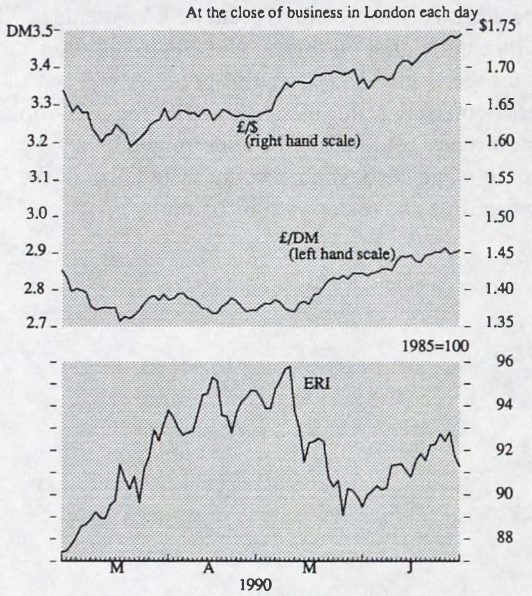
Operation of monetary policy

This article covers the three months from April to June 1990.

Review

The UK economy continued its response to tight monetary conditions, and the general level of interest rates was maintained at 15% throughout the period under review. In the early part of the year there were some signs of a small revival in consumer demand, but more recent data have given comfort that any revival was short-lived. Meanwhile the deceleration in broad money and in lending, both to companies and to individuals, has become increasingly clear, although little adjustment has so far been evident in the pace of real corporate activity. Inflation itself continued to increase during the quarter. In the circumstances, the strengthening of sterling in May and June, reversing the fall in the exchange rate index since the end of the third quarter last year, provided a welcome tightening of policy.

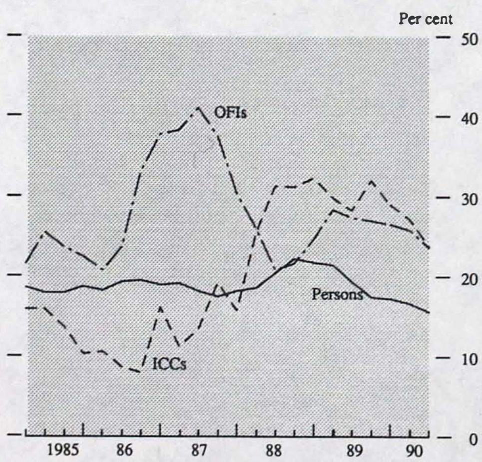
Sterling exchange rates



Figures for the first quarter showed a halt in the falling growth rates of consumer spending evident since 1988, although the heavy volume of storm damage repairs perhaps meant that the 1½% rise in the quarter overstated the underlying strength of demand. Monthly retail sales data since then have been, as usual, volatile but show sluggish volume growth and point to a slowdown in the second quarter overall. M0's fall back from its peak twelve-month growth rate of 7.3% in April, after what appeared to be erratically high growth in the aggregate of 1.7% within that month, provides some additional encouragement.

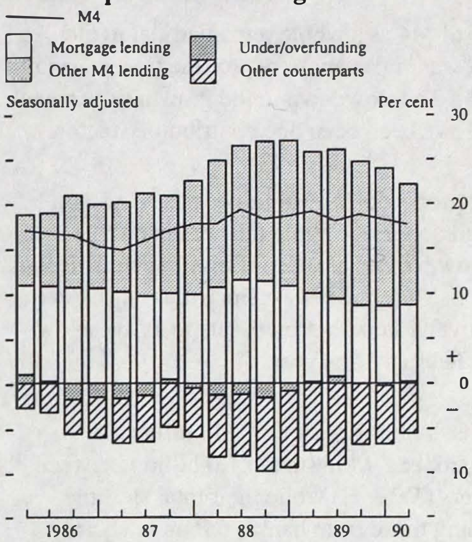
There is something of a puzzle in understanding the recent financial behaviour of companies, and explanation may rest in part in the heterogeneous experiences of different parts of the company sector (see pages 322–3 of the Economic commentary). Internal sources of funds have been falling as profits have declined, dividends have been maintained and interest payments have risen sharply. Responding no doubt partly to this high cost of borrowing, companies have also reduced their external borrowing, particularly from banks but also from the capital markets. Surprisingly little adjustment has yet taken place in spending on investment, though some reduction in stocks has occurred, particularly in the fourth quarter of 1989. The main adjustment has been the cessation of last year's very heavy expenditure on acquisitions and mergers, both at home and abroad. Lower activity of this type has no direct implications for the contributions of companies to domestic demand or for their financial deficit; it has, however, been a major factor behind the reduction in their borrowing.

Twelve-month growth rate of sectoral M4 lending



The weakness of corporate borrowing from M4 institutions in the second quarter was accompanied by subdued personal borrowing. Overall, the twelve-month growth rate of M4 lending has slowed from over 24% at its peak in March 1989 to 18.7% in June this year, and has been among the counterparts to the more modest slowing in the growth of M4 from 18.2% in January to 16.8% in June. Weakness in domestic asset prices (housing being a large component of those assets), as well as the adjustment in the real economy, had suggested that a deceleration in M4 might occur this year.

Counterparts to annual growth of M4



Sterling's exchange rate index rose by 4.0% during the period under review, with the rally partly, but by no means entirely, attributable to market speculation about the timing of UK entry into the Exchange Rate Mechanism. The strength of real economic activity is only one of the factors determining inflationary pressures, and the rebound in the currency after its fall last year will, if sustained, play an important part in restraining inflation, partly through its direct effect on the prices of imports and import substitutes. It will also tend to distribute the burden of adjustment more evenly among the different sectors of the economy as competitive pressures on prices and wages begin to be felt by those companies for whom sterling's previous fall had eased constraints on margins. Nevertheless, the effect of the pound's rise on inflation cannot be expected to be immediate. In the second quarter, neither the all-items RPI inflation rate nor underlying measures, such as the change in the producer output price index, showed any significant decline. It was by no means certain that wage settlements or unit wage costs had reached their peak. These pressures underlined the need for continued firmness in policy.

