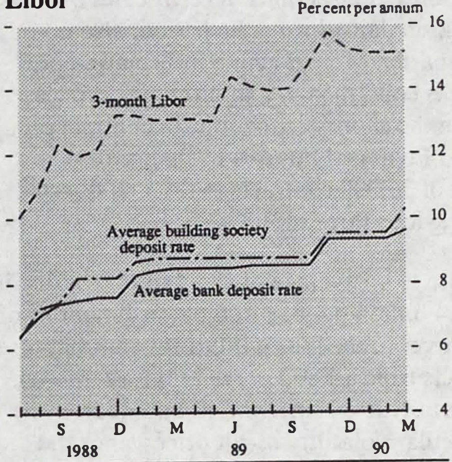
Markets improved on the smaller current account deficit for December announced on 26 January, and then remained quiet

Table N
Sterling interest rates, gilt yields and exchange rates[(a)]

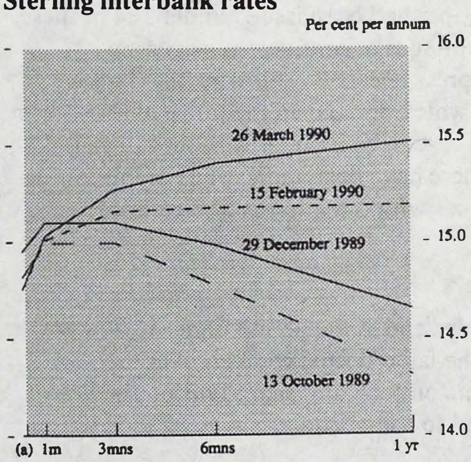
Date	Interbank interest rates (per cent per annum)				Gilt yields (per cent per annum)				Exchange rates		
					Conventionals			Index-linked			
	1 month	3 months	6 months	12 months	Short	Medium	Long	Long	ERI	£/$	£/DM
22 February	15	15 3/32	15 5/32	15 1/4	12.25	11.80	10.71	3.82	90.3	1.7150	2.8641
27 February	15	15 3/32	15 5/32	15 1/4	12.11	11.69	10.59	3.72	89.6	1.6897	2.8466
9 March	15 1/8	15 5/16	15 9/16	15 23/32	12.90	12.57	11.38	3.89	86.6	1.6197	2.7554
13 March	15 1/8	15 3/8	15 9/16	15 3/4	13.03	12.63	11.42	3.92	86.2	1.6005	2.7500
16 March	15 3/32	15 7/32	15 13/32	15 9/16	12.81	12.41	11.15	3.89	86.6	1.6242	2.7530
21 March	15 7/32	15 7/16	15 5/8	15 13/16	13.19	12.85	11.57	3.99	85.5	1.5942	2.7224
30 March	15	15 7/32	15 13/32	15 17/32	12.96	12.63	11.42	3.91	87.9	1.6455	2.7870

(a) The rates quoted are for the close of business on each day.

Retail deposit rates and three-month Libor



Sterling interbank rates



(a) For one week.

during the first half of February; the 0.9% increase in Abbey National's mortgage rate had little impact on wholesale money-market rates since it merely helped to offset the earlier narrowing in the differential between mortgage and base rates. German bond prices fell particularly sharply at this time on worries about the possible inflationary impact of German economic and monetary union, and led to a period of market nervousness about the possible effects on UK rates of a tightening of German policy.

Sterling's exchange rate index reached its peak for the quarter at 90.3 on 22 February (see Table N), its highest level since October and 5.0% above its end-December level. Sterling also reached its highest level against the dollar ($1.7165) since the previous April on the same day, before easing in advance of the January trade figures to be released on 28 February. Although the deficit was larger than expected, it had little immediate effect on the exchange rate, but the pound weakened significantly in early March amid political concerns and more pessimistic analysts' inflation forecasts; bond yields and money-market rates rose, and there was some temporary market nervousness about a possible rise in base rates, although it never became intense.

Markets stabilised at rather easier interest rate levels in advance of the Budget on 20 March, although on the Budget's eve the strengthening of the deutschemark following the East German election results pushed money-market rates and gilt yields up. Sterling then fell back, and gilt yields rose further in response to lower PSDR forecasts for 1989/90. There was a more modest rise in money-market rates, and on 23 March the Bank resisted the upward movement by declining to allot any three-month Treasury bills at the weekly tender at the prices bid by the market.

Sterling recovered over the final days of the quarter with market attention refocusing on the interest rate differential in its favour. Money-market rates in turn eased back from their peaks and the UK domestic and foreign exchange markets ended the quarter in steady conditions. Despite its losses in March, over the quarter as a whole sterling's exchange rate index rose by 2.2%, with gains of roughly equal size against the dollar and the deutschemark.

The shape of the interbank rate curve changed sharply from downward to upward-sloping during the period under review, as an early fall in base rates was seen as having become less likely. Three-month rates rose by ¼%, while one-year rates rose by over ⅞%. Nevertheless, short sterling futures prices at the end of March of 84.79 for the June contract and 85.62 for December still implied an expected modest fall in rates during the rest of 1990.

