Operation of monetary policy

This article covers the period from January to March.

Introduction

The successive ½ percentage point cuts in interest rates over the first quarter reduced the general level of rates to 12½% by end-March, and to 12% by early April. This easing of monetary conditions was made in the light of developments in the domestic monetary and economic situation and taking full account of the need to maintain market confidence in the authorities' commitment to the counterinflationary stance of policy and to the ERM discipline. The markets' response to the cuts, when they came, suggested that they had indeed been accepted as prudent.

Monetary conditions also eased over the quarter as the exchange rate depreciated in effective terms. Much of this reflected the depreciation of sterling against the strengthening dollar from mid-February onwards. The combination of dollar revival and deutschemark weakening was, however, particularly favourable to the position of sterling within the ERM, so that sterling moved from being the weakest member currency in early January to second position by end-March, before falling back more recently.

On the real economy, data which became available during the first quarter confirmed that the economy had moved rapidly into recession in the second half of 1990 and that output and demand continued falling into 1991. Hard evidence of a downturn in underlying inflation, particularly in wage settlements, remained disappointingly modest, although the demand-side pressures responsible for the original upsurge in inflation had clearly abated. Hopes of a revival in business and consumer confidence appeared to emerge during the quarter, in part associated with the ending of Gulf hostilities, leading some markets (most notably equity markets) to strengthen on the expectation of earlier economic recovery.

The authorities judged that the developing economic and monetary situation fully justified a lowering of interest rates from the 14% level established at the time of ERM entry last October. The process was deliberately cautious, in order to ensure the maintenance of confidence in the authorities' anti-inflationary resolve, to allow a considered assessment of economic developments and to discourage over-optimistic market expectations of the speed of further rate cuts.

Monetary aggregates and credit

The figures in this section are seasonally adjusted.

In the early months of 1991 both narrow and broad monetary growth continued to decline. The subdued twelve-month growth rates now being recorded are not unexpected, given the earlier tightening in monetary policy. The two measures of very narrow

Short-term interest rates in London

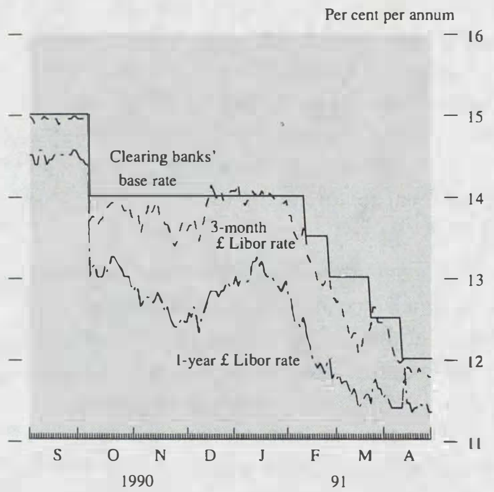


Table A
Growth rates of the monetary and credit aggregates[(a)]

Percentages; *seasonally adjusted (financial year constrained)*

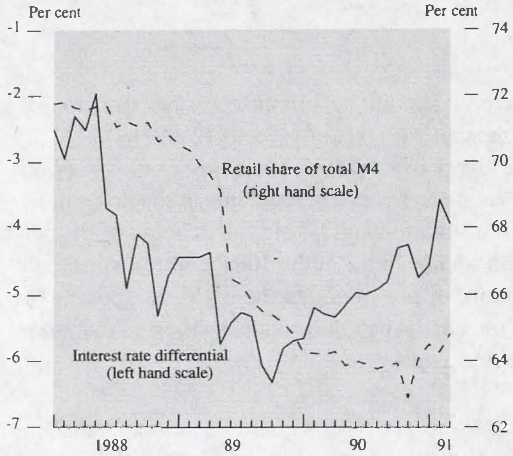
	12 months to end-Dec. 90	12 months to end-Mar. 91	1990 Q4	1991 Q1
M0 (b)	2.7	2.7	0.2	0.6
M2	7.9	10.6	3.1	3.9
M4	12.3	9.9	1.9	1.7
M4 lending	14.0	11.1	3.0	1.6

(a) See the statistical annex to the February 1991 *Bulletin* for definitions.

(b) Data are based on end-month figures, except M0, which is an average of Wednesdays in each month.

money growth—M0 and notes and coin—have decelerated in response to falling retail sales volume and lower inflation in shop prices, while the decline in M4 growth reflects a slowdown in the growth of wealth and economic activity.

Retail minus wholesale deposit rate and retail share of total M4



Components of money

The twelve-month growth rate of M0 in March (2.7%) compares with a peak of 7.6% last April. The decline over the past year principally reflects the fall in the growth of the personal sector's expenditure, as evidenced by the retail sales data. Excluding March's figure (which was markedly distorted both by the change in VAT and by the timing of Easter), the decline in the twelve-month growth rate of retail sales in value terms since early last year has in fact been even more pronounced than that of M0.

