Operation of monetary policy

This article covers the period from early October to December.

Introduction

In the fourth quarter, evidence that the economy had entered recession continued to accumulate, as a result of which the authorities found themselves facing persistent, and at times exceptionally strong, market expectations of lower interest rates. However, with sterling generally weakening within the ERM[1] and with the inevitable lags before evidence of a fall in underlying inflation could be expected to appear, any easing of policy would have been premature. The need to convey the authorities' anti-inflationary resolve to both the markets and the wider economy was the focus of official operations and policy statements over the period.

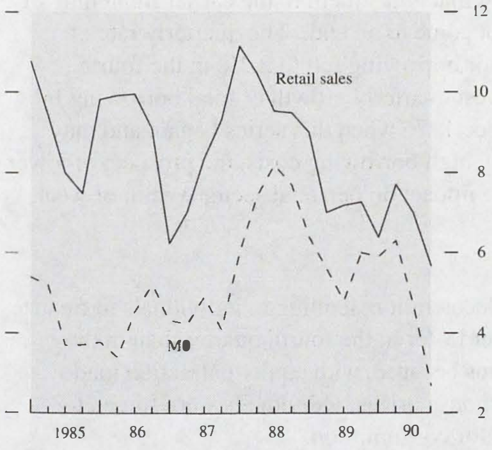
Before the end of the quarter, the consistent message from official statements, supported by the tight daily stance in the Bank's money-market operations, had come to convince the markets that an early further fall in interest rates would not be possible.

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

	12 months to end-Sept. 90	12 months to end-Dec. 90	1990 Q3	Q4
M0(b)	4.7	2.7	0.1	0.2
M2	7.5	7.9	1.5	3.2
M4	15.0	12.3	2.4	1.9
M4 lending	15.8	13.8	2.7	3.0

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

Twelve-month growth rates in M0 and retail sales value



Monetary aggregates and credit

The figures in this section are seasonally adjusted.[2]

The twelve-month growth of the monetary aggregates tended to slow during the fourth quarter as it has done since the fourth quarter of 1989. These falls in the rate of monetary growth have been associated with slower growth of real activity and overall wealth holdings.

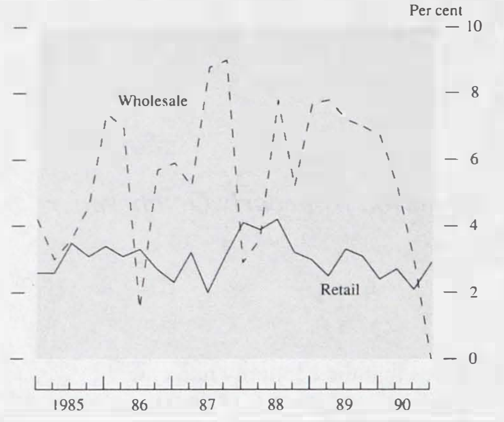
Components of money

The twelve-month growth rate of M0 continued to fall during the fourth quarter to 2.7% in December, below the mid-point of the 1%–5% target range, while the growth of notes and coin slowed to 3.1% in December. These developments in narrow money largely reflect the continued slowdown in the value of personal sector spending (Table A).

The twelve-month growth rate of M2 rose slightly to 7.9%, as the month-on-month growth rates increased to high levels from exceptionally low levels in mid-year. The twelve-month growth rate of retail deposits grew faster than M2, since longer-term building society deposits—excluded from M2—grew more rapidly than shorter-term deposits.

(1) For details of sterling's entry into the ERM, see 'Operation of monetary policy', in the November 1990 *Bulletin*, pages 465–75.
(2) They use the new seasonal adjustments, described in the note on pages 93–8.

Three-month growth rates of M4 deposits



The quarterly growth in M4 fell further to 1.9% from an already low rate of 2.4% in the third quarter. Within this, wholesale deposits in M4 were unchanged, while the growth of the retail component rose slightly to 2.9% from 2.1% in the third quarter, thus reducing the share of wholesale deposits in M4 (see chart). Cash flow problems of industrial and commercial companies (ICCs)—whose M4 deposits fell and whose borrowing grew strongly in the fourth quarter—appear to be the principal cause of this, since the fall in the share of wholesale deposits continued despite a partial recovery of the premium on wholesale compared to retail deposits in the fourth quarter.

Public sector counterparts to money

The public sector counterparts to the change in M4 had a net expansionary effect of £0.7 billion in the quarter. This included an increase in borrowing by local authorities, partly offset by additional net flows into national savings of £0.5 billion, principally from a new issue of index-linked savings certificates. The overall public sector surplus of £2.0 billion in the fourth quarter partly financed the net repayment of £2.0 billion of central government debt to companies and the personal sector and £1.4 billion of external debt (Table B).