Table A
Growth rates of the monetary and credit aggregates[(a)]

Percentages; *seasonally adjusted (financial year constrained)*

	12 months to end-Mar. 90	12 months to end-June 90	1990 Q1	Q2
M0(b)	6.3	6.5	0.1	2.2
Non-interest-bearing M1	-4.4	-2.2	-3.9	-1.9
M2	8.6	8.2	0.8	1.4
M4	17.4	16.8	3.7	3.7
M5	17.1	16.7	3.5	4.0
M4 lending	20.4	18.7	4.4	3.1

(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.

Against this background, the authorities continued to indicate that there could be no immediate prospect of lower short-term interest rates. Although one-year interbank rates fell by 15/16% during the quarter to 14 19/32% in response to the greater optimism over sterling, three-month rates declined by a more modest 5/16%. This reflected the general lack of expectation in the market of a fall in base rates for some time to come. Gilt-edged yields also declined during the quarter, by over 1% in many cases, as caution in domestic and foreign exchange markets during April about the economic and political situation gave way to more buoyant sentiment during May and June. However, this decline offset only part of the sharp rise in yields which had taken place during the first quarter against a background of worldwide capital market weakness.

Table B
Composition of changes in the money stock[(a)]

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

		1990 Q1	Q2	Level outstanding at end-June 90
	M4 private sector holdings of:			
1	Notes and coin	-0.3	0.6	15.4
2	Non-interest-bearing bank deposits	-1.5	-1.4	29.6
3	Interest-bearing retail bank deposits	4.5	4.6	104.5
4	Building society shares and deposits	4.0	3.9	149.6
5	Other interest-bearing bank deposits (including CDs)	7.5	7.4	148.4
6	Other building society deposits (including CDs)	1.6	1.2	7.4
7	**M4(=1+2+3+4+5+6)**	**15.7**	**16.2**	**455.0**
8	M4 private sector holdings of money-market instruments, CTDs and national savings in M5	-0.3	2.0	18.7
9	**M5 (=7+8)**	**15.4**	**18.2**	**473.6**

(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.

Monetary aggregates and credit

The figures in this section are seasonally adjusted.

Components of money

Most measures of monetary growth have showed signs of easing over recent months. M0, the narrowest aggregate, grew by 6.5% in the year to June compared with 6.3% in the year to March (see Table A), but it has retreated from the seemingly erratically high 7.3% figure in April. The recent moderation could be associated with the slowdown in retail sales in June; caution in interpretation is needed, however, since although there is a broad relationship between the two series, it is by no means precise on a month by month basis. Issues of the new £5 note and 5p coin in June had no discernible effect on M0.

Of the other narrow aggregates, non-interest-bearing M1 fell by 1.9% in the second quarter, taking the twelve-month decline to

2.2%. However, this movement primarily reflected a continuing switch into interest-bearing accounts and consequently a better guide to movements in transactions balances is given by trends in M2, the twelve-month growth rate of which fell to 7.7% in May, the smallest increase since 1985. Although it rebounded a little in June, its growth rate has halved since the end of 1988. The retail deposits component of M4 has not been quite as subdued. It grew by 2.6% during the quarter, a similar figure to the previous two quarters, and the twelve-month growth rate rose slightly to 12.4%.

Although the growth rate of M4 as a whole remained flat in the second quarter at 3.7%, it was sufficient to reduce the twelve-month rate from 17.5% to 16.8%. The slowdown in the growth of personal sector wealth is likely to have been been one contributory factor.

In recent years a growing proportion of M4 has consisted of wholesale rather than retail deposits. While this remained true in the second quarter, the growth of wholesale inflows has shown signs of decelerating; the 5.6% rise was the lowest since the fourth quarter of 1988 and lowered the twelve-month growth rate to 27.0%, down from 33.1% at its peak in February this year.

Among the M4 institutions, building societies' M4 inflows of wholesale deposits eased from £1.4 billion to £1.0 billion between the first and second quarters (Table B) while their total sterling wholesale inflows, including those from banks, fell more sharply from £3.1 billion to £1.1 billion. In the retail market, there is some evidence of segmentation, with societies generally concentrating on obtaining the longer-term and larger balances, which are not included in M2. This has increased the cost of their retail funds, as illustrated in the chart opposite which shows a positive relationship between the proportion of societies' retail M4 deposits accounted for by non-M2 deposits (that is their larger and longer-maturity inflows) and the spread between their basic and average share rates. The latter has widened as the proportion of deposits receiving higher rates of interest has increased.

Building societies' non-M2 deposits and share differential (average-basic)

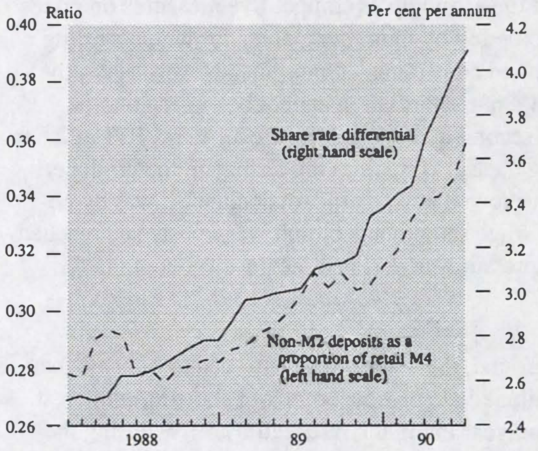


Table C
Counterparts to changes in M4 and M5[(a)]
£ billions; *seasonally adjusted figures (financial year constrained)*

	Counterparts to M4			Counter-parts to M5
	1990		12 months to end-June 90	12 months to end-June 90
	Q1	Q2		
1 PSDR (-)	-2.9	5.5	-1.3	-1.3
2 Net purchases (-) of central government debt by the M4 private sector (b)	1.1	-2.0	3.5	5.5
3 Net purchases (-) of other public sector debt by the M4 private sector (b)	-0.1	-0.9	-1.0	-0.9
4 External and foreign currency finance (-) of the public sector	1.8	0.6	-0.3	-0.3
5 Public sector contribution (=1+2+3+4)	-0.2	3.2	0.8	2.9
6 Sterling lending to the M4 private sector (b)(c)	22.1	16.5	85.4	85.7
7 Other counterparts (d)	-6.2	-3.4	-20.7	-20.7
8 Total (=5+6+7) =change in M4/M5	**15.7**	**16.2**	**65.5**	**67.9**

(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 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.