In contrast to the path of the other monetary aggregates, the twelve-month growth rate of M2 rose sharply to 10.6% in the first quarter. This was largely owing to a move from longer-term to shorter-term building society deposits (including TESSAs) and probably to the receipts of refunds of oversubscriptions and the proceeds of share sales after the electricity share issue; it may also reflect a recovery in the personal sector saving ratio.

In the first quarter, the twelve-month growth rate of M4 fell below 10% (to 9.9%) for the first time since 1970, a sharp deceleration from the growth rate of 18% at this time last year. The tightening in monetary policy since 1988 initially affected the housing market, particularly house prices, and the personal sector more generally. During last year the corporate sector also began to adjust its expenditure. As activity has slackened, and the rate of growth of wealth has fallen, the private sector has gradually adjusted, with a resulting deceleration in its holdings of broad money.

Within total M4, the slowdown has been most marked in wholesale rather than in retail deposits. In the year to March, wholesale deposits grew by less than 8% compared with a rise of 32% in the same period a year earlier. In contrast, the twelve-month growth of the retail component of M4 in the first quarter (11%) was only 1 percentage point lower than a year earlier. This reflects the scale of the adjustment by the corporate sector (see below) but it may also have been caused by the recent fall in wholesale deposit rates compared with retail rates, leading to some switching away from wholesale deposits and towards retail deposits (see chart).

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

	Counterparts to M4 1990 Q4	1991 Q1	12 months to end-Mar. 91
1 PSDR (-)	-2.3	-2.4	-0.4
2 Net purchases (-) of public sector debt by the M4 private sector	1.0	-1.0	-3.2
of which, central government debt	*1.5*	*-1.2*	*-2.4*
3 External and foreign currency finance (-) of the public sector	1.6	-0.5	2.5
4 Public sector contribution (=1+2+3)	0.3	-3.9	-1.0
5 Sterling lending to the M4 private sector (b)	17.0	9.4	58.3
6 Other external and foreign currency flows	-7.6	1.5	-8.2
7 Net non-deposit sterling liabilities of banks and building societies(-)	-1.0	0.8	-5.7
8 **Total** (=4+5+6+7) =change in M4	**8.8**	**7.9**	**43.5**

(a) See the statistical annex to the February 1991 *Bulletin* for definitions.

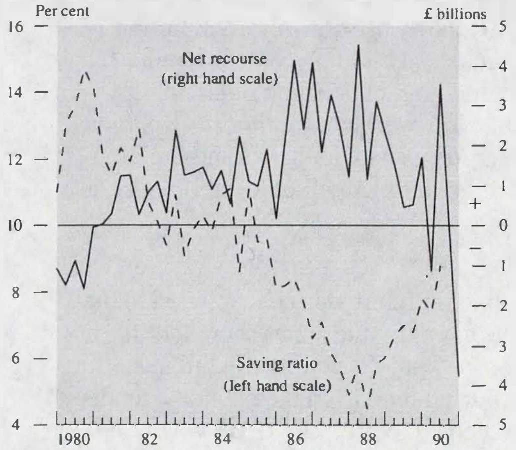
(b) Including changes in Issue Department's holdings of private sector commercial bills and promissory notes relating to shipbuilding paper guaranteed by the Department of Trade and Industry.

Public sector counterparts to money

For the second consecutive quarter there was a public sector debt repayment of over £2 billion, giving a surplus in the 1990/91 financial year of £0.4 billion, despite the large borrowing requirement early in the year caused by delayed payments of community charge and non-domestic rates. There was an overfund of £0.5 billion in the financial year, £1.4 billion of which fell in the last quarter. Funding activity was resumed towards the end of 1990/91 and will continue throughout the 1991/92 financial year as the government finances its funding requirement.

The public sector contribution to the counterparts of M4 over January-March was contractionary by £3.9 billion. In addition to the public surplus, debt sales to the M4 private sector of £1.0 billion and public sector externals of minus £0.5 billion accounted for this substantial negative contribution.

Personal sector saving and net borrowing from banks and building societies



Sectoral lending and deposits

The M4 private sector's net sterling recourse to the banks and building societies fell sharply in the first quarter and this may suggest that the company as well as the personal sector is now reducing its financial deficit in response to the previous tightening in monetary policy.

The personal sector was a net supplier of funds to banks and building societies in the first quarter by £3.1 billion, with both a rise in deposits and a weak increase in borrowing. This may indicate that the personal sector saving ratio has risen further in the first quarter (see chart). Building societies attracted the larger share of personal deposits because of their more competitive retail deposit rates, and greater success than the banks in attracting TESSA deposits.

Although lending rates fell, the quarterly rate of growth of personal sector borrowing during the first quarter was down to 2%, compared with a peak of over 5.5% in mid-1988. Building societies' mortgage lending and commitments were lower than in the previous quarter despite the reduction in mortgage rates. In part, this reflects a loss of market share to the banks. The centralised mortgage lenders have also probably gained market share since the autumn following the reduction in wholesale interest rates. Nevertheless, total mortgage demand has remained weak. Consumer borrowing from banks and building societies was also subdued during the quarter.

