Operation of monetary policy

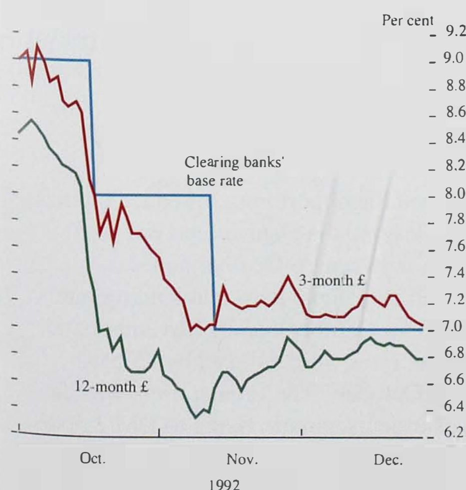
This article covers the period from October to December 1992.

Introduction

Following sterling's suspension from the ERM, the objective of monetary policy remained the pursuit of price stability as a basis for sustainable growth, but a new framework for policy was required to replace that which had been provided by ERM membership. Under the new framework set out by the Chancellor, a wide range of indicators is to be considered in judging inflationary trends and whether the long-run target for underlying inflation, of 2% or less, is at risk. Specifically, during the remainder of this parliament, a target range of 1%–4% has been set for underlying inflation, as measured by the 12-month growth of retail prices excluding mortgage interest payments, with the aim of being in the lower part of that range by the end of the current parliament. The target range for M0 has been retained and a monitoring range for M4 adopted. The exchange rate also remains of major concern, given its importance in determining prices.

Sterling's depreciation and the one percentage point reduction in base rates effected on 22 September had resulted in a significant easing of monetary conditions by the beginning of October. But sterling's suspension from the ERM and the prospect of a rise in official interest rates to 15%, however fleeting, had dealt a considerable blow to consumer and business confidence. Confidence was further weakened during the fourth quarter by large-scale redundancies and a renewed fall in house prices following the end of the stamp duty holiday. At the same time, the extent of the deflationary momentum in the economy prior to sterling's suspension became evident as data for the third quarter were released. It was therefore judged likely that the weakness of demand in the United Kingdom would dampen the effect on domestic prices of sterling's depreciation. Accordingly, the authorities were able to effect a further one percentage point reduction in the level of short-term interest rates in October without jeopardising the inflation target.

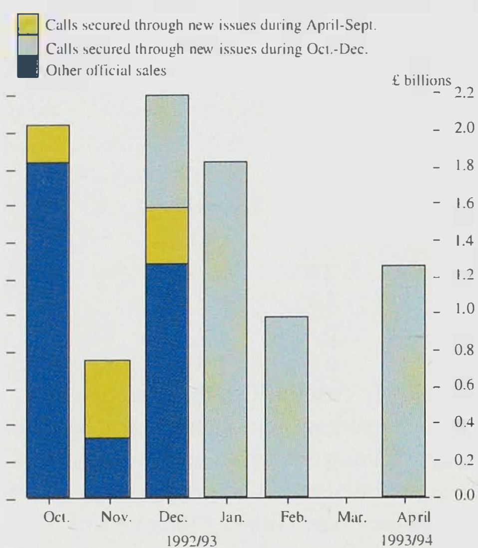
Short-term interest rates(a)



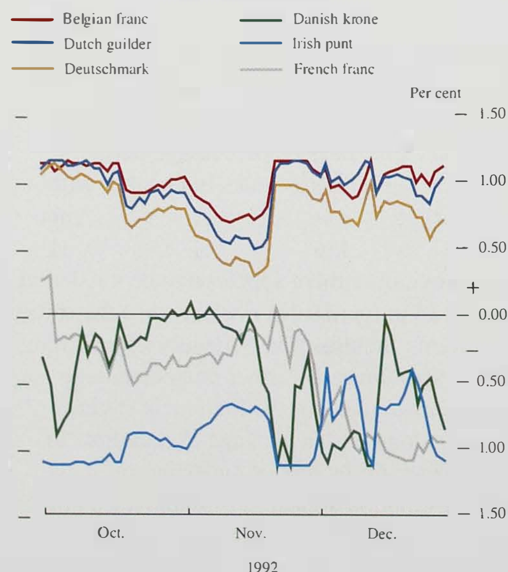
(a) Middle-market rates at the close of business in the London interbank market.