Counterparts to money

Lending by banks and building societies to the M4 private sector grew by 3.1% during the second quarter, its lowest increase for nine years. Accordingly the twelve-month rate eased further, from 20.4% to 18.7%. This suggests that high interest rates are continuing to rein back borrowing, both directly and through their effect in slowing the economy.

A large PSBR (£5.5 billion)—attributable in part to delays in payments of the community charge—was only partly offset by net sales of debt to the M4 private sector (£2.9 billion) and the overseas sector (£0.6 billion)—see Table C. Thus, the public sector counterpart to M4 was expansionary. However, its impact on M4 as a whole will have been diminished to the extent that the increase in the PSBR reduced the need for M4 private sector borrowing.

There was an expansionary banks' and building societies' external counterpart (£1.1 billion), in contrast to what might have been expected given the current account deficit. This implies that the latter has been financed by means other than inflows into M4 institutions. In contrast, sterling net non-deposit liabilities were even more contractionary than usual (-£4.5 billion) and were

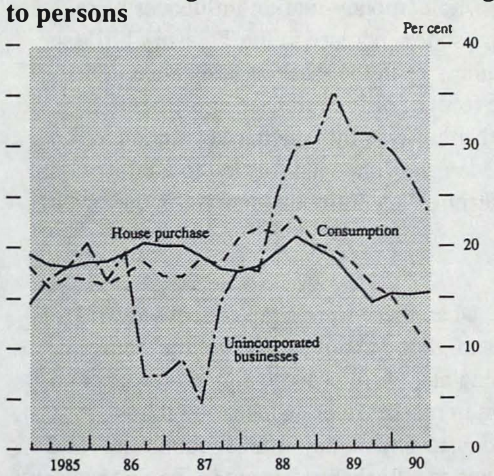
Table D
Sectoral analysis of deposits with, and borrowing from, banks and building societies

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

	1988 Year	1989 Year	1989 Q3	1989 Q4	1990 Q1	1990 Q2
Personal sector						
1 Sterling deposits	37.0	39.4	12.2	9.6	9.0	10.0
of which:						
Banks	16.7	21.9	7.5	5.6	4.9	5.9
Building societies	20.3	17.5	4.7	4.0	4.0	4.0
2 Sterling borrowing	47.8	45.8	11.4	11.9	12.2	10.0
of which:						
Mortgage	34.5	31.0	7.5	8.8	8.8	8.0
Non-mortgage	5.8	5.4	1.3	0.9	0.9	0.9
Unincorporated businesses	7.6	9.3	2.6	2.2	2.5	1.1
3 Net recourse (=2-1)(a)	**10.8**	**6.5**	**-0.8**	**2.3**	**3.3**	**—**
ICCs						
4 Deposits	6.3	13.5	0.3	5.1	6.5	3.8
of which:						
Sterling	6.1	11.5	0.4	3.7	4.6	2.1
Foreign currency	0.2	2.0	-0.1	1.4	1.9	1.7
5 Borrowing	32.4	37.2	14.1	6.0	6.8	5.6
of which:						
Sterling(b)	24.0	28.6	10.8	4.9	5.7	4.5
Foreign currency	8.4	8.6	3.3	1.1	1.1	1.1
6 Net recourse (=5-4)(a)	**26.1**	**23.7**	**13.8**	**0.9**	**0.3**	**1.8**
of which:						
Sterling	17.9	17.1	10.4	1.2	1.1	2.4
Foreign currency	8.2	6.6	3.4	-0.3	-0.8	-0.6
OFIs						
7 Deposits	11.7	19.1	5.5	4.7	4.9	4.2
of which:						
Sterling	9.4	13.2	4.9	2.3	2.5	3.6
Foreign currency	2.4	5.9	0.6	2.4	2.4	0.6
8 Borrowing	11.2	21.2	4.8	5.6	3.2	1.0
of which:						
Sterling (b)	10.1	13.9	3.9	3.9	4.3	2.0
Foreign currency	1.0	7.3	0.9	1.7	-1.1	-1.0
9 Net recourse (=8-7)(a)	**-0.5**	**2.1**	**-0.7**	**0.9**	**-1.7**	**-3.2**
of which:						
Sterling	0.7	0.7	-1.0	1.6	1.8	-1.6
Foreign currency	-1.4	1.4	0.3	-0.7	-3.5	-1.6

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

Twelve-month growth rate of M4 lending to persons



particularly marked in the case of building societies which added to reserves in preparation for interest crediting in July.

Sectoral developments

A second quarter increase of £10.0 billion in personal sector deposits with banks and building societies was balanced by an equal amount of borrowing, leaving personal sector net indebtedness to the M4 institutions essentially unchanged (Table D).