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

	1990				1991
	Year	Q2	Q3	Q4	Q1
Personal sector					
1 Sterling deposits	35.6	11.2	5.6	8.7	10.2
of which:					
Banks	15.6	6.1	1.3	3.3	3.4
Building societies	20.1	5.0	4.3	5.4	6.8
2 Sterling borrowing	39.4	10.2	9.1	8.2	7.1
of which:					
Mortgage	30.3	8.1	7.0	6.4	6.1
Non-mortgage	3.5	0.7	0.8	1.2	0.1
Unincorporated businesses, etc	5.7	1.4	1.2	0.7	0.9
3 Net recourse (=2-1)(a)	**3.8**	**-0.9**	**3.4**	**-0.4**	**-3.1**
ICCs					
4 Deposits	10.4	4.3	6.2	-4.7	-1.9
of which:					
Sterling	5.5	2.9	3.0	-2.6	-2.4
Foreign currency	4.8	1.5	3.2	-2.1	0.5
5 Borrowing	19.5	4.8	1.8	6.5	1.5
of which:					
Sterling(b)	17.2	4.1	2.2	5.3	1.8
Foreign currency	2.3	0.7	-0.4	1.3	-0.3
6 Net recourse (=5-4)(a)	**9.2**	**0.5**	**-4.4**	**11.2**	**3.4**
OFIs					
7 Deposits	17.7	4.2	3.2	3.5	0.1
of which:					
Sterling	11.6	2.8	1.1	2.9	-0.1
Foreign currency	6.1	1.4	2.1	0.6	0.2
8 Borrowing	13.2	4.2	2.6	3.1	3.8
of which:					
Sterling(b)	13.0	3.7	2.5	2.8	0.6
Foreign currency	0.1	0.5	0.1	0.3	3.2
9 Net recourse (=8-7)(a)	**-4.5**	**-0.1**	**-0.6**	**-0.4**	**3.7**

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

The net sterling recourse of ICCs to banks and building societies during the quarter (£4.2 billion) was down sharply from the previous three months (£7.9 billion). This may indicate an improvement in ICCs' overall financial position. Despite a substantial amount of takeover-related lending, the three-month growth of sterling lending to ICCs in the first quarter (1.3%) was lower than at any time since the first quarter of 1987.

Although there is little evidence of quantity rationing, banks appear to have increased their margins recently by making a smaller reduction in their lending rates than in their deposit rates (see page 201). Instead of borrowing from banks, companies have met their financing requirements, in part, through running down their deposits and by borrowing more cheaply elsewhere. In particular, they have returned to the capital market—ICCs' total net capital issues were £2.4 billion in the first quarter compared with £1.7 billion in the previous three months, and the amount of issues announced but not yet raised was also large.

Sterling deposits of other financial institutions with banks and building societies declined in the first quarter for the first time since the early 1980s. Deposits were probably run down, in part, to finance share purchases, the proceeds of which companies may have used to repay bank loans.

Market developments

The first quarter began with international concerns dominating world markets, with the Gulf crisis and unrest in the USSR

The cash position in the money market

There was a net flow of funds of £0.9 billion out of the money market during the first quarter of 1991. This drain on the market's cash position arose as seasonal net government revenue of £2.7 billion (boosted by £1.6 billion of privatisation receipts, mostly from the first instalment from the electricity generating companies in March) and official sales of government debt (including receipts from the issue of gilts) were not fully offset by other influences (Table 1).

Table 1
Influences on the cash position of the money market
£ billions: *not seasonally adjusted*
Increases in bankers' balances (+)

	1990 Q1	1990 Q4	1991 Q1	12 months to end-Mar. 91
Factors affecting the market's cash position				
CGBR (+)	-5.0	-3.5	-2.7	-2.5
of which, on-lending to local authorities and public corporations	*-3.1*	*+0.1*	*+0.9*	*+0.4*
Net sales (-) of central government debt (a)	+4.4	+1.0	-0.4	+1.4
of which: Gilt-edged	*+4.1*	*+1.4*	*-0.3*	*+2.9*
National savings	*+0.3*	*-0.3*	*-0.3*	*-1.4*
CTDs	—	*-0.1*	*+0.2*	*-0.1*
Currency circulation (increase -)	+1.3	-0.8	+0.3	-1.0
Reserves etc	-0.1	-0.2	+0.4	+0.6
Other	-0.1	-1.3	+1.5	+0.3
Total (A)	**+0.5**	**-4.8**	**-0.9**	**-1.2**
Offsetting official operations				
Net increase (+) in Bank's commercial bills (b)	+0.4	+1.8	+0.6	+2.2
Net increase (-) in sterling Treasury bills in market (c)	-0.8	+2.4	+0.4	-1.3
Other	-0.2	+0.2	—	+0.5
Total (B)	**-0.6**	**+4.4**	**+1.0**	**+1.4**
Changes in bankers' operational balances at the Bank (=A+B)	-0.1	-0.4	+0.1	+0.2

(a) Other than sterling 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*
Increases in bankers' balances (+)

