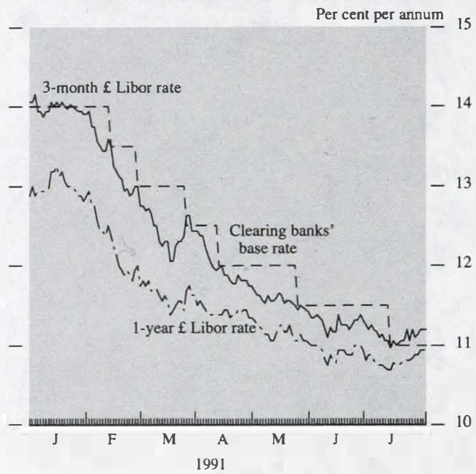
Operation of monetary policy

This article covers the period from April to June.

Introduction

During the second quarter, activity in the real economy apparently declined further, albeit at a slowing rate, and for the first time there were clear signs of a downturn in underlying inflation. Interest rates were reduced from 12½% in two half percentage point steps in April and late May—and again in July to 11%. Between end-March and end-June the exchange rate fell, in effective terms, by 3%—taking its total depreciation over the first half of 1991 to almost 5%, largely as a result of the strengthening of the dollar.

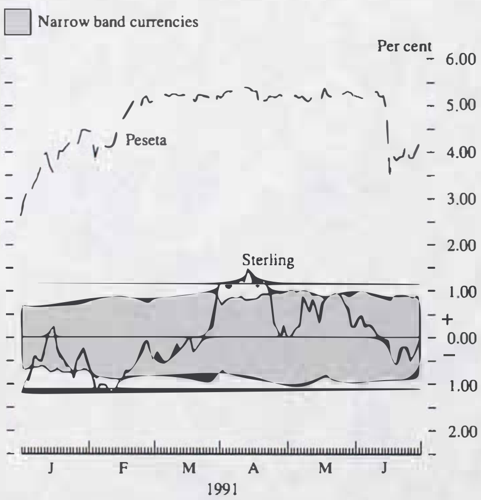
Short-term interest rates in London



The successive cuts in interest rates, together with the trend in sterling, amounted to a significant easing in monetary conditions in nominal terms, although the decline in interest rates may have been rather less in real terms. The approach has been cautious and consistent with official counterinflation objectives, with the authorities underlining their commitment to these objectives by resisting calls to cut rates further or faster. The Bank's money-market operations were at times tightened accordingly, most notably when improvements in the headline RPI in conjunction with the firmness of sterling in the ERM encouraged over-optimistic market expectations on the pace and extent of interest rate cuts.

It is still too soon to be able to assess the effect of the easing in monetary conditions to date, given the long lags before its full impact is felt on the real economy. On past relationships, the stimulus to demand should become progressively more marked as 1991 gives way to 1992; any further relaxation now would have virtually no effect until well into next year.

ERM positions



The zero line represents the middle of the narrow band.

The fall in sterling's exchange rate index over the quarter mainly reflected the strengthening dollar. In the ERM, the pound remained well away from its limit rates at all times, despite the cuts in UK interest rates. From late May, sterling weakened against ERM currencies on market fears that political and economic concerns might induce the authorities to cut interest rates further and faster than warranted. In addition, some technical selling of sterling was triggered by the fall in the Spanish peseta which lowered sterling's effective ERM floor. However, the scale of this depreciation was contained and market conditions remained orderly throughout. Towards the end of the quarter and early in July, the markets' concerns appeared to diminish and sterling moved modestly back up in the ERM, and was not affected by the reduction in interest rates on 12 July.

Throughout the period since it joined the ERM, sterling has traded comfortably within its bands. This reflects market confidence that the authorities are ready to conduct monetary policy in a manner consistent with ERM membership. While the ERM represents a

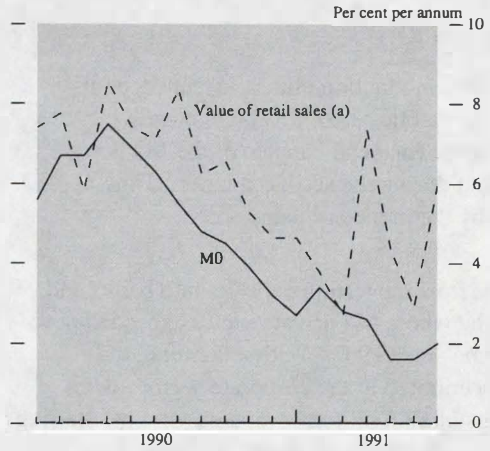
Table A
Growth rates of the monetary and credit aggregates[a]

Percentages; *seasonally adjusted (financial year constrained)*

	12 months to end-Mar. 91	12 months to end-June 91	1991 Q1	1991 Q2
M0(b)	2.6	2.0	1.2	0.6
M2	10.8	12.1	4.1	2.9
M4	9.8	7.9	1.5	1.8
M4 lending	11.1	8.7	1.8	1.1

(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.