Personal sector borrowing has slowed down markedly over the last two years, bringing its twelve-month growth rate down from 22.3% at its peak in 1988 to 15.6%. Growth in the second quarter alone, at 3.1%, was the lowest since 1975. Much of the latest quarter's slowdown was attributable to relatively weak growth of 2.6% in borrowing by unincorporated businesses, sharply down from the 6.0% rise in the first quarter and the lowest figure since 1987. Lending to individuals also eased from 3.6% in the first quarter to 3.2%. The slowdown has been more pronounced in the case of lending for consumption than in lending for house purchase. Loans for house purchase increased by 3.4% in the second quarter, down from 3.8% in the first but, as the chart opposite illustrates, the twelve-month growth rate has remained flat for a year at around 15.5%. Factors restraining lending are the present softness of the housing market and high mortgage rates. As a result, there could have been some moderation in equity extraction. In addition, the centralised mortgage lenders (ie non-M4 mortgage lending institutions) appear to have recaptured market share from the banks and societies. That said, building society data suggest that growth in their mortgage lending is unlikely to decline significantly in the immediate future. For example, commitments remain quite buoyant.

Lending for consumption continued to moderate, rising by 2.1% compared with 2.3% in the previous quarter. The twelve-month increase at 10.5% was the lowest since 1977 and a downward trend has been visible for some time. This could have been driven in part by individuals substituting borrowing on mortgage for more traditional forms of consumer loan.

Industrial and commercial companies' (ICCs') sterling borrowing increased by 3.3% (£4.5 billion), down from 4.5% in the previous three months. The twelve-month growth rate fell to 23.3% compared with 29.0% at the end of 1989. ICCs' deposits rose by 3.0% (£2.1 billion). Hence their net sterling recourse to the banks and building societies was £2.4 billion, more than in the previous two quarters but well down on the quarterly average for each of the last two years. Meanwhile, ICCs' foreign currency deposits rose by a robust £1.7 billion and their foreign currency borrowing increased by £1.1 billion. Their capital issues fell, with a net redemption of foreign currency instruments. The modest overall net borrowing requirement could partly be explained by a decline in takeover activity. In addition, however, there is some evidence of a decline in business confidence. Finally, banks could have become more cautious in their lending, as domestic loan problems have risen sharply.

Sterling lending to other financial institutions (OFIs) rose by 2.8% (£2.0 billion), compared with 6.4% (£4.3 billion) in the first quarter. This was the smallest increase since 1985 and brought down the twelve-month growth rate to 23.8%. Meanwhile, OFIs made net

Table E
Influences on the cash position of the money market
£ billions; *not seasonally adjusted*
Increases in bankers' balances (+)

	1989 Q2	1990 Q1	Q2	12 months to end-June 90
Factors affecting the market's cash position				
CGBR (+)	+2.0	-5.0	+4.3	-3.3
of which, on-lending to local authorities and public corporations	*+1.1*	*-3.1*	*—*	*-1.3*
Net sales (-) of central government debt (a)	+5.7	+4.4	+0.3	+11.8
of which: Gilt-edged	*+5.6*	*+4.1*	*+0.9*	*+11.1*
National savings	*+0.1*	*+0.3*	*-0.4*	*+ 1.2*
CTDs	*-0.1*	*—*	*-0.3*	*- 0.5*
Currency circulation (increase -)	-0.2	+1.3	-0.6	- 1.1
Reserves etc	-2.1	-0.1	+0.2	- 3.6
Other	-1.5	-0.1	-0.2	+ 0.9
Total (A)	+3.8	+0.5	+3.9	+ 4.7
Offsetting official operations				
Net increase (+) in Bank's commercial bills (b)	-1.4	+0.4	-1.1	+ 1.4
Net increase (-) in Treasury bills in market (c)	-2.6	-0.8	-3.2	- 6.2
Other	+0.2	-0.2	+0.4	—
Total (B)	-3.9	-0.6	-3.8	- 4.8
Changes in bankers' operational balances at the Bank (=A+B)	-0.1	-0.1	+0.1	- 0.1

(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
Influences on the cash position; alternative presentation of factors affecting the market's cash position
£ billions; *not seasonally adjusted*
Increase in bankers' balances (+)

	1989 Q2	1990 Q1	Q2	12 months to end-June 90
Factors affecting the market's cash position				
Under/overfunding (+/-)	+3.3	-2.2	+5.9	+3.1
Central government net debt sales to banks and building societies(a) (-)	+0.7	+1.8	+0.3	+4.2
Other public sector net borrowing from banks and building societies (-)	+0.8	-0.3	-1.7	-1.4
of which, local authorities' deposits with banks and building societies	*+1.0*	*-1.0*	*-1.0*	*-2.1*
Currency circulation (-)	-0.2	+1.3	-0.6	-1.1
Other	-0.9	-0.1	—	-0.1
Total	+3.8	+0.5	+3.9	+4.7

(a) Other than Treasury bills.

Table G
Average daily money-market statistics
£ millions; *not seasonally adjusted*
Increases in the market's cash (+)

	1990 Mar.	Apr.	May	June
Average daily figures				
Influences (excluding maturing assistance)	+ 100	—	+ 70	+ 110
Maturing assistance (a)	- 860	- 790	-1,140	- 760
Surplus (+)/shortage (-) before daily operations	- 760	- 790	-1,070	- 650
End-period levels				
Stock of assistance	4,970	6,380	5,670	4,320
Treasury bills outstanding(b)	8,890	10,240	10,750	12,050

(a) Including net issuance of Treasury bills and the level of bankers' balances above or below target from the previous day.
(b) Other than those held outright by the Bank, Bank customers and government accounts but including those purchased by the Bank on a repurchase basis.

repayments of foreign currency borrowing for the second successive quarter. Sterling deposits increased by 5.8% (£3.6 billion).

Official operations in financial markets

The figures in this section are not seasonally adjusted.