In late October and early November there appeared to be a risk that even the modest upward trend in retail sales evident since the spring might falter. With the Autumn Statement in November confirming the tight control of public expenditure, a further one percentage point reduction in rates was announced in the Statement (to be effective the following day) along with a package of measures to give temporary stimulus to specific sectors of the economy. Subsequently the economic situation appeared to stabilise and there was a degree of recovery in consumer confidence and increased optimism about export orders. There were also encouraging reports of increased high-street spending and car sales in December, apparently corroborated by the buoyancy of notes and coin in circulation. Although it was unclear whether these reports indicated

Gross official sales of gilt-edged stocks



Narrow band positions(a)



(a) Relative to the centre of the narrow band.

that a wider and sustainable recovery in consumer spending was under way, they presented a case, when combined with the rapid pick-up in import and producers' input prices, for pausing to await further evidence on the economic and monetary situation since September.

Following the heavy official purchases of sterling prior to its suspension from the ERM, the public sector at the end of September was hugely overfunded, although this was expected to unwind over the rest of the financial year. Given the residual funding requirement for 1992/93 and the prospective requirement for next year, it was felt desirable to maintain the momentum of funding; but in order to avoid adding further pressure to the money market, gilt payments were spread forward as far as April.

International financial developments

The fourth quarter was marked by the US dollar's recovery and by continued tensions in and around the ERM. The dollar began to strengthen against major currencies in October, supported by the growing belief that the US-German interest rate differential would at last begin to narrow. This reflected the view that sustainable recovery had begun in the United States while the extent of weakness in the German economy had become more apparent. German market interest rates had fallen in September, and expectations of a downward trend in official rates were increased by the 15 basis points fall in the German repo rate to 8.75% on 21 October, following which the dollar decisively breached DM 1.50. The expected timing of further reductions in German interest rates was nevertheless the subject of changing views in the market. In the event, the Bundesbank's concerns about inflationary pressures within Germany meant that official German interest rates remained unchanged. Meanwhile, the market thought that interest rates in some other ERM countries were too high in real terms to be appropriate or sustainable at a time of slowing domestic activity. Although all narrow band parities were successfully maintained over the period, the Irish punt was subsequently devalued by 10% at the end of January.

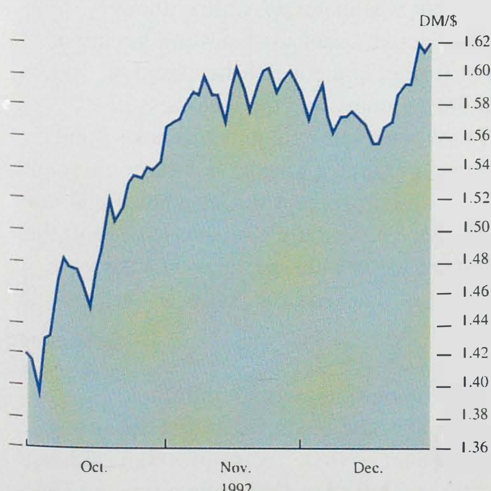
The ERM narrow band remained at, or close to, full stretch during the first three weeks of October, with the punt coming under particular pressure. Tensions eased, however, as the deutschmark weakened against the dollar and yen. Governor Clinton's victory in the US presidential election on 3 November lent further support to the dollar as the market believed that an expansionary fiscal package was likely which would not only foster recovery but also make less likely any further easing of interest rates. Further economic data also encouraged a more optimistic view of growth prospects.