Twelve-month growth rates of M0 and the value of retail sales



(a) The spike in retail sales growth in March 1991 is due mainly to the effects of higher spending prior to the increase in VAT, which appears to have been financed by means other than cash, such as credit card borrowing.

Table B
Counterparts to changes in M4[a]

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

	Counterparts to M4 1991 Q1	Counterparts to M4 1991 Q2	12 months to end-June 91
1 PSBR (+)	-0.1	1.9	-0.3
2 Net purchases (-) of public sector debt by the M4 private sector	-1.0	0.7	-1.1
of which, central government debt	*-1.0*	*0.5*	*-0.9*
3 External and foreign currency finance (-) of the public sector	-0.8	-0.2	1.2
4 Public sector contribution (=1+2+3)	-1.9	2.4	-0.2
5 Sterling lending to the M4 private sector (b)	10.6	6.2	47.1
6 Other external and foreign currency flows	-1.0	1.2	-6.5
7 Net non-deposit sterling liabilities of banks and building societies (-)	-0.4	-1.0	-4.4
8 Total (= 4+5+6+7) =change in M4	**7.3**	**8.7**	**36.0**

(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.

potential constraint on policy, its requirements have not diverged from what has been seen as appropriate for domestic objectives.

Monetary aggregates and credit

The figures in this section are seasonally adjusted unless otherwise stated.[1]

Over the second quarter, the deceleration in annual M0 growth apparently stopped, while M4 growth continued to decline. Sectoral data on the flow of funds and on net recourse to the banks and building societies suggest that M4 private sector[2] savings rose, possibly markedly, during the period. Within the total, the monetary data point to financial adjustment being concentrated in the company rather than the personal sector.

Components of money

The twelve-month growth rate of M0 fell to 2.0% in June, compared with its recent peak of 7.5% in April 1990. The broad pattern of M0 has been of a steady decline throughout the latter part of 1990 but a flattening more recently. A similar pattern is evident in the data on the value of retail sales (see the chart opposite and accompanying text).

In contrast to the other monetary aggregates, the twelve-month growth rate of M2 continued to increase in the second quarter. However, this appears largely to reflect the attractiveness of TESSAs, which were introduced in the first quarter, a change in the terms of some accounts that brought them within M2 and other accounts coming within the (one-month) maturity threshold for M2 with the passage of time. The three-month figures suggest M2 growth slowed in the second quarter as the flow into TESSAs moderated.

The twelve-month growth rate of M4 slowed further in the second quarter, although the three-month rate of increase was similar to the previous quarter. The continuing decline in the growth rate of M4 reflects the long lags of adjustment to the previous policy tightening.

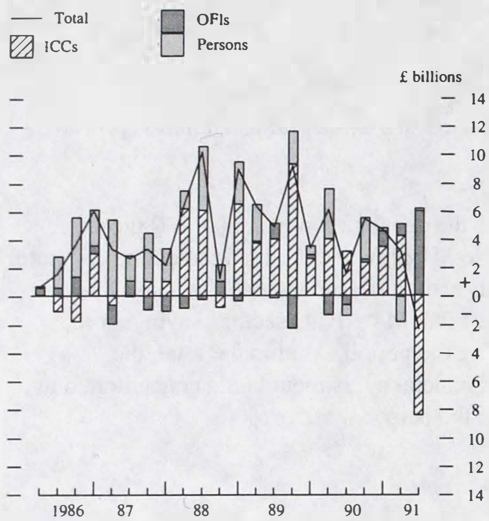
Within aggregate M4, the slowness of growth was again more pronounced in wholesale than in retail deposits. In part, this may be because wholesale deposit rates have responded more promptly to the recent base rate cuts than have retail deposit rates. Other financial institutions, in particular, appear to have switched their asset holdings away from bank deposits into more attractive assets (see below).

Public sector counterparts to money

The public sector moved into large deficit in the first quarter of this financial year, with a (not seasonally adjusted) PSBR of £7.0 billion—£9.2 billion excluding privatisation proceeds. Because the broad aim of the funding programme is fully to fund the PSBR only during the financial year as a whole, there was underfunding this quarter of some £4.7 billion (not seasonally adjusted). The underfund was reflected in large public sector

(1) The figures also incorporate new seasonal adjustments (see the note on page 397).
(2) The M4 private sector comprises the personal sector, industrial and commercial companies and financial institutions other than banks and building societies.

Private sector net sterling recourse to banks and building societies (a)



(a) Net borrowing (recourse) is positive, net saving negative.