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

	Counterparts to M4 1990 Q3	Q4	12 months to end-Dec. 90
1 PSDR (-)	-0.9	-2.0	-1.7
2 Net purchases (-) of public sector debt by the M4 private sector	-1.7	1.4	-1.4
of which, central government debt	*-1.4*	*2.0*	*-0.2*
3 External and foreign currency finance (-) of the public sector	—	1.4	4.1
4 Public sector contribution (=1+2+3)	-2.6	0.7	1.0
5 Sterling lending to the M4 private sector (b)	14.6	16.6	69.8
6 Other external and foreign currency flows	1.9	-7.4	-10.9
7 Net non-deposit sterling liabilities of banks and building societies(-)	-2.9	-1.1	-7.9
8 Total (=4+5+6+7) =change in M4	**11.0**	**8.9**	**52.0**

(a) See the statistical annex for definitions.
(b) 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 PSBR for the first three quarters of the current financial year was £2.3 billion, compared with a PSDR of £3.4 billion for the same period last year. The Autumn Statement projected a PSDR for the full current financial year of £3.0 billion. If privatisation receipts are excluded, the public deficit in the first three quarters of this financial year rose to £5.9 billion, compared with a deficit of £0.1 billion for the same period last year. The deterioration compared both with last year and with the projected outturn this year reflects in part high local authority borrowing—much of which was caused by the later issue of business rates demands and community charge bills, combined with more payments by instalments—as well as higher central government expenditure.

Private sector counterparts to money[1]

The personal sector reduced its net debt to banks and building societies in the fourth quarter (Table C). In so doing, it partly reversed the large addition to its net debt to these institutions in the third quarter, suggesting that adjustment to the earlier tightening of monetary policy had not come to an end. The quarterly rate of growth of personal sector borrowing fell to 2.4% in the fourth quarter. This is the lowest quarterly growth of total borrowing by the personal sector[2] since 1976 when this series began, and may have been influenced by high borrowing costs, the prospect of lower earnings growth and the impact on personal sector wealth of weak house prices.

However, despite this deceleration, lending to individuals to finance consumption grew rather faster in the fourth quarter than in the previous quarters perhaps because, with equity extraction made more difficult by weak house prices, individuals were forced to borrow more explicitly for consumption.

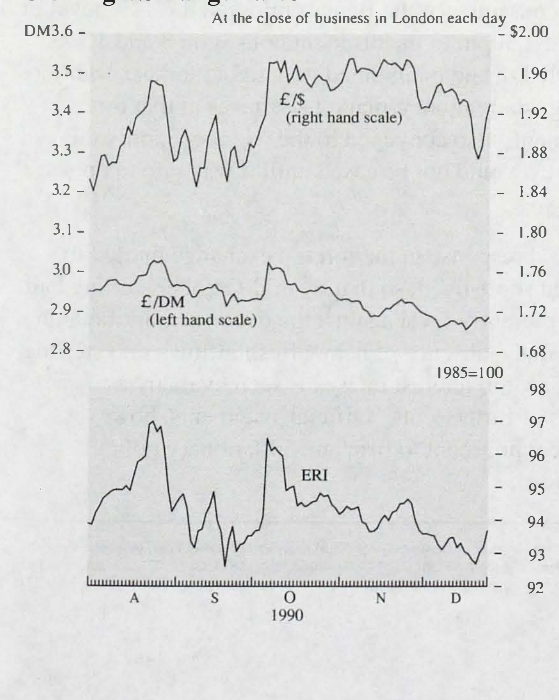
(1) See the article on recent sectoral financial behaviour on pages 83–92 for an analysis of sectoral developments over a longer period.
(2) Comprising borrowing for housing, consumption and by unincorporated businesses.

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

	1989 Year	1990 Q1	Q2	Q3	Q4
Personal sector					
1 Sterling deposits	40.0	10.1	11.2	6.0	8.8
of which:					
Banks	21.9	4.9	6.1	1.3	3.4
Building societies	18.1	5.2	5.1	4.8	5.4
2 Sterling borrowing	45.8	11.9	10.1	9.0	8.1
of which:					
Mortgage	31.0	8.7	8.0	7.0	6.5
Non-mortgage	5.4	0.8	0.7	0.8	1.2
Unincorporated businesses. etc	9.3	2.4	1.4	1.2	0.4
3 Net recourse (=2-1)(a)	**5.7**	**1.8**	**-1.0**	**3.0**	**-0.7**
ICCs					
4 Deposits	14.1	5.1	4.0	6.4	-5.1
of which:					
Sterling	12.0	2.9	2.6	3.1	-2.9
Foreign currency	2.1	2.2	1.5	3.3	-2.2
5 Borrowing	37.1	6.4	5.0	2.1	5.8
of which:					
Sterling(b)	28.6	5.5	4.2	2.2	5.2
Foreign currency	8.6	0.8	0.7	-0.4	1.2
6 Net recourse (=5-4)(a)	**23.1**	**1.3**	**1.0**	**-4.3**	**10.9**
OFIs					
7 Deposits	19.3	6.3	4.5	2.8	3.7
of which:					
Sterling	13.4	4.2	3.1	0.6	3.1
Foreign currency	5.9	2.0	1.4	2.2	0.6
8 Borrowing	21.3	3.2	4.2	2.7	3.1
of which:					
Sterling(b)	14.0	4.0	3.7	2.5	2.7
Foreign currency	7.3	-0.8	0.5	0.1	0.3
9 Net recourse (=8-7)(a)	**2.0**	**-3.1**	**-0.3**	**0.1**	**0.3**