Several European countries took the opportunity to reduce interest rates from exceptionally high levels: the Danish repo rate was lowered from 11.4% to 10.2% between 26 October and 10 November, Sweden reduced its official marginal lending rate from 16.5% to 11.5% between 14 October and 10 November and the Dutch and Belgian discount rates were reduced by 25 basis points to 7.75% on 21 and 22 October. The French franc was the main beneficiary of the weaker deutschmark, rising to DM 3.3676 on 17 November and allowing the Banque de France to cut its 5–10 day repo rate from 13% to 10% between 29 October and 12 November.

After a period of sustained pressure, however, the Swedish authorities ceased to maintain the krona's Ecu peg on 19 November, after an increase in the official marginal overnight rate to 20%. The krona fell by about 10% against the Ecu that day, following which the Norwegian and Danish currencies came under immediate selling pressure, causing market interest rates to rise sharply: indeed money-market rates rose throughout Europe and spreads between bid and offer rates widened. French call money rates rose from 9.31% on 19 November to 9.75% the next day, while Portuguese rates rose from 14.60% to 28%. The punt, which was also at the bottom of the narrow band with the Danish krone, traded nervously prior to the general election to be held on 25 November. Tension abated only temporarily following the 6% downward realignment of the peseta and escudo on 23 November, and the Danish krone and Irish punt fell to their limit rates, in part reflecting disappointing German money supply data published on 24 November which were thought to rule out an early cut in German interest rates. The official Irish overnight lending rate was raised to 100% on 30 November.

The link between the Norwegian krone and its Ecu peg was suspended on 10 December and official overnight interest rates were cut from 16% to 11%. Attention immediately focused on the Danish krone and on the French franc, which was affected by uncertainty about the elections to be held in March. Fears of a realignment therefore emerged before the EC Summit in Edinburgh on 12–13 December. After the Summit, in the absence of a realignment, pressure lifted from the punt and also from the krone as the Summit resolved some of the difficulties of Danish ratification of the Maastricht Treaty. The National Bank of Denmark was able to cut its CD rate by one percentage point to 14% on 14 December and Ireland lowered its overnight assistance rate to 16% on 15 December. But the French franc remained under pressure, touching DM 3.42 at times despite overt intervention, and money-market rates backed up to over 10% on 16 December. Pressure eased in the week of Christmas, however, helped by comments by the Bundesbank President that long-term German interest rates could eventually fall to 6% and by the release of better than expected German money supply data for November. With tension in the ERM easing, the Irish overnight lending rate was reduced to 14% on 24 December and the Danish official CD and repo rates to 13% and 14% respectively on 28 December.

Deutschmark/dollar exchange rate



The dollar met resistance at around DM 1.60 in December, and failed to breach that level decisively during much of the month despite benefiting on a number of occasions from signs of stronger than expected economic recovery. However, as the deutschmark weakened the dollar finally broke through DM 1.60 late in December, gaining further strength from 'safe haven' buying associated with tensions in Iraq and Bosnia-Herzegovina.