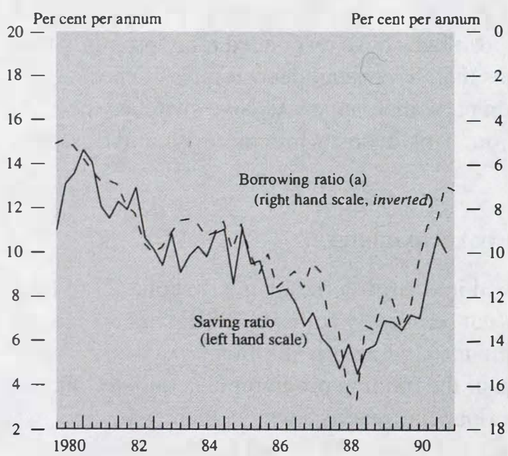
Table C
Sectoral analysis of sterling deposits with, and borrowing from, banks and building societies

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

	1990 Year	Q3	Q4	1991 Q1	Q2
Personal sector					
1 Deposits	33.8	5.9	8.6	8.6	7.2
of which:					
Banks	15.6	1.4	3.5	3.0	2.1
Building societies	18.2	4.5	5.2	5.6	5.2
2 Borrowing	39.6	8.7	8.7	7.1	7.3
of which:					
Mortgage	30.4	6.8	6.7	6.3	6.4
Non-mortgage	3.5	0.7	1.0	0.3	0.1
Unincorporated businesses, etc	5.6	1.2	1.0	0.5	0.8
3 Net recourse (=2-1)(a)	**5.8**	**2.8**	**0.1**	**-1.5**	**0.1**
ICCs					
4 Deposits	4.4	0.3	1.1	-2.2	5.3
5 Borrowing (b)	17.2	2.7	4.6	2.1	-3.3
6 Net recourse (=5-4)(a)	**12.8**	**2.3**	**3.5**	**4.4**	**-8.5**
OFIs					
7 Deposits	13.5	2.4	1.3	0.5	-3.6
8 Borrowing (b)	12.8	2.7	2.4	1.4	2.3
9 Net recourse (=8-7)(a)	**-0.7**	**0.3**	**1.1**	**0.9**	**5.9**

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

Personal sector savings and borrowing



(a) Borrowing from banks and building societies as a proportion of disposable income.

borrowing from banks and building societies which partly offset the effect on M4 of the sharp fall in borrowing by the private sector, specifically by industrial and commercial companies (ICCs).

The normal seasonal pattern of excess government expenditure over revenue towards the beginning of the financial year was exaggerated this year by the effects of the Budget changes to the community charge and VAT. There was a substantial early payment of central government grants to local authorities to take account of both the reduction in community charge receipts and the delay in their collection, while the offsetting increase in VAT receipts will not begin to be paid over substantially to government until August. The impact on the PSBR was compounded by the effects of the recession, which both depressed general tax revenues and increased some expenditures, particularly social security.

Sectoral lending and deposits

The combination of a marked reduction in the current account deficit and the return of the public sector to a large borrowing requirement suggests that the financial balance of the M4 private sector improved somewhat during the second quarter. This conclusion is supported by the monetary data.

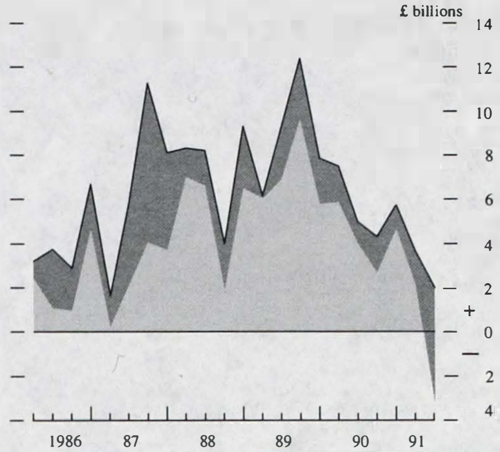
In the second quarter, the flow of sterling deposits into banks and building societies from the whole M4 private sector exceeded new borrowing for the first time since 1983. Within the total, the adjustment has been concentrated in the corporate sector. ICCs made net sterling deposits of £8.5 billion compared with net sterling borrowing of £4.4 billion in the previous three months and a quarterly average of £3.2 billion in 1990.[1] This turn-round has occurred in part as companies have reduced their spending (evidence for which comes from recent business surveys and labour market data) but also as they have resorted increasingly to the capital markets to finance their deficits and to pay off bank loans. The recent strength of UK equity markets has meant that capital issues have in many cases offered a more attractive source of finance than the banks which, according to both survey and anecdotal evidence, have tended to widen their spreads. Net sterling capital issues by ICCs were £5.2 billion in April–June, compared with £1.5 billion in the first quarter and £5.3 billion for 1990 as a whole.

OFIs substantially increased their net sterling recourse to the banks and building societies in the April–June period. This may be a counterpart to ICCs' behaviour; OFIs appear to have run down their bank deposits and borrowed from the M4 institutions in order, in part, to purchase some of the securities issued by ICCs.