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

Sterling exchange rates



The third quarter improvement of the financial position of ICCs with respect to banks and building societies had indicated that the ICCs were attempting to reduce their unusually large net debt to these institutions, as well as adjusting to the earlier policy tightening. However, their financial position may have deteriorated sharply in the fourth quarter, judging by the £8.1 billion rise in their net sterling debt to banks and building societies, compared with a decline of £0.9 billion in the third quarter. Their M4 deposits fell 3.8%, the first sizable fall since 1982, and the growth of borrowing increased to 3.7%. The two quarters taken together suggest that, though adjustment has continued, ICCs experienced considerably increased difficulties in the fourth quarter. The net debt of ICCs to banks and building societies now stands at £73 billion, compared with £25 billion in the fourth quarter of 1987 when the recent sharp increases in net indebtedness began.

This increase in ICCs' sterling-denominated net debt to UK banks and building societies was compounded by a fall of £2.2 billion in their foreign currency deposits and an increase of £1.2 billion in their foreign currency denominated borrowing with these institutions. These developments were offset by only a small decline of £1.3 billion in net bond and share issues in domestic and foreign markets between the third and fourth quarters. The evidence of continued borrowing by ICCs suggests that their financial position primarily reflects cash-flow difficulties and that they are not subject to widespread credit constraints, even though lending institutions may be acting cautiously in the current climate.

Bank and building society sterling lending to other financial institutions (OFIs) rose by 3.5% in the fourth quarter, a similar rate to the previous quarter and thus considerably below its earlier pace. OFIs' deposits rose by 4.5%, after the small increase in the third quarter which reflected unusual falls in deposits held by pension funds and investment and unit trusts. Thus OFIs' net debt to banks and building societies fell slightly.

Market developments

Market developments in the fourth quarter occurred against the unsettled background of the Gulf situation. In contrast to the previous quarter, oil market fundamentals (increasing production, high stocks, falling demand) gradually reasserted themselves over the international tensions, and oil prices generally eased from the peaks of early October. The support which the oil price had provided to sterling earlier in the Gulf crisis was thus no longer present. The main influence on sterling's position in the ERM appeared instead to be interest differentials.

Although by early November sterling had become the weakest currency in the ERM, it remained well above its lower limit. The width of the 2¼% band, which had earlier been extremely small, increased substantially over the quarter as the deutschemark strengthened after the increase in the German Lombard rate at the beginning of November and the ensuing rises in German money-market rates. These increases were in response to the continued high levels of activity in the wake of unification and the outlook for inflation in Germany. They took place at a time when prospects for activity (and hence pressures on interest rates) in most other countries were moving in the opposite direction, and accounted for some of sterling's weakness over the quarter by

Short-term interest rates in London

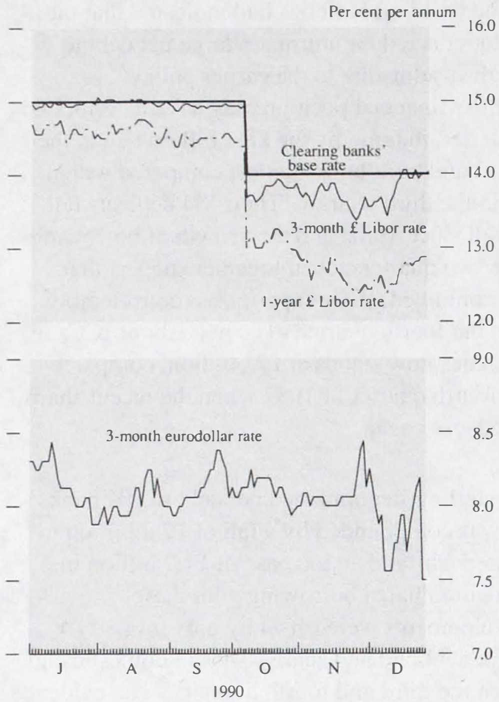
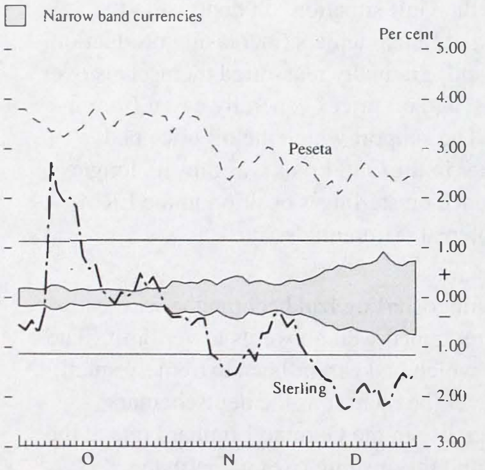