Official operations in financial markets

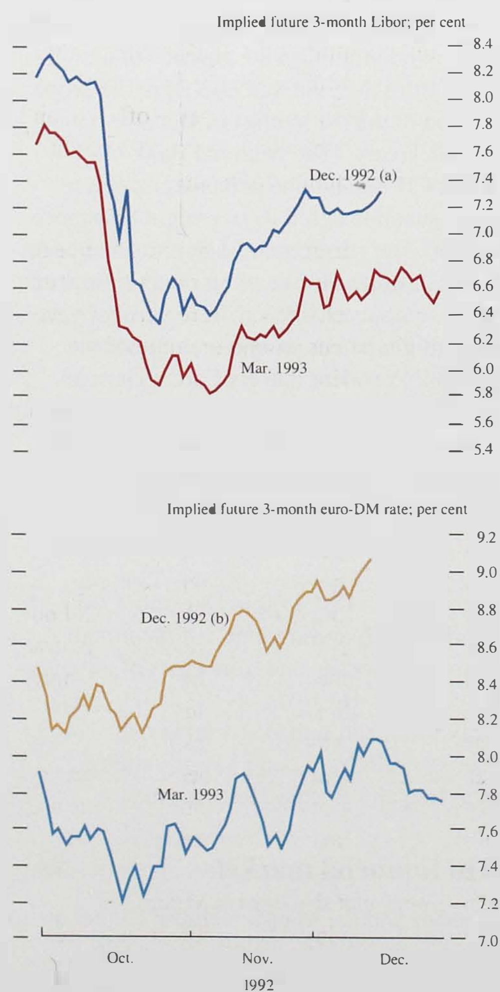
Between the end of September and the Mansion House Dinner at the end of October there was considerable uncertainty in the markets and among commentators about the future path of the economy and of policy. Without the framework of the ERM as a guide to official interest-rate movements, a wide range of expectations existed in the markets as to the future path of interest rates. These focused on the Governor's warning at the end of

September that the exchange rate could not be ignored in setting policy and the Chancellor's continued emphasis on inflation in his letter to and subsequent appearance before the Treasury and Civil Service Committee; but they also reflected uncertainty over whether activity would be given immediate priority, within the constraint imposed by the inflation target.

Early in October there was little downward pressure on market interest rates as sterling's fall to DM 2.3709 on 5 October was taken to rule out a rate cut during the Conservative Party Conference and even prompted some market talk of a rise in interest rates. Some further easing of interest rates was nevertheless generally expected before the end of the year.

As sterling recovered, however, and steadied at around DM 2.50, and as pessimism about the economy deepened—in particular in response to announcements of redundancies—so pressure for a rate cut grew. The Bank tightened its money-market operations in order to disabuse the most bullish expectations, which were of a cut either with or before an easing in German rates following the Bundesbank Council meeting on 15 October. No hint of a cut was detected in the Chancellor's TCSC appearance on 12 October. But on 14 October a report that ministers were considering a substantial rate cut, possibly with the Autumn Statement, caused market rates to fall again and very few bills were offered for outright sale to the Bank in the early rounds of money-market operations. The absence of a repo at the 2 pm round, with more than £1,300 million of the shortage remaining was, however, taken as a signal that the Bank intended market rates to firm. And the absence of any move on German rates following the Bundesbank Council meeting on 15 October further reduced expectations of a cut.

Three-month sterling and euro-deutschmark futures contracts



(a) The December contract expired on 16 December.
(b) The December contract expired on 14 December.

The timing of the announcement, at midday on 16 October, that the Bank would lend to discount houses at 8% at 2.30 pm that day was generally unexpected. The cut was made possible without jeopardising the inflation objective because of sterling's relative stability and in the light of further evidence of the extent of deflationary pressures in the economy and the weakness of confidence. Period interbank rates fell by around 50 basis points immediately after the cut and continued to ease as further cuts came to be expected even without any movement in German official rates. Hopes of a German easing were nevertheless raised by a report that the Bundesbank wished to see lower rates by the end of the year; this was taken to imply that UK rates could be reduced further with less risk to the exchange rate.

The announcement that the Bundesbank would return to variable-rate repos and official acknowledgement that the strong growth of M3 was partly because of the effects of foreign exchange intervention generated stronger downward pressure on rates. The downward pressure increased after the Prime Minister emphasised the priority which could be given to growth and employment without danger to the inflation objective. Some came to expect a further cut of two percentage points in the belief that sterling had already discounted such an easing. Strong expectations of a rate cut resulted in few bills being offered for outright sale to the Bank and bill rates were such that the Bank's established repo rates were not very attractive. With shortages therefore proving intractable, there was huge pressure on overnight interbank rates, which reached 30% on 20 October and 105% on 23 October. The fall of up to 15 basis