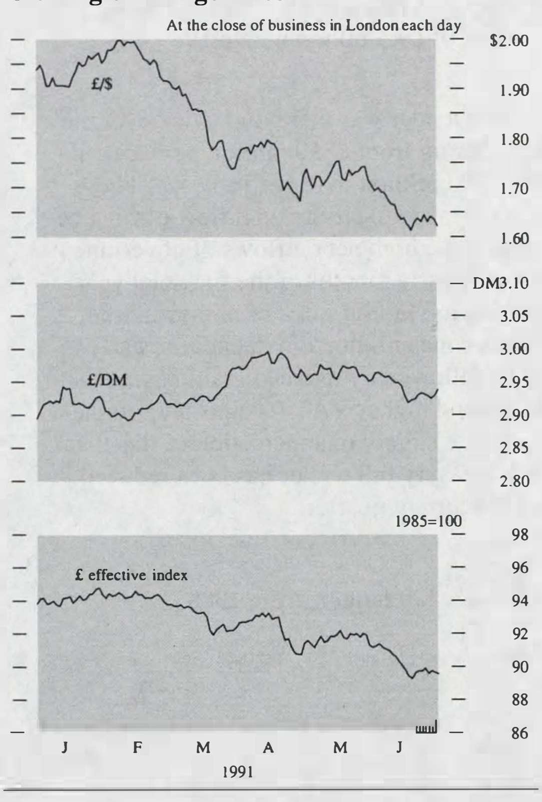
The personal sector's net sterling recourse to the banks and building societies was little changed in the second quarter. There was a modest increase in both net and gross borrowing, suggesting that the saving ratio may have changed little during the quarter (see the chart opposite). Borrowing for consumption from banks and building societies was very modest while borrowing for house purchase remained flat, in line with the absence of any generalised recovery in the housing market.

(1) The net recourse figures for previous quarters have been substantially revised since the publication of the May *Bulletin* (see 'Changes in this issue' on page 400 in the statistical annex).

Borrowing by ICCs



Sterling exchange rates



The overseas sector was a net borrower from UK banks and building societies, possibly reflecting a switch into purchases of UK company shares as well as a narrowing of the current account deficit.

Market developments

In the second quarter interest rates fell in a number of countries. In most of Europe, this movement has taken place against a background of weakening activity and modest declines in inflation. The exception has been Germany where domestic demand has been strong as a result of the pressures of unification, and where inflationary pressures have consequently increased. In the United States, the markets' sense that an economic upturn had begun was among the main causes of the dollar's recovery, which was the most prominent feature of the foreign exchanges over the period. Between its February lows and its end-June level, the dollar rose by around 19% against sterling, 8% against the yen and 25% against the deutschemark.

The dollar's strength in part reflected the deutschemark's weakness, particularly with the heightened Eastern European tensions over the later part of the quarter. The deutschemark's relative weakness within the ERM perhaps added to the attraction of high interest rate currencies—notably the peseta and the lira—and also sterling. The strength of the peseta in combination with the weakness of the French franc (influenced by relatively low nominal interest rates in France) caused tension within the ERM for a period, with intervention being required to keep the two currencies within their bilateral limits. This pressure was eased by the sharp fall in the peseta in mid-June, which caused the wide band to narrow from its maximum width. The width of the narrow band, however, changed little over the period.

Equity markets were relatively strong over the quarter, with the US and UK markets touching new highs on falling interest rates and optimism about the prospects of economic recovery.[1] The rally in the UK market helped companies raise funds on the capital market, most notably via rights issues, which had reached record levels by the end of the first half of the year—a period during which the authorities also reverted to funding in the gilt-edged market. However, the developing sense of optimism about an early move out of recession which developed during the first quarter and which helped push the FTSE index to new highs in April (since exceeded) was gradually overtaken by a more cautious view of the timing of recovery—the earlier sense of revival perhaps having reflected the transitory impact of the ending of the Gulf hostilities.

Official operations in financial markets

The money market began the quarter on a quiet note after the Easter holidays, with interbank rates consistent with the prevailing 12½% level of base rates. However, the market soon began to look for another reduction in rates—an expectation encouraged by the fact that sterling had risen to second position in the ERM by late March, where it remained until mid-April, benefiting from a deutschemark weakened by concern over the costs of German unification and the deteriorating political situation in the USSR.

(1) See discussion of world equity markets on page 353.

The cash position in the money market

There was a substantial net flow of £4.1 billion into the money market over the second quarter as net government expenditure of £6.7 billion was only partially offset by sales of gilt-edged stock (Table 1). This arose as the normal seasonal pattern of a relatively high CGBR in the early months of the financial year was exaggerated by the higher level of payments to local authorities on account of the reduction in their community charge receipts (following the change to a higher level of VAT and a lower level of community charge) and the delayed collection of these community charge payments necessitated by the rebilling process. Furthermore, most of the increase in VAT receipts which will eventually offset the higher grant payments will not begin to be received by central government until later in the year, since most VAT is paid quarterly in arrears. Privatisation proceeds, comprising the first instalment on the sale of the Scottish electricity companies and repayment of debt by other regional electricity companies, offset central government expenditure by £2.2 billion over the period.