Table D
2.30 pm lending in Q4 1990

Date	Duration
8 October	Overnight
12 October	7 days
26 October	7 days
2 November	7 days
22 November	7 days
23 November	14 days
30 November	14 days
7 December	14 days

ERM positions



The zero line represents the middle of the narrow band.

narrowing its positive interest differential. At the end of the quarter, as the political tensions in the USSR grew, the deutschemark's strength diminished significantly. In contrast, US interest rates were substantially lowered as weakening economic activity combined with concern over problems in the banking sector.

During the period, forecasts for growth were marked down in most major economies, and hence there were rallies in most bond markets—with the exception of Germany where the increasing cost of unification was the major influence. In the United Kingdom, accumulating evidence of the extent of the economic slowdown was an important influence on movements in all financial markets over the fourth quarter.

Official operations in financial markets

Persistent expectations of early cuts in interest rates were the most prominent feature of financial markets for most of the fourth quarter. The need to emphasise anti-inflationary resolve and the associated implications of ERM membership both to the markets and to the wider economy, was the focus of official operations over the period. It was not until towards the end of the quarter that the strength of the authorities' counterinflationary resolve, and its implications for the course of interest rates, had been fully accepted by the market.

Until the announcement on 5 October that the United Kingdom would enter the ERM on 8 October, sterling's effective rate was around 93.5 with a sterling/deutschemark rate of around 2.93, and money-market rates were generally calm and steady. Upon the news of entry, sterling appreciated sharply to become briefly the strongest currency in the system and touched period highs on 8 October of DM 3.06 and $1.9880. This appreciation reflected a belief that the lessening of uncertainty about sterling's future exchange rate would attract funds into sterling, and that membership demonstrated a narrowing of domestic political differences over European issues. Money-market rates initially responded to the simultaneous announcement of a 14% Minimum Lending Rate[1] by falling to an extent that indicated expectations of further cuts in official rates. In consequence the Bank reinforced the 14% level of rates by lending at 2.30pm to the discount houses on 8 and 12 October (see Table D), and maintained very tight market conditions, helped by the large daily money-market shortages at that time. Ministerial statements also conveyed to the wider economy the message that policy would not be eased until it was safe to do so.

The euphoric initial response in the foreign exchange market to ERM entry proved short-lived, so that by mid-October sterling had fallen back to its pre-entry level against the deutschemark both on profit taking and in the absence of heavy fresh inflows into sterling. Moreover, the 1% cut in interest rates was seen by many as presaging a series of further cuts. Official statements, however, emphasised that commitment to firm anti-inflationary policy remained unchanged.

(1) The reduction in the general level of interest rates upon ERM membership was effected by announcing on 5 October that a Minimum Lending Rate (MLR) of 14% would apply on 8 October. The announcement was immediately followed by a similar reduction in bank base rates. See the November 1990 *Bulletin*, page 471, for details.

The cash position in the money market

The fourth quarter saw a net flow of funds of £4.8 billion out of the money market (Table 1), as net government revenue of £3.5 billion, a fall in official foreign exchange reserves and a seasonal rise in currency circulation was only partially offset by net official purchases of gilt-edged stock. The government revenue over this period was supported by receipts from asset sales (£2.0 billion from the electricity privatisation) and seasonally high tax payments; there was also a temporary outflow from the market caused by the oversubcription for electricity shares which had not been fully repaid by end-December (which is included in the 'other' category).