The upward slope to the interbank rate curve at that time purely reflected the arithmetic effects of interest rate compounding.

Conventional gilt yields at most maturities rose by 1¾%–2% during the quarter, so that the slope of the yield curve was little changed. During the period, yields reached their highest levels since the early 1980s. Index-linked gilt yields also rose, although by less than 1%, reflecting their insensitivity to changes in inflation expectations.

Market turnover

Transactions in eligible bills by discount houses,[1] including sales to the Bank, averaged £1.6 billion daily over the period under review, up by 12% from the previous quarter and the highest since reporting began at the start of 1988. However, average daily Treasury bill turnover fell back from £300 million to £170 million. Discount house transactions in certificates of deposit averaged £0.6 billion daily during the period, also up by 12% from the previous quarter. More detailed information on discount house turnover is contained in a monthly press release.[2] Average daily turnover in the short sterling futures contract on the London International Financial Futures Exchange rose to another quarterly record of 36,300 contracts in the first quarter, up from 33,900 in the previous three months.

Total turnover in gilts rose to an average of £3.8 billion per day in the first quarter from £3.4 billion per day in the fourth quarter of 1989. Average daily turnover in the long gilt futures contract rose sharply to 21,100 contracts from 14,800 in the previous quarter. This was the highest quarterly level since the second quarter of 1988, reflecting the particular volatility in gilt prices since the start of the year.

Commercial paper and medium-term notes

Gross issues during the first quarter of commercial paper issued under the terms of the Bank's notices of 14 March 1989 and 11 January 1990 totalled £14,561 million, up from £11,714 million in the previous quarter and the largest quarterly total to date. There were redemptions of £13,949 million, and the total paper outstanding rose to £4,141 million at the end of March. The Bank had been notified of 223 programmes by the end of the quarter, and paper had been issued under 184 of these. More detailed data about issues of commercial paper are contained in a monthly press release.[3] Following the Bank's 11 January 1990 notice, which broadened the range of short-term paper issues available to certain companies without infringing the Banking Act 1987, there have been indications of interest in issuing medium-term notes within the terms of the notice.

Other capital markets

The FT-SE 100 Share index ended the period under review at 2,247.9, a fall of 7.2%. The fall reflected concern over the inflationary and economic outlook and sharp falls on the Tokyo Stock Exchange, mirrored to a lesser degree in New York.

Table P
Sterling capital issues: amounts announced
£ millions

	Equities(a)	Fixed rate (b)			FRNs
		Domestic issues(c)	Sterling eurobonds		
			UK borrowers	Overseas borrowers	
1988	5,954	3,084	3,877	2,693	5,450
Q1	894	380	1,555	1,100	459
Q2	1,686	909	1,342	1,543	1,694
Q3	2,027	631	175	—	1,836
Q4	1,347	1,164	805	50	1,461
1989	7,071	4,954	4,060	2,977	5,830
Q1	636	1,587	1,898	922	725
Q2	2,527	1,502	847	935	1,485
Q3	2,165	1,202	1,075	895	1,705
Q4	1,743	663	240	225	1,915
1990					
Jan.	752	95	780	450	700
Feb.	495	73	311	435	800
Mar.	257	471	70	224	150
Q1	1,504	639	1,161	1,109	1,650

(a) Excludes privatisation issues.
(b) Of which £795million was equity-related in the first quarter of 1990.
(c) All UK borrowers except for:
Two preference share issues in 1988 Q2 for £218 million.
Two 'bulldog' issues in 1988 Q4 for £200 million.
Two 'bulldog' issues in 1989 Q1 for £225 million.
Two 'bulldog' issues in 1989 Q2 for £100 million.
Two 'bulldog' issues in 1989 Q3 for £275 million.
Three 'bulldog' issues in 1989 Q4 for £385 million.
Excludes local authority issues.

(1) Figures for discount houses cover only those money-market dealing counterparties of the Bank of England which are authorised under the Banking Act 1987.
(2) Available on request from Banks' Balance Sheets Group, Financial Statistics Division, BB-l, Bank of England.
(3) Available on request from Sector Finance and Markets Group, Financial Statistics Division BB-l, Bank of England.

The amount of sterling bonds announced in the first quarter rebounded from the low level in the previous quarter (see Table P), as the pound itself recovered some of its decline against the deutschemark. At times, attractive swap rates into other currencies particularly boosted issuance. On the other hand, the general weakness in capital markets may have tempered issuers' enthusiasm. The majority of issues of floating-rate notes were, as in the whole of 1989, by building societies.

Total bond issues by UK borrowers in foreign currencies declined from $1.6 billion in the fourth quarter of 1989 to $1.3 billion in the latest quarter. All issues were fixed-rate bonds. The Swiss franc was the foreign currency most actively used by UK borrowers, accounting for 28% of issues, followed by the yen (23%) and the Australian dollar (19%). Issues by UK banks and other financial institutions declined from $0.9 billion in the fourth quarter to $0.8 billion in the first. Issues by the corporate sector also fell, from $0.7 billion to $0.5 billion.