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

	1990 Q2	1991 Q1	1991 Q2	12 months to end-June 91
Factors affecting the market's cash position				
CGBR (+)	+4.3	-2.6	+6.7	—
of which, on-lending to local authorities and public corporations	—	*+0.9*	*+0.2*	*+0.6*
Net sales (-) of central government debt (a)	+0.2	-0.4	-3.1	-2.0
of which: Gilt-edged	*+0.9*	*-0.3*	*-2.5*	*-0.5*
National savings	*-0.4*	*-0.3*	*-0.6*	*-1.6*
CTDs	*-0.3*	*+0.2*	—	*+0.1*
Currency circulation (increase -)	-0.6	+0.3	+0.1	-0.4
Reserves etc	+0.2	+0.4	+0.9	+1.3
Other	-0.2	+1.4	-0.5	+0.1
Total (A)	+3.9	-0.9	+4.1	-1.0
Offsetting official operations				
Net increase (+) in Bank's commercial bills (b)	-1.1	+0.6	-2.3	+0.9
Net increase (-) in sterling Treasury bills in market (c)	-3.2	+0.4	-3.3	-1.4
Other	+0.5	—	+1.5	+1.6
Total (B)	-3.8	+1.0	-4.1	+1.1
Changes in bankers' operational balances at the Bank (=A+B)	+0.1	+0.1	—	+0.1

(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.

An alternative presentation of the market's cash position is shown in Table 2, from which it can be seen that the excess of government spending over net debt sales (underfunding of £4.7 billion) was only partially offset by outflows from the market caused by public sector net borrowing from banks and building societies of £0.7 billion. The largest part of this was by local authorities, who ran down their deposits with banks and building societies by £0.6 billion, the largest such fall since the same period last year. The outstanding stock of local authority deposits with banks and building societies had fallen to £6.7 billion by end June, from a peak of £9.5 billion in late 1989.

Table 2
Alternative presentation of factors affecting the market's cash position
£ billions; *not seasonally adjusted*
Increase in bankers' balances (+)

	1990 Q2	1991 Q1	1991 Q2	12 months to end-June 91
Factors affecting the market's cash position				
Under/overfunding (+/-)	+5.8	-4.1	+4.7	-1.3
Central government net debt sales to banks and building societies(a) (-)	+0.3	+1.7	+0.1	+1.3
Other public sector net borrowing from banks and building societies (-)	-1.6	+0.6	-0.8	-0.4
of which, local authorities' deposits with banks and building societies (+)	*-1.0*	*-0.2*	*-0.6*	*-0.6*
Currency circulation (-)	-0.6	+0.3	+0.1	-0.4
Other	+1.0	+0.8	+0.6	+0.4
Total	**+3.9**	**-0.9**	**+4.1**	**-1.0**

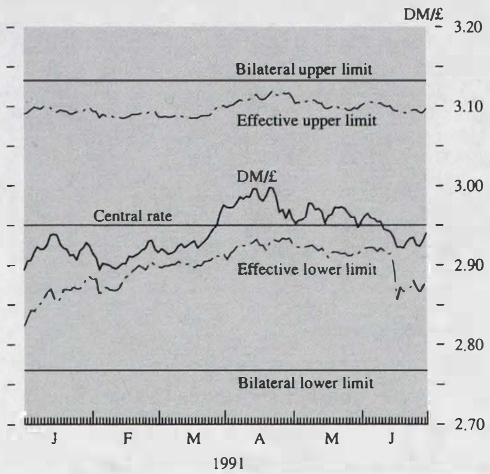
(a) Other than sterling Treasury bills.

The Treasury bill tender was increased twice over the second quarter, rising from £550 million per week at end-March to £900 million in May (Table 3). These adjustments were made to ensure an inflow of finance sufficient to meet the high net outflows of government expenditure in the early months of the financial year, without depleting too far the stock of money market assistance. This concentration of expenditure early in the year will be followed by reduced grant payments to local authorities and higher VAT receipts later in the financial year. It is largely in anticipation of this that the size of the Treasury bill tender has been reduced in the course of the current quarter.

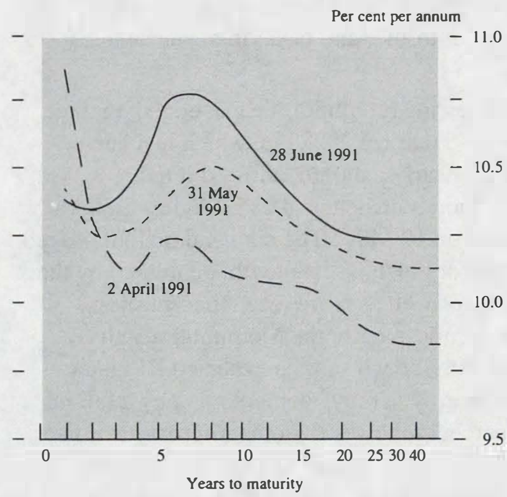
Table 3
Size of the Treasury bill tender, from 1988
£ millions

	63 days	91days	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
1991				
15 February	—	350	200	550
19 April	—	500	200	700
10 May	200	500	200	900
12 July	—	500	200	700
2 August	—	300	200	500

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



Time/yield curves of gilt-edged stocks



By the time the ½ percentage point interest rate cut came, on 12 April, it had been fully discounted by both the foreign exchange and money markets. The move down was signalled by the Bank in new dealing rates for eligible paper immediately ahead of March's better than expected RPI data. The 12% level was quickly reinforced by 2.30 pm lending for 7 days following the Treasury bill tender that afternoon, at which the three-month yield of 11.56% was substantially below the new level of base rates. Thereafter, the money market settled down for around three weeks at a level consistent with the Bank's dealing rates although, given the improving path of RPI data—notably the sharp headline fall due in the April figure following earlier changes in mortgage interest rates—coupled with the firmness of sterling in the ERM, it seemed reasonable to suppose that it was only a matter of time before strong market expectations of another move would develop.