Money-market operations

There was a large flow of funds into the money market during the second quarter, arising from the excess of central government expenditure over revenue (see Table E), which was not funded within the quarter by net sales of gilts. The alternative presentation of the influences, shown in Table F, indicates that the two factors to which the net flows into the market during the last few years as a whole may be attributed, namely net deposits by local authorities with banks and building societies and net sales of gilt-edged securities by banks and building societies, did not contribute significantly to the inflow in the most recent quarter. In fact, local authorities reduced their deposits for the third successive quarter, and these have fallen from £9.5 billion at end-September last year to £7.3 billion at the end of June. The size of the weekly tender had been raised in February in order to prevent the loosening in money-market conditions which would otherwise have been caused by the anticipated inflow of funds to the market in the second quarter, and Table E shows that the inflow was indeed largely offset by the expansion of the Treasury bill issue during that period.

In the early part of April, seasonally heavy central government expenditure led to relatively modest daily cash shortages in the money market, but the shortages became more substantial later in the month as Exchequer transactions began to drain funds from the market. Over April as a whole, money-market influences were neutral (see Table G), and so the increase in the Treasury bill issue led to an increase of similar size in the stock of assistance. This extra assistance took the form of bill repurchase agreements maturing in early May. Net inflows into the market tended to persist throughout both May and June, and this led to a fall back in the stock of assistance despite the continued increase in the size of the Treasury bill issue.

On 17 May and 13 June, when there were signs that downward pressure on interest rates might be about to emerge, the Bank conducted 2.30 pm lending at 15% in order to signal resistance to the downward movement in market rates. Since then it has maintained pressure on day-to-day money-market conditions, and thus indicated its resistance to a further softening in interest rates, by providing funds to relieve market shortages only relatively late in the day and also, on occasion, by inviting offers only of bills of band 1 maturity when market conditions have made it appropriate.

The Bank announced on 2 July that the inauguration date for the Central Moneymarkets Office, a computerised book-entry system for settling money-market transactions in bills, certificates of deposit and commercial paper, would be 1 October. Forty-two institutions, including the main participants in the sterling money markets, have committed themselves in principle to be direct members of CMO, and a large number of other firms intend participating indirectly through the agency of a direct member.

Table H
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	89	93	9 3/4% Treasury 2002	2,030	3,071	£94.55
28/7/1990	8 1/2% Treasury 2000	1,200	109	91	9% Conversion 2000	1,554	2,609	£96.70

(a) The nominal amount received of the stock being converted into per £100 nominal of the stock from which the conversion is being made.

Table J
Financing of the public sector
£ billions; *seasonally adjusted (financial year constrained)*

	1989 Q4	1990 Q1	1990 Q2	12 months to end-June 90
1 Central government borrowing on own account	-2.8	+0.3	+2.8	-1.9
2 Other public sector borrowing (a)	+0.4	-3.2	+2.7	+0.6
3 **PSDR (-)(=1+2)**	-2.4	-2.9	+5.5	-1.3
4 Net sales (-) of central government debt to the M4 private sector	+0.7	+1.1	-2.0	+3.5
of which: Gilt-edged stocks	*+0.4*	*+0.7*	*-0.4*	*+3.9*
Treasury bills	*-0.1*	*+0.1*	*-1.1*	*-1.1*
National savings	*+0.3*	*+0.4*	*-0.3*	*+1.2*
CTDs	..	*-0.2*	*-0.2*	*-0.4*
5 Sales (-) of local authorities' and public corporations' net debt to the M4 private sector	-0.1	-0.1	-0.9	-1.0
6 External and foreign currency finance (-) of the public sector	-1.6	+1.8	+0.6	-0.3
of which: Gilt-edged stocks	*+1.0*	*+1.6*	*+1.1*	*+3.1*
Treasury bills	*-0.4*	*+0.2*	*-0.6*	*-1.2*
7 Total financing (-) of the public sector from the M4 private and overseas (=4+5+6)	**-1.0**	**+2.8**	**-2.3**	**+2.2**

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

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

	1989 Q2	1989 Q3	1989 Q4	1990 Q1	1990 Q2
Gross official sales (a)	-3.0	-1.2	-1.0	-0.6	+0.2
less					
Redemptions and net official purchases of stock within a year of maturity	-2.6	-3.1	-0.8	-3.4	-1.2
Equals net official sales (b)	-5.6	-4.3	-1.8	-4.1	-0.9
of which, net purchases by:					
Banks (b)	*-0.1*	*-0.8*	*-0.5*	*-1.3*	*-0.1*
Building societies	*-0.6*	*-0.9*	*+0.1*	*-0.5*	*-0.2*
Overseas sector	*-1.2*	*+0.6*	*-1.0*	*-1.6*	*-1.1*
M4 private sector	*-3.7*	*-3.2*	*-0.4*	*-0.7*	*+0.4*

(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 Apr.	May	June
Change in reserves	- 267	- 94	+ 80
of which:			
Net borrowing (+)/ payment (-) of public debt	+ 10	- 159	- 35
Valuation change on roll-over of EMCF swap	- 179	—	—
Underlying change in reserves	- 98	+ 65	+ 115
Level of reserves (end of period)	**39,028**	**38,934**	**39,014**

Gilt-edged operations

Gilt-edged yields fell substantially in May and June, reversing much of the rise since the start of the year. In these market conditions, the Bank made small gross official sales of stock, but once redemptions of stock are taken into account, net official purchases of stock still took place within the quarter. Table K shows the changes in sectoral holdings of gilt-edged stock in recent quarters.

Six separate offers to convert holdings of smaller gilt-edged stocks into larger, more liquid issues have so far been made since the series of conversions began last October. Details of these conversions are shown in Table H. 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 fell by $0.3 billion, as the small underlying rise was more than offset by the reduction in the valuation of gold and dollars in terms of ECU arising from the quarterly rollover of the European Monetary Co-operation Fund swap, and by net repayments of public sector external debt.

ECU Treasury bills

At each of the latest three tenders of ECU Treasury bills, on 8 May, 12 June and 10 July, the Bank allotted to the market ECU 300 million of both one-month and three-month bills and ECU 400 million of six-month bills. The amount of bills outstanding in the market rose to ECU 3,400 million as at 12 July.