	1990 Q1	1990 Q4	1991 Q1	12 months to end-Mar. 91
Factors affecting the market's cash position				
Under/overfunding (+/-)	-2.2	-1.7	-4.3	-0.5
Central government net debt sales to banks and building societies(a) (-)	+1.8	-1.0	+1.7	+1.5
Other public sector net borrowing from banks and building societies (-)	-0.3	-0.1	+0.6	-1.2
of which, local authorities' deposits with banks and building societies (+)	*-1.0*	*+0.1*	*-0.2*	*-1.0*
Currency circulation (-)	+1.3	-0.8	+0.3	-1.0
Other	-0.1	-1.2	+0.8	—
Total	**+0.5**	**-4.8**	**-0.9**	**-1.2**

(a) Other than sterling Treasury bills.

An alternative presentation of the market's cash position is shown in Table 2. The government's surplus during the quarter is reflected in an overfund of £4.3 billion, only partly offset by the £2.3 billion reduction by banks and building societies in their holdings of central government and other public sector net debt. However, local authorities continued to run down their deposits with banks and building societies, which fell by £1.0 billion over 1990/91 as a whole.

The seasonal drain in funds was concentrated in the early part of the quarter—the annual height of the tax-paying season—and the continuing fall in sterling Treasury bills outstanding from the cut in the tender last November helped to offset this. However, the size of the Treasury bill tender was increased again, by £100 million, in the middle of the quarter (15 February) to £550 million per week, as the 91-day tender was increased from £250 million to £350 million. The 182-day tender remained unchanged at £200 million. This change was made in anticipation of seasonal inflows to the market arising from government expenditure from March onwards, and helped to offset the softening in money-market conditions which would otherwise have resulted.

The average daily cash shortages over the quarter were relatively large, reflecting the substantial stock of outstanding assistance, which on several occasions in February and March exceeded £9 billion (Table 3). These shortages kept short rates firm, accentuating the downward slope of the yield curve at times when expectations of interest rate cuts were particularly strong.

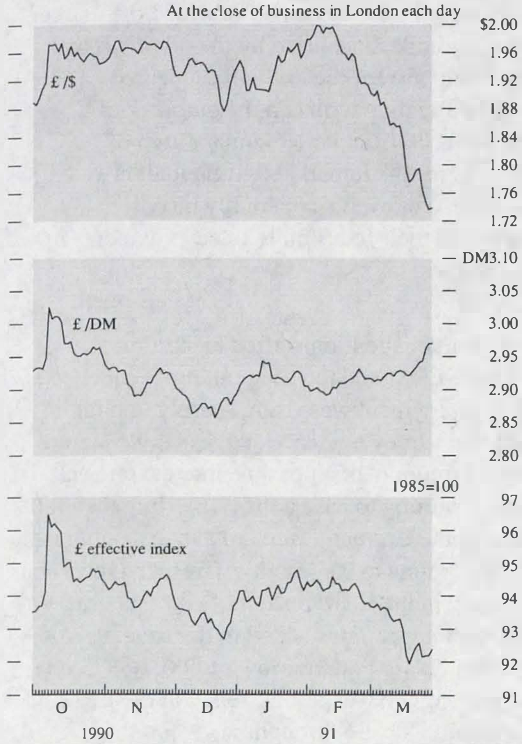
Table 3
Average daily money-market statistics
£ millions; *not seasonally adjusted*

Increases in the market's cash (+)

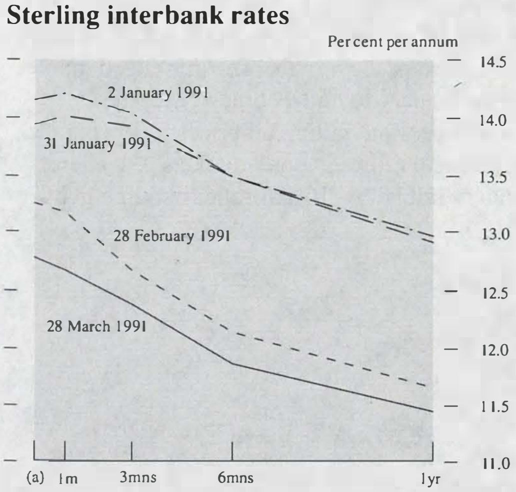
	1990 Dec.	1991 Jan.	Feb.	Mar.
Average daily figures				
Influences (excluding maturing assistance)	- 170	- 40	- 80	+ 80
Maturing assistance(a)	- 950	- 820	-1,040	-1,250
Surplus (+)/shortage (-) before daily operations	-1,130	- 870	-1,120	-1,170
End-period levels				
Stock of assistance	6,930	7,070	8,390	7,620
Sterling Treasury bills outstanding(b)	10,670	9,620	9,350	10,280

(a) Including net issuance of sterling 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 and government accounts but including those purchased by the Bank on a repurchase basis.