Sterling continued to advance after the move to 12%, briefly exceeding the DM 3.00 level. Soon afterwards, however, nervousness ahead of the local government elections (2 May) and wider political uncertainties, together with a degree of selling pressure on sterling against a strong dollar, caused the pound to fall back towards the middle of its band, although it soon rose again in the ERM grid with the strengthening dollar.

In the gilt-edged market, a rally around Easter enabled two tranchettes issued in late March to be sold out and provided the background to the announcement on 5 April of the tender of £800 million of 9% Treasury Stock 2008. However, renewed political nervousness, further weakness in international bond markets and supply factors (the weight of actual and prospective funding and a sustained flow of corporate sterling issues) acted to dampen the market, particularly at the long end, leaving the stock substantially unsold at the tender on 10 April. The short end fared rather better, encouraged by the prospect of further interest rate cuts. At the auction of gilt-edged stock on 24 April (the first auction since funding resumed earlier this year) the £1.2 billion of 10% Conversion 1996 was covered 4.5 times (see Table D for details of issues of gilt-edged stocks in the second quarter.)

From early May, the expected easing in money-market rates took place as the market began to anticipate that a move to 11½% would come either with, or shortly after, the publication of April's RPI figure on 17 May. The three-month interbank rate first fell to 11½% on 8 May, but subsequently rose again as the authorities, through their words and actions, ruled out an immediate move. The Bank's operations were tightened to reinforce the 12% level, and

Table D
Issues of gilt-edged stock, 1991 Q2

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
9% Treasury 2008 'C'	1,000 (b)	5/4/91	11/4/91	Tender	94.25	Part paid (c)	9.69	9.96	8/5/91
10% Conversion 1996 'B'	1,200	16/4/91	25/4/91	Auction	98.5313	Part paid (d)	10.35	10.35	25/4/91
2 1/2% Index-Linked 2011	100	10/5/91	10/5/91	To Bank	132.75	In full	4.19	4.38	18/7/91
2 1/2% Index-Linked 2001	100	10/5/91	10/5/91	To Bank	141.9375	In full	4.12	4.17	22/5/91
8 1/2% Treasury 2007	100	10/6/91	10/6/91	To Bank	86.5313	In full	10.22	10.19	11/6/91
10% Treasury 1994	300	10/6/91	10/6/91	To Bank	99.3125	In full	10.26	10.24	4/7/91
10% Treasury 2001	1,500	18/6/91	27/6/91	Auction	96.2813	Part paid (e)	10.63	10.63	27/6/91

(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) With 40% payable at issue and balance paid on 13/5/91.
(d) With 50% final call on 28/5/91. Auction was covered 4.48 times.
(e) With 60% final call on 22/7/91. Auction was covered 2.19 times.

Table E
Sterling interest rates, exchange rates and yields on gilt-edged stocks; end-month and selected dates [a]

	Interbank interest rates (per cent per annum)				Yields on gilt-edged stocks (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 April	12 21/32	12 13/32	11 29/32	11 17/32	10.24	10.31	9.81	4.02	92.7	1.7625	2.9725
12 April	12 1/16	11 15/16	11 21/32	11 3/8	10.24	10.34	9.81	3.99	93.0	1.7810	2.9912
30 April	11 27/32	11 11/16	11 13/32	11 9/32	10.29	10.44	9.89	4.03	91.4	1.7205	2.9627
2 May	11 7/8	11 9/16	11 5/16	11 7/32	10.26	10.39	9.85	4.02	91.4	1.7150	2.9575
17 May	11 31/32	11 5/8	11 11/32	11 7/32	10.38	10.59	10.11	4.11	91.8	1.7175	2.9739
24 May	11 11/16	11 7/16	11 3/16	11 1/16	10.26	10.54	10.09	4.12	91.8	1.7315	2.9574
31 May	11 1/2	11 5/16	11 3/32	10 31/32	10.31	10.56	10.09	4.13	91.2	1.7030	2.9530
28 June	11 17/32	11 5/16	11 1/32	10 7/8	10.47	10.67	10.18	4.24	89.6	1.6215	2.9382

(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).

were assisted in this by large money-market shortages (Table F). Clear statements of the authorities' anti-inflationary intent, the Bank's 2.30 pm lending for 14 days (10 May) and the dwindling prospect of a summer election following the government's defeat in the Monmouth by-election (16 May) dampened the most bullish expectations of declining interest rates.