The cover at each of the three tenders in turn was the largest since July 1989, and on average they were covered 3.1 times, with the three-month maturity attracting the highest level of cover, as it has done throughout 1990. The margin by which the average accepted yield has been below the bid rate for ECU-denominated bank deposits widened to an average of 3/8% for the three-month and six-month maturities, but narrowed to 5/32% for the one-month maturity. Daily turnover by market-makers in the second quarter averaged ECU 240 million, 1% above the previous quarter and 20% above the second quarter of 1989.

Market developments

Overall market sentiment underwent a marked change during the course of the second quarter, with a more bullish mood apparent from the end of April, in large part reflecting heightened expectations of early ERM entry. Sterling, having traded at an

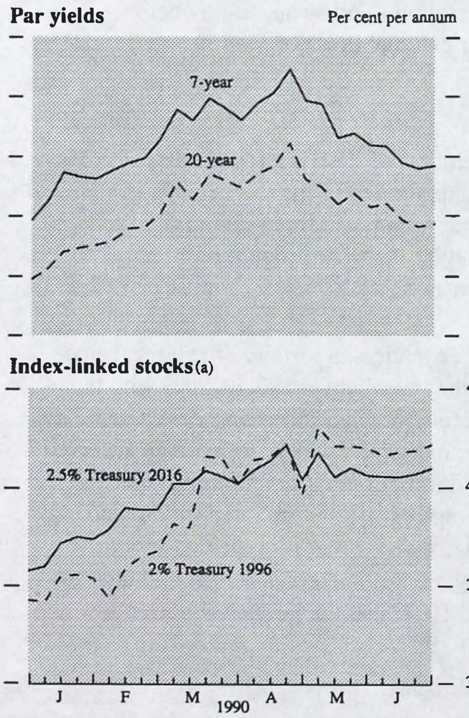
Table M
Sterling interest rates, gilt yields and exchange rates; selected dates [a]

	Interbank interest rates (per cent per annum)				Gilt yields (b) (per cent per annum)				Exchange rates		
					Conventionals			Index-linked			
Date	1 month	3 months	6 months	12 months	Short	Medium	Long	Long	ERI	£/$	£/DM
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
5 April	14 31/32	15 5/32	15 11/32	15 15/32	12.67	12.39	11.23	3.87	87.9	1.6422	2.7909
17 April	15	15 3/16	15 1/2	15 3/4	13.14	12.86	11.65	3.96	86.7	1.6297	2.7374
30 April	15 1/32	15 11/32	15 21/32	15 15/16	13.58	13.33	12.08	4.07	86.6	1.6350	2.7447
11 May	15	15 7/32	15 13/32	15 7/16	12.87	12.61	11.27	4.00	87.1	1.6805	2.7409
16 May	14 15/16	15 5/32	15 5/16	15 13/32	12.89	12.65	11.36	4.01	87.4	1.6797	2.7609
17 May	14 31/32	15 1/16	15 1/16	15 1/16	12.42	12.26	11.04	3.90	88.1	1.6900	2.7860
23 May	15	15 1/32	15	14 29/32	12.24	12.15	11.10	3.89	89.0	1.6950	2.8337
7 June	14 29/32	15 1/16	15 3/32	14 15/16	12.26	12.13	11.10	3.90	89.5	1.6882	2.8551
13 June	14 7/8	14 7/8	14 13/16	14 11/16	12.08	11.88	10.89	3.87	90.6	1.7085	2.8911
26 June	14 29/32	14 29/32	14 29/32	14 5/8	11.85	11.66	10.70	3.91	91.5	1.7366	2.9135
29 June	14 15/16	14 29/32	14 27/32	14 19/32	11.92	11.75	10.76	3.94	91.4	1.7440	2.9067

(a) The rates quoted are for the close of business on each day.
(b) For representative stocks: short—12% Treasury 1995; medium—12% Exchequer 1998; long—9% Treasury 2008; index-linked—2 1/2% Treasury Index-Linked 2004 (5% inflation assumed).

exchange rate index of around 87 during April, appreciated throughout May and June to end the quarter some 5% higher than at the end of April (see Tables M and N). Money-market rates rose in the early part of the quarter, reflecting some nervousness that base rates might not yet be at their peak, but rates then fell back over May and June as sentiment towards the pound improved. The interbank interest rate curve moved from a pronounced upward to a downward slope as confidence that base rates were at their peak increased, and gilt-edged yields fell substantially between April and June, to end the quarter as much as 1½% below their end-April highs. Despite this movement in money-market rates over the second quarter, there was little market expectation at any time of a change in official interest rates in the immediate future.

Gross redemption yields on UK government securities



(a) Real yields assuming 5% inflation.

Sterling began the second quarter on a relatively stable note, having made some recovery after its fall earlier in March. Its fall had been associated with concerns over the strength of demand and inflationary pressures, coupled with political uncertainties. Money-market interest rates too were steady at a little below their mid-March levels, with three-month rates around 15¼%.

The market was cautious throughout April amid a renewal of the earlier worries, which were given added focus by the forthcoming local authority elections and as it become apparent that the RPI for April would show a sharp rise, primarily because of special factors. Money-market rates and gilt yields tended to rise during the month, while the pound traded in a narrow range around $1.64 and DM2.76.

Sentiment weakened following the publication of the March trade figures on 25 April; sterling declined following these figures and the ERI subsequently fell to its second-quarter low of 86.4 on 30 April. Longer-term money-market rates rose by around 3/16% over the same period, but there was nevertheless no market expectation of an imminent rise in the general level of interest rates.

Over April as a whole, longer-term money-market interest rates rose by ¼%–⅜%, and the upward slope of the interbank rate curve increased; however the curve remained no steeper than could be accounted for by the effect of interest-rate compounding, so that it implied no market expectation of rising rates. Conventional gilt yields rose by ⅝%–¾%, a development mostly attributable to the worsening in market inflation expectations, as the rise of only ⅛% in index-linked gilt yields made clear.