Table A
Interest rates, gilt yields and exchange rates; selected dates (a)

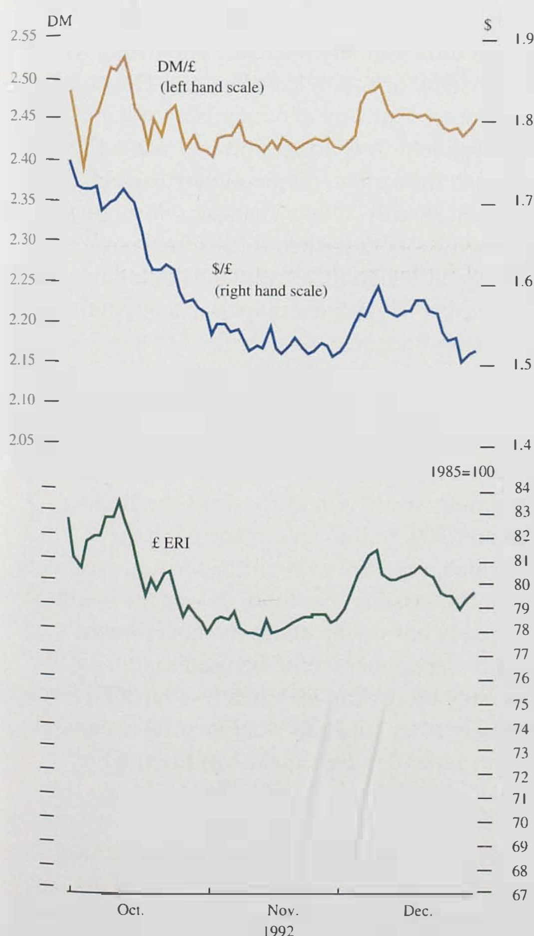
Date, 1992	Interest rates (per cent per annum)					Gilt yields (b) (per cent per annum)				Exchange rates		
	Sterling interbank rates (c)				Short sterling future (d)	Conventionals			Index-Linked			
	Overnight	1 month	3 months	12 months	3 months	Short	Medium	Long	Long	ERI	$/£	DM/£
1 October	9 1/4	9 3/16	9	8 7/16	8.15	8.49	9.04	9.35	4.06	82.7	1.7505	2.4840
5 October	9 3/8	9 11/32	9 3/32	8 17/32	8.31	8.60	9.26	9.51	4.15	80.6	1.7160	2.3930
13 October	9 5/16	8 7/8	8 21/32	8 3/16	8.10	8.32	8.87	9.13	4.06	83.4	1.7155	2.5281
28 October	9 7/8	8 11/16	7 23/32	6 11/16	6.33	7.12	8.15	8.66	3.83	79.0	1.5790	2.4317
2 November	8 1/4	8 3/32	7 17/32	6 27/32	6.60	7.23	8.28	8.73	3.80	77.9	1.5363	2.4063
9 November	9 3/8	7 3/8	7	6 13/32	6.38	6.97	8.05	8.53	3.76	78.2	1.5298	2.4255
12 November	7 1/2	7 9/32	7 1/32	6 3/8	6.60	7.06	8.06	8.52	3.78	77.8	1.5205	2.4126
27 November	7 3/16	7 1/4	7 9/32	6 3/4	7.21	7.46	8.44	8.82	3.94	78.4	1.5105	2.4186
8 December	7 1/16	7 1/8	7 1/8	6 27/32	6.61	7.51	8.39	8.68	4.02	81.5	1.5960	2.4942
31 December	6 15/16	7 1/32	7 1/32	6 25/32	6.58	7.36	8.25	8.55	3.91	79.6	1.5150	2.4520

(a) Close of business rates in London.
(b) Gross redemption yield. Representative stocks: short—10 1/2% Exchequer 1997; medium—9 3/4% Treasury 2002; long—9% Treasury 2008; index-linked—2 1/2% Index-Linked Treasury 2024 (real yield assuming 5% inflation).
(c) Middle-market rates.
(d) Implied future rate: until 30 November, the December contract, thereafter the March contract.

points in the German repo rate on 21 October was, however, smaller than anticipated and expectations receded.