Sterling exchange rates



Sterling interbank rates



(a) For one week.

provoking considerable tension and uncertainty. In the event, the outbreak and rapid conclusion of Gulf hostilities caused remarkably little market instability. The oil price fell sharply back to pre-invasion levels, and markets' attention quickly reverted to developments in the major domestic economies.

There was something of a reappraisal of the outlook for major economies in the wake of the Gulf conflict. This was most obvious in the United States, where confidence began to revive as markets started to anticipate the end of the recession, encouraged by the easing in US interest rates, and the dollar recovered sharply from its mid-February lows.

In contrast, the deutschemark weakened substantially towards the end of the quarter, despite the earlier rise in the German Lombard rate and falling interest rates elsewhere. Concerns over the political situation in the USSR and the difficulties of German unification were behind the depreciation of the deutschemark during March, which was particularly conspicuous against the sharp recovery of the US dollar. During the first quarter the deutschemark fell from being close to the top of the narrow ERM band to around the middle; and the high yielding peseta and lira moved to the top of the wide and narrow bands respectively and the French franc to the bottom.

Falling interest rates in many countries and the prospects of economic recovery contributed to the rallies in world stock markets seen during the quarter. The early Allied successes in the Gulf conflict were the catalyst for these rallies—with the FTSE rising to new highs some 20% above its mid-January lows by late March, and many other major stock markets showing similar rises. In the United Kingdom, this encouraged companies to return to the capital markets, with a sustained flow of rights issues towards the end of the period. The period also saw a return to the issuing of gilt-edged stock, with new issues of some £2 billion of stock to the market to meet the full funding rule in 1990/91 and as the authorities prepared for a return to active funding in the following financial year.

Official operations in financial markets

The quarter began with a firm tone to both sterling and money-market rates. Sterling was appreciating within the ERM from its pre-Christmas lows, while interbank rates had been at a level consistent with 14% base rates since mid-December. Heightened confidence in the authorities' counterinflationary resolve and commitment to the ERM parity brought a sense in markets that there would be no immediate easing in interest rates—a view reinforced by firm policy statements by both the Prime Minister and the Chancellor in New Year interviews, ruling out a downward adjustment of sterling within the ERM.

For the first part of January, markets were preoccupied with developments in the Gulf—with the continued failure of diplomatic moves, the approach of the United Nations' 15 January deadline and the onset of hostilities two days later—and showed only muted response to domestic indicators and the appreciation of sterling within the ERM (sterling having ceased to be the lowest currency in the mechanism on 8 January). The Gulf situation, along with the problems in the Baltic states, kept interbank rates at around 14% (three months) for the first half of January. The markets sensed that any moves to cut interest rates would be postponed until the Gulf outcome became clearer.

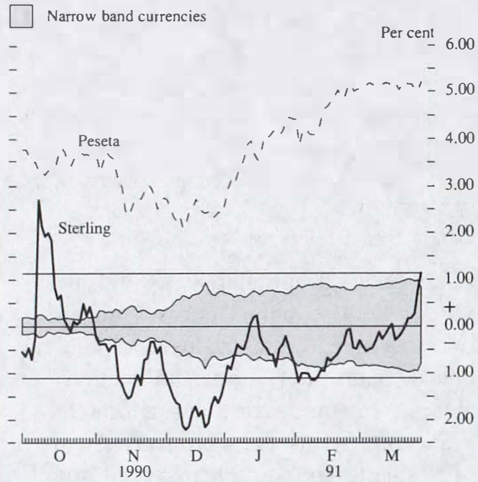
The first Allied air strikes of the Gulf conflict were accompanied by rallies in financial markets, but once these had subsided the market tensions of the previous period lessened (led by the oil price) and the previous 'safe haven' support for the dollar disappeared. The dollar fell by nearly 2% in effective terms on the outbreak of hostilities, and sterling fell back from its 16 January high of DM 2.9435. Thereafter, there was remarkably little market volatility and, with the course of events apparently heavily discounted, markets returned their focus more to developments in the major domestic economies.

In the United Kingdom, market attention shifted to sterling's resilient performance in the ERM and the accumulating evidence of domestic recession. Unemployment was rising sharply, the fall in output was accelerating and survey evidence suggested the picture would continue. Sporadic rumours of a possible interest rate cut began to develop, causing sterling to ease a little. Sterling then fell further with the increase in the German Lombard and discount rates on 31 January (by 50 basis points to 9% and 6½% respectively) and became the lowest currency in the ERM once more on 1 February when the further fall in US interest rates added to the weakness of the dollar. Sterling touched its first quarter low of DM 2.8875 on 12 February, but despite being the weakest currency in the ERM, it remained comfortably within its band throughout.

Sterling rallied the next day when, after a cut in Spanish interest rates, the Bank signalled a ½ percentage point reduction in rates to 13½%. The response of the exchange rate demonstrated that the easing had already been discounted as prudently cautious, given the economic situation, and two days later sterling moved decisively above the next lowest currency in the ERM. Over the next week the Bank acted to discourage over-optimistic expectations about the pace of future rate cuts (three-month rates for a time moved below 13%) by lending at 2.30 pm at 13½% on three occasions, two of them following a fall in yields at the Treasury bill tender.