The move down to 11½%, when it came on 24 May, was received rather less well by the market than the earlier interest rate reductions this year. Soon afterwards sterling developed a more nervous tone as gloomy economic forecasts from the CBI and the NIESR combined with existing concerns that political pressures might induce interest rates to be cut further and faster than warranted.

May proved to be another testing month for the gilt-edged market. A cut in the price of the 9% Treasury 2008 tap, which had been overhanging the market for nearly a month, allowed it to be exhausted. Two £100 million tranchettes of 2½% Index-Linked 2001 and 2011 were issued on 10 May. The conventional gilt-edged market drifted downwards for much of the month, depressed by the same factors as previously, as well as more recent nervousness about the exchange rate. In mid-month, the Monmouth result (17 May) in combination with the worse than expected RPI data caused the market to fall sharply, a move compounded by a fall in the US bond market. There was, however, some improvement later in the month, and the 2001 tap sold out on 22 May, although the 2011 stock was to remain on tap beyond the end of the quarter.

From mid to late June, sterling's relative weakness within the ERM continued, and it fell to seventh position in the grid. It then fell further as a sharp depreciation of the peseta on 17 June, apparently reflecting market speculation of an imminent Spanish move to the narrow band, removed some technical support as the effective lower limit of sterling against the deutschemark fell. Soon afterwards, sterling touched its low of the quarter against the dollar, at $1.6065 (18 June) as the market became more optimistic about the speed of US recovery. Although the sterling/deutschemark rate also touched its lows of the quarter in this period, dipping below DM 2.92 on several occasions between 17 and 20 June, sterling remained well above its effective lower limit throughout, in an orderly market.

This weakening of sterling coincided and was associated with developing expectations of a further ½ percentage point cut to 11%, following a relatively calm two weeks in the money market after the previous rate cut. Publication of a CBI report on lower wage settlements on 10 June triggered a strongly bullish mood and, with

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

	1991			
	Mar.	Apr.	May	June
Average daily figures				
Influences (excluding maturing assistance)	+ 80	+ 90	+60	+40
Maturing assistance (a)	-1,250	-880	-1,170	-1,080
Surplus (+)/shortage (-) before daily operations	-1,170	-790	-1,110	-1,040
End-period levels				
Stock of assistance	7,620	5,810	6,240	6,890
Sterling Treasury bills outstanding (b)	10,280	10,450	12,270	13,620

(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.

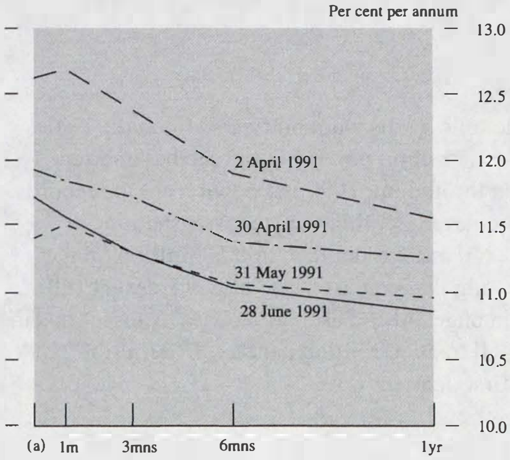
Table G
Official transactions in gilt-edged stocks
£ billions: *not seasonally adjusted*

	1990			1991	
	Q2	Q3	Q4	Q1	Q2
Gross official sales (+) (a)	+0.2	+0.1	+0.5	+2.0	+3.3
less					
Redemptions and net official purchases of stock within a year of maturity	-1.2	-1.0	-2.0	-1.7	-0.8
Equals net official sales (b)	-0.9	-0.9	-1.4	+0.3	+2.5
of which, net purchases by:					
Banks (b)	*-0.1*	*-0.3*	*+0.7*	*-0.8*	*+0.2*
Building societies	*-0.2*	*-0.2*	*+0.3*	*-0.9*	*-0.2*
Overseas sector	*-0.9*	*-0.5*	*-1.5*	*+1.5*	*+2.1*
M4 private sector	*+0.3*	*+0.1*	*-0.9*	*+0.5*	*+0.5*

(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.

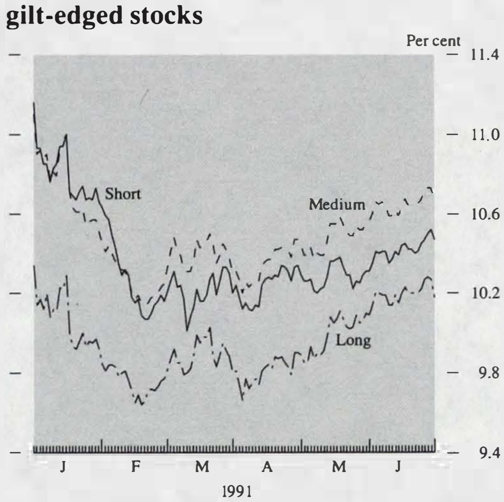
(b) Apart from transactions under purchase and resale agreements.