Nevertheless, although no move was generally expected until the Autumn Statement on 12 November there were some hopes of a rate cut day by day. Consequently, period rates tended to ease early each morning but then to firm after it became clear through official operations that rates would not be cut that day. Although the Bank might have wished to be accommodating in its market operations because of the large size of its bill portfolio and the associated larger daily shortages, few bills were in any case being offered, and the Bank was constrained not to operate in any way which might have fuelled the already strong expectations of a cut.

Sterling exchange rates(a)



(a) At close of business in London.

The most bullish expectations were disappointed by the absence of a cut around the time of the Mansion House Dinner on 29 October and the tone of the Chancellor's speech itself. There was, however, some expectation that rates might be cut around the time of the parliamentary vote on the paving motion for the European Communities (Amendment) Bill. Sterling's fall below DM 2.40 on 2 November gave pause for thought, but did not destroy market expectations of lower rates; and in any case sterling recovered well.

Technical pressures on money-market rates abated as the Bank's bill holdings fell and daily shortages became smaller, allowing 3-month interbank rates to ease, to around 7¼%. The Bank did not seek to resist this movement in market rates but it remained neutral in its operations as the Autumn Statement approached. Very short rates tended to rise, despite smaller shortages, because of the market's reluctance to part with bills amid the widespread expectation that a rate cut was imminent. This expectation was encouraged by press reports that a cut of two percentage points was being considered. But, as sterling weakened, expectations were generally of a cut of one percentage point and so the announcement in the Statement on 12 November that the Bank's Minimum Lending Rate would be 7% the following day caused no surprise.

The Autumn Statement was generally well received in the money market. But the extent of the easing by then effected and the cautious tone of the Statement encouraged the view that there would be no further reduction in rates at least until the New Year. Market

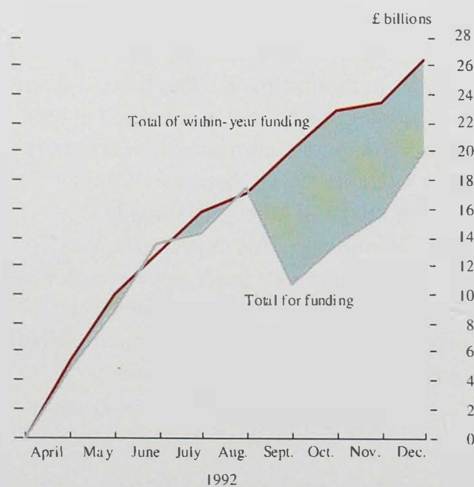
rates therefore firmed and the Bank was able to return to a more normal operating stance.

The temporary facilities, which were first extended to institutions on 18 September (to reduce the drain on private sector bill holdings which would otherwise have resulted from the settlement of official foreign exchange intervention) matured on 30 November. These facilities were renewed until 1 February and extended to a further five building societies. However, the amount renewed fell short of the amount maturing by £1.15 billion and this contributed to a record money-market shortage of £4 billion on 30 November. In response the Bank once again invited offers of bills in all four maturity bands, for the first time since 16 September, including, exceptionally, eligible bank bills within seven days of acceptance. Although the shortage was larger than expected, it was relatively easily relieved.

The pressure on interbank rates which usually occurs towards the end of the year because of the renewal of maturing deposits was most evident this year on one and two-month rates in November with relatively little pressure in December. And bills were offered reasonably readily to the Bank during December, ensuring easier short rates on the whole than had been feared.