Table 1
Influences on the cash position of the money market

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

	1989 Q4	1990 Q3	1990 Q4	12 months to end-Dec. 90
Factors affecting the market's cash position				
CGBR (+)	-3.0	-0.6	-3.5	-4.8
of which, on-lending to local authorities and public corporations	*-0.1*	*-0.6*	*+0.1*	*-3.6*
Net sales (-) of central government debt (a)	+2.3	+0.5	+1.0	+6.2
of which: Gilt-edged	*+1.8*	*+0.9*	*+1.4*	*+7.3*
National savings	*+0.6*	*-0.4*	*-0.3*	*-0.8*
CTDs	*-0.1*	—	*-0.1*	*-0.3*
Currency circulation (increase -)	-1.6	—	-0.8	-0.1
Reserves etc	-2.9	+0.2	-0.2	—
Other	+0.7	+0.5	-1.3	-1.1
Total (A)	**-4.5**	**+0.6**	**-4.8**	**+0.2**
Offsetting official operations				
Net increase (+) in Bank's commercial bills (b)	+3.2	+0.8	+1.8	+1.9
Net increase (-) in Treasury bills in market (c)	+1.0	-0.9	+2.4	-2.4
Other	+0.3	-0.2	+0.2	+0.2
Total (B)	**+4.5**	**-0.3**	**+4.4**	**-0.3**
Changes in bankers' operational balances at the Bank (=A+B)	—	+0.3	-0.4	-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 2
Alternative presentation of factors affecting the market's cash position

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

	1989 Q4	1990 Q3	1990 Q4	12 months to end-Dec. 90
Factors affecting the market's cash position				
Under/overfunding (+/-)	-3.3	-0.3	-1.6	+1.7
Central government net debt sales to banks and building societies(a) (-)	+0.4	+0.5	-1.0	+1.6
Other public sector net borrowing from banks and building societies (-)	+0.1	—	-0.2	-2.1
of which, local authorities' deposits with banks and building societies (-)	*-0.1*	*+0.1*	*+0.1*	*-1.8*
Currency circulation (-)	-1.6	—	-0.8	-0.1
Other	-0.1	+0.4	-1.2	-0.9
Total	**-4.5**	**+0.6**	**-4.8**	**+0.2**

(a) Other than Treasury bills.

Table 2 shows the influences on the market's cash position in an alternative presentation: net debt sales to banks/building societies (£1.0 billion), and the fact that net sales to the funding sector did not fully offset the PSDR (overfunding, £1.6 billion) as well as the electricity oversubscription funds (£1.7 billion at end-December) were the main factors contributing to the flow of cash out of the markets in the fourth quarter. For the second consecutive quarter there was little change to the level of local authorities' deposits with banks and building societies.

The average daily cash shortage in the money market was relatively large throughout the quarter (see Table F on page 32), which supported the Bank's tight money-market operations, in contrast to September when the small size of the daily shortage had been a contributory factor to the softness of short rates. The largest daily shortages in December coincided with the rise in the stock of outstanding assistance—which peaked at £9.0 billion in the middle of the month, including £2.8 billion of outstanding repurchase agreements, as the largest effect of the oversubscription of electricity shares was felt by the market.

The size of the Treasury bill tender was reduced over the period from £650 million to £450 million per week with the removal of the 63-day tender (Table 3). This change was in anticipation of the increasing drainage of liquidity from the market caused by seasonally large net government receipts (particularly of corporate tax payments) and made it possible to avoid an unnecessarily sharp increase in the amount of outstanding money-market assistance with repayments of 63-day bills taking place throughout December and January.

Table 3
Changes in the size of the Treasury bill tender, from 1988

£ millions

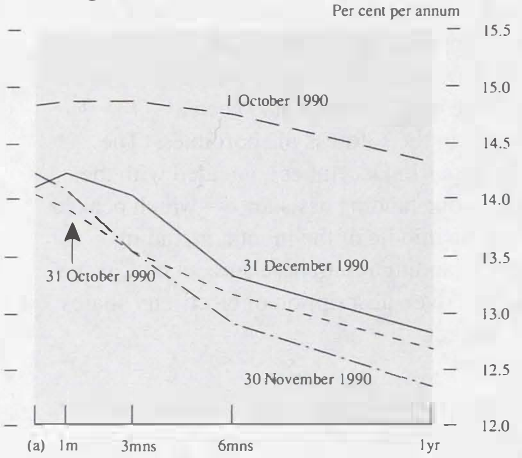
	63 days	91 days	182 days	Total
End-1987	—	100	—	100
1988				
23 September	—	400	—	400
28 October	400	100	—	500
25 November	—	100	—	100
1989				
12 May	—	300	—	300
19 May	—	500	100	600
29 September	200	500	100	800
17 November	—	500	100	600
24 November	—	300	100	400
1990				
2 February	—	500	200	700
28 September	200	250	200	650
30 November	—	250	200	450

Table E
Sterling interest rates, gilt yields and exchange rates; end-months and selected dates[(a)]