The cut in interest rates also contributed to a flattening of the gilt-edged yield curve during February—short yields fell by some 35 basis points over the course of the month. The gilt-edged market had generally rallied from January to mid-February with the accumulating evidence of recession, falling oil prices following the outbreak of Gulf hostilities and rallies in bond markets elsewhere. Long yields in mid-January fell below 10% for the first time in over

ERM positions



The zero line represents the middle of the narrow band.

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

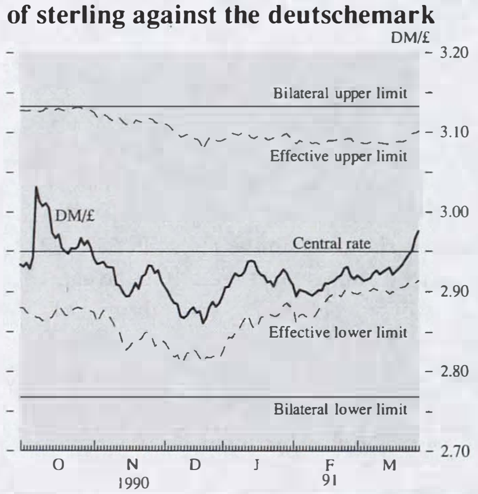


Table D
Sterling interest rates, gilt yields and exchange rates; end-months and selected dates [(a)]

	Interbank interest rates (per cent per annum)				Gilt yields (b) (per cent per annum)				Exchange rates		
					Conventionals			Index-linked			
Date (1991)	1 month	3 months	6 months	12 months	Short	Medium	Long	Long	ERI	£/$	£/DM
2 January	14 7/32	14 1/16	13 1/2	12 31/32	11.16	11.10	10.34	4.06	93.8	1.9385	2.8951
31 January	14 1/32	13 15/16	13 1/2	12 15/16	10.63	10.45	9.84	4.03	94.2	1.9590	2.9062
13 February	13 19/32	13 1/4	12 11/16	12 3/16	10.18	10.20	9.71	4.02	94.6	1.9955	2.9035
27 February	13 7/32	12 25/32	12 9/32	11 3/4	10.16	10.25	9.77	4.06	93.8	1.9165	2.9160
28 February	13 3/16	12 11/16	12 5/32	11 11/16	10.21	10.33	9.82	4.05	93.8	1.9135	2.9171
22 March	12 3/4	12 5/16	11 13/16	11 7/16	10.26	10.39	9.89	4.10	92.6	1.7945	2.9412
28 March	12 11/16	12 3/8	11 7/8	11 15/32	10.20	10.30	9.80	4.04	92.4	1.7385	2.9702

(a) Close of business rates.

(b) For representative stocks: short—12% Treasury 1995: medium—12% Exchequer 1998: long—9% Treasury 2008: index-linked—2½% Treasury Index-Linked 2024 (5% inflation assumed).

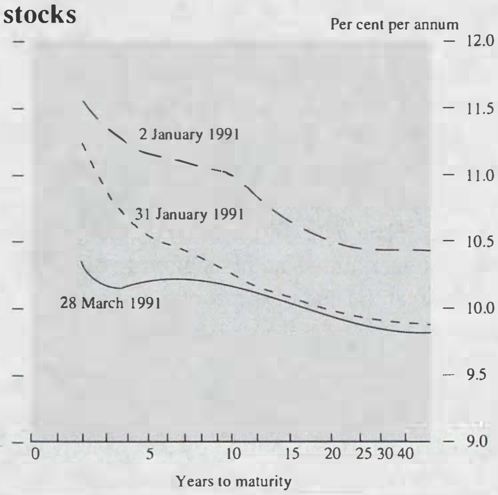
Table E
Issues of gilt-edged stock, 1991 Q1

Stock	Amount issued (£ million)	Date announced	Date issued	Method of issue	Price at issue (per £100 stock)	Details of payment	Yield(a) at issue	Yield(a) when exhausted	Date exhausted
10% Conversion 1996 'A'	700 (b)	18/1/91	24/1/91	Tender	97.75	In full	10.52	10.46	25/1/91
9½% Conversion 2004	150	1/2/91	1/2/91	To Bank	95.8125	In full	10.06	10.01	11/2/91
9% Conversion 2000	150	1/2/91	1/2/91	To Bank	93.5625	In full	10.09	10.38	7/2/91
9¾% Exchequer 1998	200	1/2/91	1/2/91	To Bank	96.9375	In full	10.38	10.38	4/2/91
10% Treasury 2001	600 (c)	15/2/91	15/2/91	To Bank	99.9375	In full	10.01	10.27	20/3/91
2% Index-Linked 1994	100	22/3/91	22/3/91	To Bank	117.3125	In full	3.72	3.97	2/5/91
9½% Conversion 2005	200	22/3/91	22/3/91	To Bank	95.3750	In full	10.12	10.09	28/3/91
10% Treasury 1994	200	22/3/91	22/3/91	To Bank	99.5625	In full	10.15	10.10	4/4/91

(a) Gross redemption yield, per cent.
(b) Of which £200 million was reserved for the Commissioners for the Reduction of the National Debt (CRND).
(c) Of which £100 million was reserved for the CRND.

a year on the benchmark 9% Treasury 2008 stock, and fell to a mid-February low of 9.65%. These market conditions provided opportunity for the Bank to issue stock, for the first time since October 1988, beginning on 24 January with a £500 million tranche of 10% Conversion 1996, which was sold out within a day of issue (see Table E). Three tranchettes totalling £500 million were issued on 1 February, which were sold over the course of the next two weeks, before the market began to consolidate.