During December period rates changed by only a little, unmoved by sterling's rally early in the month and with the path of UK rates thought to be largely independent of developments in Germany. The notes and coin data for November were taken as apparently corroborating the upward trend in retail sales and, if anything, pushed back the expected timing of any rate cut. The strong rise in producers' input prices evident in data released in mid-December caused a little further firming. Calls by two members of the Treasury's panel of independent forecasters for base rates of 5% and for further depreciation had little effect on the money market, although sterling weakened sharply. New Year interviews by the Chancellor and Prime Minister both pushed further back expectations of any easing, although there were the beginnings of some expectation of an easing of rates to complement any tightening of fiscal policy in the Spring Budget.

Cumulative funding position



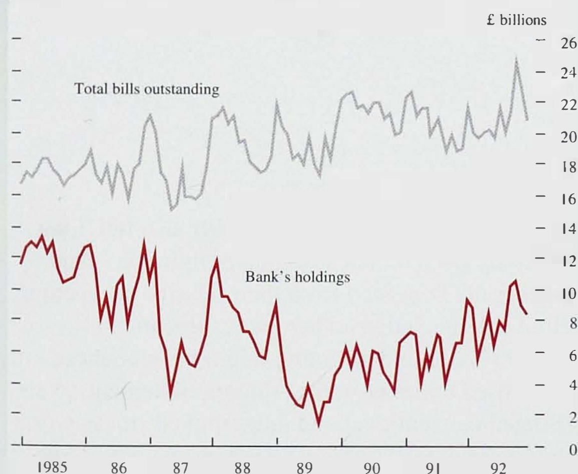
By September, six months into the financial year, a within-year overfund of some £10 billion had been achieved, with a significant contribution from the underlying fall in foreign exchange reserves which occurred in September itself. On the basis of the Budget forecast, a PSBR of around £10 billion was expected in the following six months which, together with gilt maturities, was more than sufficient to absorb the existing overfund. It was the intention that further foreign currency borrowing under the government's programme announced in September would be used to repay short-term foreign currency borrowing and therefore have no impact on the funding position. Further gilt sales were therefore required for the current financial year and in anticipation of the funding requirement for 1993/94.

The market was receptive to further tap sales in October as both conventional and index-linked sectors rallied. In the index-linked market, short real yields fell sharply as nominal yields fell and the market perceived that economic policy was being reoriented towards growth. Longer real yields also fell, although by much less, no doubt affected in some degree by the more uncertain outlook for

The eligible bill market

The extent of overfunding which occurred in September because of the underlying fall in foreign exchange reserves caused a sudden and heavy drain on the money market and a huge rise in the stock of assistance. Some of the pressure on private sector bill holdings was relieved by the provision of liquidity through temporary facilities but the Bank's holdings of eligible bank bills still rose sharply, to a peak on 23 October of £12.3 billion (see Chart 1), or around half of all such bills in issue. This compares with the peak of the 'bill mountain' of £14.3 billion during February 1985, when overfunding of the PSBR was being actively used in the pursuit of broad money targets.

Chart 1
The eligible bank bill market(a)

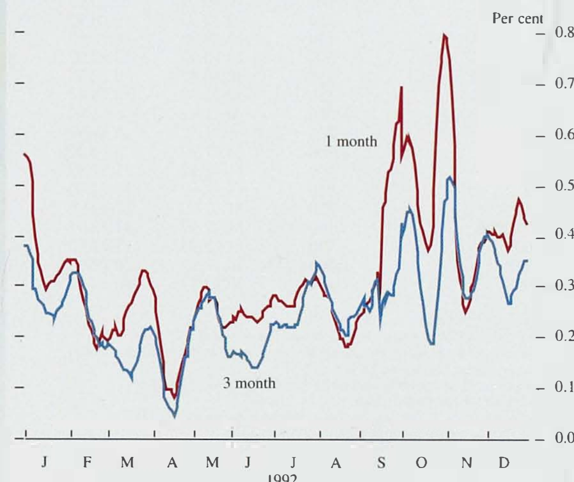


(a) Data refer to last working day of each month.