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

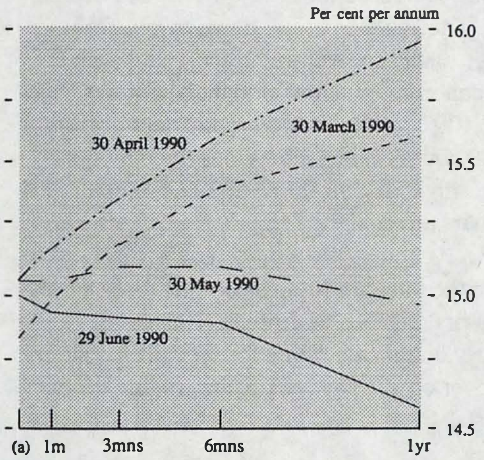
	Interbank interest rates (per cent per annum)				Gilt yields (b) (per cent per annum)				Exchange rates		
					Conventionals			Index-linked			
Month	1 month	3 months	6 months	12 months	Short	Medium	Long	Long	ERI	£/$	£/DM
April	14.97	15.21	15.45	15.68	13.08	12.81	11.60	3.95	87.1	1.6374	2.7615
May	15.00	15.15	15.24	15.29	12.74	12.55	11.34	3.94	88.0	1.6778	2.7896
June	14.90	14.97	14.96	14.76	12.06	11.90	10.94	3.91	90.4	1.7094	2.8788

(a) Averages of the daily close of business rates during the month.
(b) For representative stocks: short—12% Treasury 1995; medium—12% Exchequer 1998; long—9% Treasury 2008; index-linked—2 1/2% Treasury Index-Linked 2004 (5% inflation assumed).

Sentiment changed after the end of April, following the local election results and, on 11 May, a figure for the RPI in April which did not match the market's worst fears. The pound touched $1.6855 that day, its highest level against the dollar since the end of February, and by mid-May money-market interest rates and conventional gilt yields had fallen back below the levels at which they had begun the quarter.

On 17 May, rumours of earlier than hitherto expected ERM membership by the United Kingdom provoked widespread covering of short positions and led to a very sharp domestic market rally. At one point in the day, the one-year money-market rate was ½% below its opening level, before the Bank announced 2.30 pm lending at 15% to indicate resistance to the downward movement in market rates. Longer-term money rates then stabilised at just above 15% and gilt yields ended the day up to ½% lower than their previous close.

Sterling interbank rates



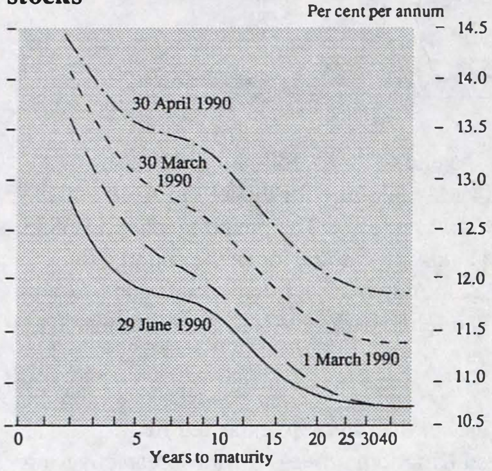
(a) For one week.

The rise in sterling on 17 May was more moderate than the movements in domestic markets, but in the succeeding weeks it appreciated strongly on continued speculation about ERM entry. Some further softening of interbank rates in response to the pound's rise was temporarily reversed after the announcement of the larger than expected April current account deficit on 23 May, although the figure seemed to have little effect on sterling.

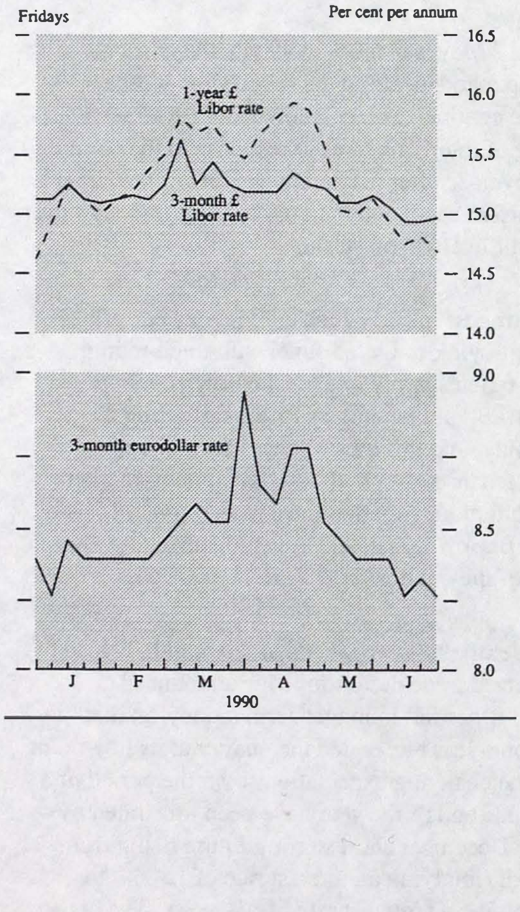
Sterling's continued firmness in early June led to renewed softness in interbank rates and gilt yields. On 13 June, with three-month interbank rates having fallen sharply to a level below 14⅞%, the Bank again announced 2.30 pm lending at 15%, reinforcing the message given on 17 May, and this message was backed up afterwards by the maintenance of tight day-to-day money-market conditions. Three-month money-market rates rose to touch 15% in the days following the Bank's signal, and hovered just below that rate for the remainder of the quarter.