Time/yield curves of British government stocks



A second ½ percentage point reduction in interest rates, to 13%, was signalled on 27 February. Again the move itself was fully discounted and sterling soon steadied around DM 2.9155. Around this time, however, the dollar was beginning to strengthen as the rapid conclusion to Gulf hostilities (the ground conflict having ended on 27 February, after only four days) led to hopes of an early recovery from the US recession. As a result the pound fell against the dollar for the rest of the quarter. It reached a low point of $1.7320 on 27/28 March, having traded close to (and briefly above) $2.00 earlier in the month. Within the ERM, though, sterling advanced steadily from early March as concern about the mounting cost of German unification and the deteriorating political situation in Eastern Europe weighed heavily upon the deutschemark.

In late February the gilt market fell back, largely in sympathy with other bond markets, on the ending of Gulf hostilities which led to the expectation of a shallower recession (particularly in the United States). The volume of current and prospective new issues—especially eurosterling and Ecu issues—along with the resumption of funding also weighed the market down. The fall in the market meant that the £500 million tranche of 10% Treasury 2001 issued on 15 February was not exhausted until 20 March.

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

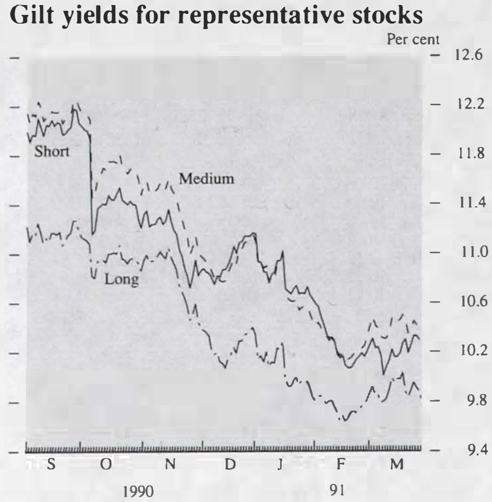
	1990 Q1	Q2	Q3	Q4	1991 Q1
Gross official sales (+) (a)	-0.6	+0.2	+0.1	+0.5	+2.0
less					
Redemptions and net official purchases of stock within a year of maturity	-3.4	-1.2	-1.0	-2.0	-1.7
Equals net official sales (b)	-4.1	-0.9	-0.9	-1.4	+0.3
of which, net purchases by:					
Banks (b)	*-1.3*	*-0.1*	*-0.3*	*+0.7*	*-0.8*
Building societies	*-0.5*	*-0.2*	*-0.2*	*+0.3*	*-0.9*
Overseas sector	*-1.5*	*-0.8*	*-0.5*	*-1.4*	*+1.2*
M4 private sector	*-0.8*	*+0.2*	*+0.1*	*-0.9*	*+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.

In early March, speculation over the Ribble-Valley by-election and the possible timing of the General Election brought forward expectations of further interest rate cuts. Strong expectations of a cut of up to 1 percentage point developed, focusing on the Budget on 19 March, in response to which the Bank lent at 2.30 pm on four occasions—twice for fourteen days. Over this period large daily shortages kept short rates firm so the money-market yield curve (already downward sloping) steepened.

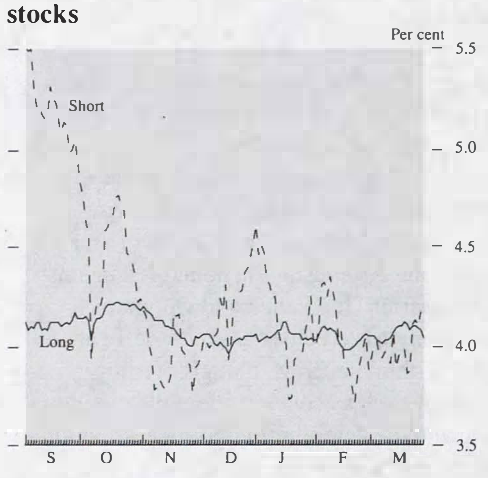
After the Budget the money market quickly accepted that it had been over-enthusiastic about the near-term prospects for substantial rate cuts. Thus the ½ percentage point cut to 12½% on 22 March was very much in line with market expectations and fully discounted. On this occasion the Bank signalled through its normal operations that it was prepared to acquiesce in a reduction in interest

Gilt yields for representative stocks



Gross redemption yields on representative stocks:
Short - 12% Treasury 1995, Medium - 12% Exchequer 1998, Long - 9% Treasury 2008.