Sterling interbank rates



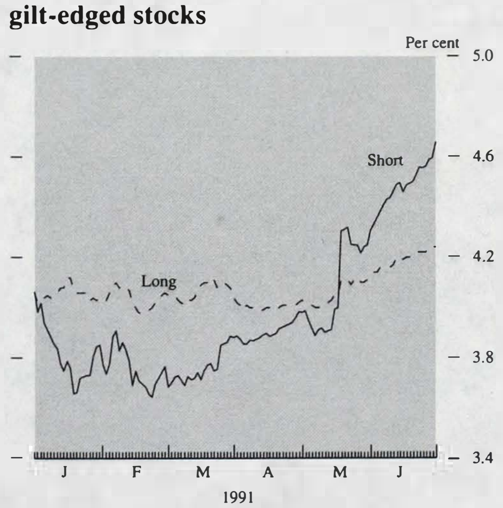
(a) For one week.

Yields on representative conventional gilt-edged stocks



Representative stocks: short - 12% Treasury 1995; medium - 12% Exchequer 1998; long - 9% Treasury 2008.

Yields on representative index-linked gilt-edged stocks



Representative stocks: short - 2% Treasury Index-linked 1994; long - 2 1/2% Treasury Index-Linked 2024.

three-month rates down to 11¹⁄₁₆% the following morning, the Bank signalled that there was no immediate prospect of a cut by tightening its bill operations and lending at 11½% at 2.30 pm for 9 days, followed three days later by lending at 2.30 pm for 10 days. These operations, in combination with the evident weakening of sterling, dented the market's earliest expectations. By the end of June the mood in the money market had adjusted to expect a move to 11% some time over the next month, sterling's position in the ERM permitting.

By the end of the month, however, sterling had risen from its lows, supported by the firmer dollar and the government's improved standing in opinion polls, and remained fairly steady, ranging around DM 2.93, despite rumours of an imminent increase in German interest rates. After the Bundesbank decided not to raise rates and with increasing tension in Yugoslavia, sterling moved up slightly against the weaker deutschemark, along with the dollar, to end the quarter at just below DM 2.94, down around 1% from end-March, compared with a fall of around 7% against the dollar over the same period.

For the most part, the gilt-edged market drifted lower during June, to end the quarter with long yields some 40 basis points higher and short yields up around 25 basis points on the beginning of the quarter. A firmer market allowed the issue of a £400 million packet of tranchettes on 10 June, which met with immediate demand —the 2007 stock selling out on the following day. The announcement and choice of stock for the second auction of the year was well received, and the £1.5 billion of 10% Treasury Stock 2001 on offer proved to be covered 2.2 times, keeping the authorities well ahead with the funding programme.

Official reserves

The level of official reserves rose by around $2 billion between the first and second quarters, to $44.3 billion. Foreign currency contributions to the cost of Gulf operations contributed a total of $1.3 billion to underlying reserves in April and June, and proceeds from the Scottish electricity privatisation added a further $0.3 billion in June. See Table H.

Ecu bond and Ecu Treasury bills

The UK government ECU 2.75 billion 9.125% 2001 bond issued on 13 February maintained its position as the lowest yielding issue in the 10-year sector of the market during the second quarter. It was the most actively traded Ecu issue in the international settlement systems.

There were ECU 3.6 billion of Treasury bills outstanding at the end of the second quarter of 1991, unchanged from the previous quarter. The Bank allotted ECU 300 million of one-month and three-month bills and ECU 400 million of six-month bills at each of the tenders held on 9 April, 14 May and 11 June; tenders continue to be substantially oversubscribed, around 2 to 3 times at each maturity. The margin of the average yield accepted at tender below the bid-rate for Ecu-denominated bank deposits widened for all maturities during the quarter to around 25 basis points for one-month bills and 35–45 basis points for three-month and six-month bills. Total turnover rose slightly to ECU 13.8 billion in

Table H
Changes in UK official reserves
$ millions

	1991 Mar.	Apr.	May	June
Changes in reserves	**+ 532**	**+1,333**	**+120**	**+553**
of which:				
Net borrowing(+)/payment (-) of public debt	- 8	- 25	- 15	- 40
Valuation change on rollover of EMCF swap	—	+ 288	—	—
Underlying changes in reserves	+ 540	+1,070	+135	+593
Level of reserves (end of period)	**42,326** (a)	**43,591**	**43,711**	**44,264**

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

the second quarter of 1991, from ECU 13.4 billion in the previous quarter.

Bill turnover

Transactions in eligible bills by discount houses[1][2] (including sales to the Bank) averaged £1.8 billion per day in the second quarter, similar to the level seen throughout 1990 but down from the record £2.0 billion in the first quarter. Within the total, transactions in Treasury bills rose to £240 million per day, up £50 million on the previous quarter, reflecting the increased size of the Treasury bill tender. (See Table 3 on page 348.) Discount houses' transactions in certificates of deposit fell to £650 million per day, £70 million below the level in the first quarter.

(1) Figures for discount houses cover only those money-market dealing counterparties which are authorised under the Banking Act 1987.
(2) See the Bank's monthly press notice, *Bill Turnover Statistics*.