Date (1990)	Interbank interest rates (per cent per annum)				Gilt yields (b) (per cent per annum)				Exchange rates		
					Conventionals			Index-linked			
	1 month	3 months	6 months	12 months	Short	Medium	Long	Long	ERI	£/$	£/DM
28 September	14 29/32	14 15/16	14 7/8	14 1/2	12.06	12.19	11.19	4.14	93.3	1.8705	2.9286
8 October	13 7/8	13 21/32	13 3/8	13	11.19	11.49	10.80	4.11	96.5	1.9715	3.0253
31 October	13 15/16	13 9/16	13 3/16	12 11/16	11.21	11.48	10.86	4.18	94.5	1.9445	2.9492
14 November	14 3/16	13 27/32	13 3/8	12 3/4	11.36	11.61	11.05	4.10	93.7	1.9630	2.8895
22 November	13 29/32	13 7/16	12 29/32	12 3/8	10.88	11.19	10.64	4.04	94.2	1.9715	2.9188
30 November	14 3/32	13 9/16	12 15/16	12 13/32	10.86	10.98	10.39	4.05	94.0	1.9370	2.9123
14 December	14 7/16	13 15/16	13 3/8	12 11/16	10.91	10.85	10.15	3.96	93.5	1.9405	2.8787
31 December	14 9/32	14 1/32	13 3/8	12 13/16	11.17	11.15	10.40	4.05	93.7	1.9295	2.8875

(a) Close of business rates.
(b) For representative stocks: short—12% Treasury 1995; medium—12% Exchequer 1998; long—9% Treasury 2008; index-linked—2 1/2% Treasury Index-Linked 2024 (5% inflation assumed).

Sterling interbank rates



(a) For one week.

The fall of sterling within the ERM, together with the Government's unexpected Eastbourne by-election defeat, contributed to a temporarily more subdued mood in the money market in mid-October. Period interbank rates firmed slightly, taking the three-month rate to 13⅞%. By the end of the month, however, sterling had recovered modestly following the escalation of Gulf tensions, the associated rise in oil prices, and support from better than expected September trade figures.

Around this time the money market became more optimistic about the possibility of further interest rate cuts in response to continuing news of the slowdown in the domestic economy as well as to sterling's recovery. The Bank reacted by lending at 2.30 pm at 14% for 7 days on 26 October, and continued to delay the full relief of money-market shortages until late in the day.

Political uncertainties were to dominate domestic markets in November, but the month began with the ½% rise in the German Lombard rate, which was followed by a rise in German money-market rates and a widening of the ERM narrow band. While the German move was explained as having been made for technical reasons, it led to speculation that further rises might prove necessary to counter the potentially inflationary effects of unification. Sterling's fall within the ERM band followed the German tightening, as well as the announcement of Sir Geoffrey Howe's resignation on that evening. At the same time, the continued expectation of cuts in domestic interest rates led the Bank to maintain the tough operational stance adopted at end-October, an exercise facilitated by the large day-to-day shortages (Table F). Simultaneously, statements by ministers and the Governor were made to explain that a premature interest rate cut would be damaging and was therefore to be avoided.

Political uncertainties continued to weigh heavily on sterling and the news on 14 November of a leadership contest in the Conservative Party saw sterling fall to DM 2.8871 on the following day, and its weak tone continued when Mrs Thatcher failed to secure re-election in the first ballot on 20 November. These factors helped briefly to establish a firmer tone to money-market rates in mid-month, enabling the Bank to return to more neutral daily operations for a short period, but strong restraining signals had to be given once again as bullishness re-emerged when publication of further weak economic data gave focus to market worries of recession.

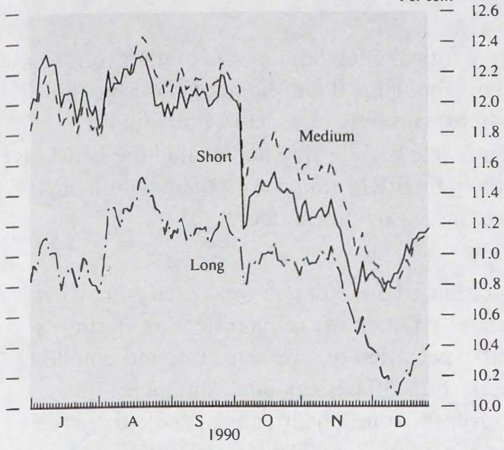
Against this background, the news that the Prime Minister would no longer contest the Conservative leadership was viewed as presaging

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

	1990 Sept.	Oct.	Nov.	Dec.
Average daily figures				
Influences (excluding maturing assistance)	+ 110	- 70	+ 10	- 170
Maturing assistance(a)	- 790	- 770	- 850	- 950
Surplus (+)/shortage (-) before daily operations	- 680	- 840	- 840	-1,130
End-period levels				
Stock of assistance	4,910	5,540	5,430	6,930
Treasury bills outstanding(b)	13,080	12,420	12,460	10,670