Sterling rose further over the last two weeks of the month, helped by the narrower than expected trade deficit for May announced on 22 June. This led to a further fall in longer-term money-market interest rates, and the one-year rate ended the quarter at its low-point for the year to date. The changing expectations over the period of a fall in interest rates by the end of the year have been illustrated by futures prices, with the December short sterling future rising from 84.89 at the end of April (implying an interest rate of 15⅛%) to 86.31 at end-June (implying an interest rate of 13¹¹⁄₁₆%). The higher than expected PSBR, published on 18 June, dampened sentiment in the gilt market somewhat but on balance gilt yields too fell during June as a result of sterling's strength.

Time/yield curves of British government stocks



Short-term interest rates in London



Over the quarter as a whole, sterling's exchange rate index rose by 4.0%. Sterling increased by 4.3% against the deutschemark and 6.0% against the dollar, reaching its peak for the year so far against both currencies on 29 June, the last working day of the quarter. It appeared that the change in ERM expectations was not the only cause of sterling's rise during May and June, since its rally had begun before the onset of ERM rumours on 17 May, and the announcement of the larger than expected May RPI, which might have been assumed to lead to a deferral of the forecast date for joining the ERM, did not lead to a significant fall in sterling. The continued interest rate differential in sterling's favour was an additional factor supporting the currency.

Over the quarter as a whole, three-month interbank rates fell by 5/16% and one-year rates by 15/16%, almost exactly reversing their rises in the first quarter. Short-term gilt yields fell by around 1% while long-term yields declined by 5/8%, thus causing a flattening of the yield curve, and only partially reversing the first quarter increase in yields. Longer-term index-linked gilt yields changed little in the second quarter, indicating that, for those maturities at least, a change in inflation expectations was the main influence on conventional yields.

Market turnover

Transactions in eligible bills by discount houses,[1] including sales to the Bank, averaged £1.7 billion daily over the period under review, and were the highest since reporting began at the start of 1988, being 4% above the previous record figure set in the first quarter of 1990. Treasury bill turnover rebounded from £170 million to £260 million as the stock of Treasury bills outstanding increased substantially. Discount house transactions in certificates of deposit averaged £0.6 billion daily during the period, down by 5% from the previous quarter. Average daily turnover in the short sterling futures contract on the London International Financial Futures Exchange fell back to 31,100 contracts in the second quarter from its record figure of 36,300 contracts in the previous three months. This was despite a record single day's volume of 127,600 contracts on 17 May as ERM rumours affected the market.

Average daily turnover in the long gilt futures contract rose sharply to 27,300 contracts in the first quarter, up from 21,100 in the previous quarter and nearly double the figure for the fourth quarter of 1989. The day's turnover on 17 May set a record in this contract as well, at 71,400 contracts.

£200 million of call warrants exerciseable into gilt-edged stock were issued during the first half of 1990. These were the only call or put warrants outstanding at the end of June.

Commercial paper and medium-term notes

Gross issues during the second quarter of commercial paper made under the terms of the Bank's notice of 11 January 1990 totalled £14,694 million, a slight increase from the revised £14,576 million figure in the first quarter. There were redemptions of £13,639 million, and the total paper outstanding rose to £5,211 million at the end of June, its highest amount to date. The

(1) Figures for discount houses cover only those money-market dealing counterparties which are authorised under the Banking Act 1987.

Bank had been notified of 235 programmes by the end of the quarter, and paper had been issued under 201 of these.

The Bank has also been notified during the quarter of four medium-term note programmes under the terms of the 11 January 1990 notice. These are the first such programmes since the notice was issued, broadening the range of issues available to certain companies without infringing the Banking Act 1987.

Other capital markets

The FT-SE 100 share index ended the period under review at 2,374.6, up 5.6% from the end of March and 12.9% from its low-point on 30 April. The pattern of movements in the index over the quarter closely resembled those in the domestic interest-rate markets, as equities were also primarily influenced by political and inflation worries in April and sterling's appreciation in May and June. The rise in US and Japanese stock market prices over the quarter reinforced the rally. Nevertheless, the yield differential between gilts and equities narrowed by almost 1% during the last two months of the quarter to stand below 6½% at the end of June.

Data on the volume of sterling capital issues announced in the second quarter are shown in Table P. The sterling eurobond figures include the largest eurosterling convertible to date, a £200 million issue by Tesco announced in June. Overall, the volume of issues during the quarter increased from mid-May onwards as sterling capital market prices rallied. Issues of floating-rate notes were particularly strong in June and included the first issue to date of a sterling FRN backed by car loans.

Total bond issues by UK borrowers in foreign currencies declined from $1.3 billion in the first quarter to $0.8 billion in the second quarter. Issues by UK banks and other financial institutions accounted for most of the decline, falling from $0.8 billion to $0.3 billion, while the volume of issues by the corporate sector was little changed at $0.5 billion. The deutschemark and the US dollar were the most actively used foreign currencies by UK borrowers, accounting for 33% and 31% of issues respectively, while the ECU accounted for 15%.

Table P
Sterling capital issues: amounts announced
£ millions

	Equities	Fixed rate(a)			FRNs
		Domestic issues(b)	Sterling eurobonds		
			UK borrowers	Overseas borrowers	
1988	5,953	3,084	3,977	3,299	5,650
Q1	893	380	1,555	1,300	459
Q2	1,687	909	1,342	1,743	1,894
Q3	2,026	631	175	—	1,836
Q4	1,347	1,164	905	256	1,461
1989	7,072	5,048	4,162	3,524	5,845
Q1	637	1,587	1,900	1,069	725
Q2	2,527	1,502	947	1,035	1,500
Q3	2,165	1,202	1,075	1,095	1,705
Q4	1,743	757	240	325	1,915
1990					
Q1	1,504	639	1,105	1,126	1,673
Apr.	313	38	275	75	535
May	613	—	400	425	260
June	358	231	300	120	1,578
Q2	1,284	269	975	620	2,373

(a) Of which £556 million was equity-related in the second quarter of 1990.
(b) 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.