Gilt yields for representative index-linked stocks



Gross redemption yields on representative stocks:
Short - 2% Treasury Index-linked 1992.
Long - 2 1/2% Treasury Index-linked 2024.

Table G
Changes in UK official reserves

$ millions

	1990 Dec.	1991 Jan.	Feb.	Mar.
Changes in reserves	**- 6**	**- 96**	**+3,426**	**+ 532**
of which:				
Net borrowing(+)/payment (-) of public debt	- 174	- 12	+2,995	- 8
Valuation change on rollover of EMCF swap	—	- 130	—	—
Underlying changes in reserves	+ 168	+ 46	+ 431	+ 540
Level of reserves (end of period)	**38,464**	**38,368**	**41,794**	**42,326** (a)

(a) After the annual revaluation the reserves stood at $42,258 million at the end of March.

rates, by accepting bills from the discount houses ½ percentage point lower than previously (rather than by the mechanism of 2.30 pm lending). Interbank rates firmed slightly shortly afterwards as the market was disappointed when February's RPI and trade figures showed little underlying improvement. In the meantime sterling had continued its appreciation against the weakening deutschemark, particularly when continuing concerns about German economic and monetary union came to the surface.

The weakness of the deutschemark, strength of the dollar and good underlying demand for the pound allowed sterling to move up against all the narrow band ERM currencies and on 28 March it reached second place within the system, a position it had last held in October shortly after ERM entry. The pound touched its first quarter high of DM 2.9815 that day, but later eased slightly on profit-taking to close the quarter at DM 2.9702.

The money market finished the period quietly ahead of the Easter weekend; expectations of an immediate move to 12% rates had not yet developed, although such a move in the near future was discounted.

The gilt-edged market recovered towards the end of March as investors reassessed the prospects for gilts in the light of the Budget, welcoming the cautious approach to interest rates. The remainder of the 10% Treasury 2001 tranche was exhausted on 20 March, which helped the market to consolidate its gains. A further three tranchettes totalling £500 million were issued on 22 March, most of which were sold to contribute to funding in April (ie in the 1991/92 financial year). These tranchettes included £100 million of short-dated index-linked stock. The index-linked market had made modest gains on the political uncertainties at the beginning of March, and began to rise again at the end of the period and into April with the rally in equities.

Official reserves

The level of official reserves rose to $42.3 billion by end-March, up $3.9 billion from the end of 1990. The most significant factor was the sale to the public of ECU 2.5 billion of the UK Government's first Ecu bond (see below), proceeds of which added the equivalent of $3.0 billion to reserves during February. Underlying reserves in both February and March were boosted by foreign currency contributions to the cost of Gulf operations, and March's total also included foreign currency receipts from the privatisation of the electricity generating companies (see Table G).

Ecu bond and Ecu Treasury bills

The UK Government launched its first Ecu bond, with a total size of ECU 2.75 billion, on 13 February. The bond has a coupon of 9.125%, payable annually, and a maturity of ten years. The issue is designed to consolidate London's leading position in the Ecu financial markets and to deepen investment interest in Ecu instruments, including among domestic investors. It is the largest Ecu bond in the market, and has become the benchmark issue against which other Ecu bonds are valued. The issue was very well received, notwithstanding its size, and has traded in the secondary market at a yield around 4 basis points below the yield on the French government issue of similar maturity. The bond was underwritten and sold by means of the fixed price re-offer technique, with ECU 250 million allocated to the Bank of England for use in lending operations designed to enhance the liquidity of the issue. The management group for the issue incorporated the leading international firms in London actively involved in the Ecu bond market, as well as other market participants (such as the gilt-edged market makers) with a developing interest in this growing market.

There were ECU 3.6 billion of Treasury bills outstanding at the end of the first quarter of 1991, as there had been at the end of the previous quarter. At each of the three latest tenders, on 8 January, 12 February and 12 March, the Bank allotted ECU 300 million of both the one and three-month bills and ECU 400 million of the six-month maturity; tenders continued to be substantially oversubscribed. The margin of the average yield accepted at tender below the bid-rate for Ecu-denominated bank deposits widened for all maturities, to a range of 15–30 basis points for one-month bills and 35-55 basis points for three and six-month bills. Total turnover rose to ECU 13.4 billion in the first quarter of 1991, from ECU 9.7 billion last quarter.

Bill turnover

Transactions in eligible bills by discount houses (including sales to the Bank) rose from an average of £1.7 billion per day in the final quarter of 1990 to £2.0 billion in the first quarter of this year. This was the highest quarterly turnover since reporting began in 1988. Within this total, Treasury bill turnover fell back to £190 million per day (from £250 million), reflecting the reduction in the tender size last November, while the stock held by discount houses[1] stood at £540 million at end-March. Discount house transactions in certificates of deposit rose to £720 million per day, £90 million above the average for the previous quarter.

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