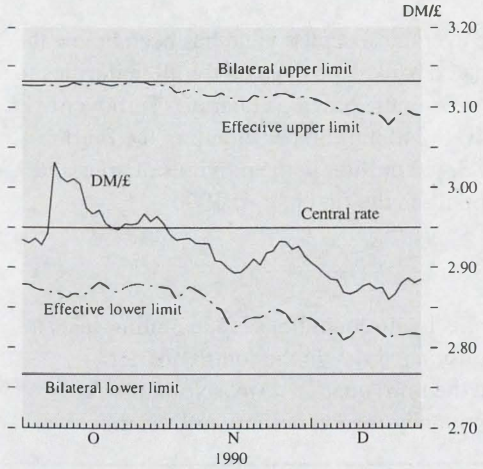
(a) Including net issuance of Treasury bills and the level of bankers' balances above or below target from the previous day.
(b) Other than those held outright by the Bank, Bank customers and government accounts but including those purchased by the Bank on a repurchase basis.

Gilt yields for representative stocks



Representative stocks: Short - 12% Treasury 1995, Medium - 12% Exchequer 1998, Long - 9% Treasury 2008.

Effective and bilateral wide-band limits of sterling against the deutschemark



an early end to the political upheavals and the money market rallied accordingly. Interbank rates at three and twelve months fell to 13⅜ % and 12¹¹⁄₃₂% respectively, and 2.30 pm lending was undertaken on that day (for seven days); and again the following day (for fourteen days) in response to a sharp fall in yields at the Treasury bill tender. On the same day the pound advanced to DM 2.9285.

News on 27 November of Mr Major's selection as leader of the Conservative party reduced the previous uncertainty, and sterling appreciated to DM 2.9385 on that day. At the same time the money market began to become more cautious about the likely size and timing of an interest rate cut, and three and twelve-month interbank rates firmed to 13⅝% and 12⁷⁄₁₆%, some ³⁄₁₆% and ¹⁄₁₆% respectively above their closing levels on the day of Mrs Thatcher's resignation.

The second half of November saw a considerable rally in the gilt market, with yields on all maturities falling by some 50 basis points over the period. This rally, which continued into December, largely reflected a perceived improvement in the inflation outlook, as evidenced by the narrowing of the differential between conventional long and index-linked gilt yields, but was also in part technical with increased demand for stock arising from doubts about the legal robustness of stock lending agreements.

At the beginning of December there was still some expectation of a small cut in interest rates—focused around the anticipation of a substantial reduction in the November RPI figure. Restraining money-market operations were again required, but over the course of the month market expectations of an early cut in interest rates gradually evaporated. The consistency of official statements (the Chancellor's speech to the Commons on 12 December made it clear that there would be no further reduction in interest rates unless it was justified by sterling's position in the ERM) and the Bank's money-market operations began to carry conviction with the market. From mid-December three-month interbank rates moved above 14% for the first time since base rates fell to that level—and remained thereabouts for the rest of the quarter.

Additional support to money-market rates in late-December came from worries over the Soviet Union and the Gulf, and from the usual end-year position-squaring. The firm tone of rates enabled the Bank to return to a more normal mode of money-market operations.

Sterling, however, turned down again from end-November with the narrowing of its interest differential caused by soft UK market rates (until mid-December) and by rises in other European rates. Moreover, sterling's soft tone was underlined by market speculation that the deutschemark's strength might lead to a general ERM realignment and the slowdown in the UK economy encouraged expectations that any sterling rally would be met with an interest rate cut. However, the Chancellor's reaffirmed commitment to firm interest rates on 12 December lent support to the pound (although it moved a little lower in the following week in thin pre-Christmas trading). Towards Christmas the deutschemark weakened sharply, triggered by the resignation of the Soviet Foreign Minister and the market's fear that disorder in the Soviet Union would threaten Germany more than any other industrial country. This relative

Table G
Official transactions in gilt-edged stocks
£ billions: *not seasonally adjusted*

	1989	1990			
	Q4	Q1	Q2	Q3	Q4
Gross official sales(+)(a)	-1.0	-0.6	+0.2	+0.1	+0.5
less					
Redemptions and net official purchases of stock within a year of maturity	-0.8	-3.4	-1.2	-1.0	-2.0
Equals net official sales(b)	-1.8	-4.1	-0.9	-0.9	-1.4
of which, net purchases by:					
Banks(b)	*-0.5*	*-1.3*	*-0.1*	*-0.3*	*+0.7*
Building societies	*+0.1*	*-0.5*	*-0.2*	*-0.2*	*+0.3*
Overseas sector	*-1.1*	*-1.5*	*-0.8*	*-0.5*	*-1.4*
M4 private sector	*-0.3*	*-0.8*	*+0.2*	*+0.1*	*-1.0*

(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.

Time/yield curves of British government stocks

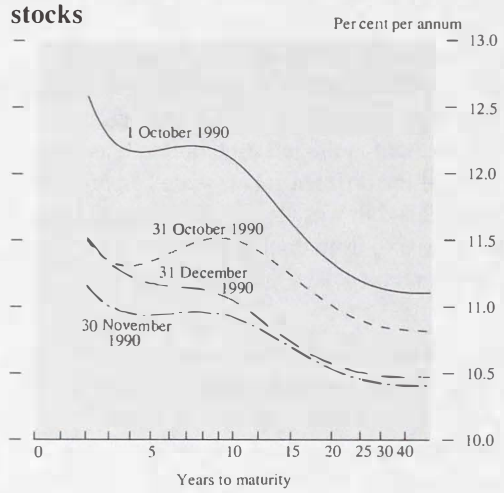


Table H
Changes in UK official reserves
$ millions

	1990			
	Sept.	Oct.	Nov.	Dec.
Change in reserves	**- 237**	**- 488**	**- 102**	**- 6**
of which:				
Net borrowing (+)/payment (-) of public debt	+ 107	- 31	- 17	- 37
Valuation change on rollover of EMCF swap	—	- 127	—	—
Underlying changes in reserves	- 344	- 330	- 85	+ 168
Level of reserves (end of period)	**39,060**	**38,572**	**38,470**	**38,464**

deutschemark weakness helped sterling to recover from its low of the quarter of DM 2.8520 on 20 December.

The combination of the political uncertainties and market concerns about recession which overhung the domestic market during the fourth quarter would almost certainly have had a more marked influence on the exchange rate had sterling not been in the ERM. It is conceivable that without the ERM framework there would have been pressure at times to increase interest rates.

By the end of the quarter the gilt market had weakened somewhat from its late November/early December rally, reflecting sterling's decline and the reduced expectation of base rate cuts, and both long and short yields had risen some 30 basis points from their mid-December lows. Over the fourth quarter as a whole there were gross official gilts sales of £0.5 billion (Table G). Including redemptions, however, there were net official purchases of £1.4 billion. There were no new issues of stock, with official transactions being directed towards day-to-day market management. During the fourth quarter there was another conversion of gilt-edged stock, with an offer to convert holdings of 10% Treasury 2004 into 10% Treasury 2003. 97% of the holdings of the original stock were converted.[1]

Official reserves

The level of official reserves stood at $38.5 billion at the end of December, having remained virtually unchanged in the previous two months. The fall of $0.5 billion between September and October followed a fall in underlying reserves and the reduction in the valuation of gold and dollars (in ECU terms) arising from the quarterly rollover of the European Monetary Co-operation Fund swap (Table H).

Ecu Treasury bills

The amount of Ecu Treasury bills outstanding in the market at the end of the fourth quarter was ECU 3,600 million, unchanged from the previous quarter. At each of the three latest tenders, on 9 October, 13 November and 11 December, the Bank allotted to the market ECU 300 million of both the one-month and three-month bills and ECU 400 million of the six-month bills.

The margin by which the average accepted yield has been below the bid rate for Ecu-denominated bank deposits rose for all maturities to average $^{15}/_{32}$%, up from $^{5}/_{16}$% in the previous quarter. Turnover by market makers fell to ECU 3,240 million per month in the fourth quarter, down from ECU 3,470 million in the previous quarter and ECU 4,920 million per month in the first half of 1990.

Bill turnover[2]

Transactions in eligible bills by discount houses[3] including sales to the Bank averaged £1.7 billion per day in the fourth quarter, virtually unchanged from the third quarter. Any seasonal effect from the usual slowing in money-market activity in December was

(1) The conversion programme is discussed in 'The gilt-edged market: developments in 1990' on pages 49-52.
(2) See the monthly Bank of England press notice, 'Bill turnover statistics.'
(3) Figures for discount houses cover only those money-market dealing counterparties which are authorised under the Banking Act 1987.

more than offset by the effect of the unusually large money-market shortages.

Within total turnover, daily Treasury bill turnover fell slightly to £250 million, while the stock outstanding held by discount houses fell back sharply to £420 million, under half the level at the beginning of the quarter. Discount house transactions in certificates of deposit remained broadly stable at £630 million daily.

Revised operating hours of ERM

From 2 January 1991 the hours of operation of the ERM were extended by one hour in the afternoon, to between 8am and 4pm GMT. These are the hours between which the central banks of the ERM countries are prepared to buy and sell other ERM currencies for their own currencies in order to maintain them within the agreed exchange rate margins.