The Bank's bill holdings fell after 1985, to a low point in 1989, but have tended to rise since then. The market as a whole has tended to grow modestly throughout but not as fast as other forms of lending to companies and other financial institutions. (The data underestimate by a small amount the size of the market in so far as banks' holdings of their own acceptances are excluded.)

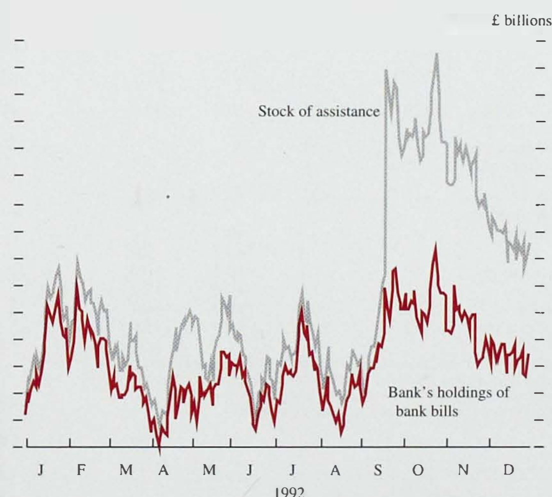
Although the market has shown little overall growth, Chart 1 shows that a sharp increase in the Bank's holdings may cause the market to expand temporarily. When the Bank's holdings increase, the quantity of bills in private sector hands which remains available to be sold to the Bank falls. As a result, the price of bills may be bid up so that bill yields fall, at least relative to interbank rates, making it attractive for borrowers to draw bills rather than borrow on interbank-related terms. The market therefore tends to expand to accommodate increased demand. In the second half of October there was additional upward pressure on very short interbank rates because of very tight money-market conditions caused by banks' reluctance to sell bills to the Bank when a rate cut was expected imminently. This upward pressure fed down the yield curve, so offsetting some of the downward effect on period rates of expectations of a rate cut. Chart 2 shows the spread between interbank rates and the yield on eligible bank bills during 1992. Apart from a trough in April 1992, the spread in the first half of 1992 was about 25 basis points at one month's maturity and 20 basis points at three months' maturity. In September and October, the spreads widened considerably as interbank yields rose by more than bill yields: the one-month spread reached a maximum width of

Chart 2
Yield differential(a)



(a) Libid less eligible bank bill bid rate (10-day moving average).

Chart 3
Money-market assistance(a)



(a) Bank of England holdings of eligible bank and local authority bills outright and on a repurchase basis; its holdings of gilt-edged stocks, sterling Treasury bills, export and shipbuilding credit-related paper on a repurchase basis, and market advances.

190 basis points in the turbulent money-market conditions around 16 September; while the October peak was concentrated on 23 and 26 October, when expectations of a rate cut were at their strongest, the Bank's stock of assistance was at its greatest and the daily money-market shortages were consequently at their largest. The spread at one month's maturity was greater than at three months' because of the greater pressure on one-month rates: cheaper financing, as well as expectations of an imminent cut, meant that the bulk of bills drawn were of one month's maturity. However, when these bills matured in November, not all were renewed since the cost advantage had by then been eroded. The fall in the Bank's bill holdings (Chart 3) which resulted from a within-month underfund, and the associated smaller shortages, reduced the demand for bills, while pressure on interbank rates eased, especially as expectations of rate cuts diminished after the Autumn Statement.

Table B
Issues of gilt-edged stock

Stock	Amount issued (£ millions)	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
8¾% Treasury 1997 'E'	800	9.10.92	9.10.92	To Bank	102.0000	Partly paid (b)	8.23	8.18	14.10.92
2½% Index-Linked 2001	100	16.10.92	16.10.92	To Bank	155.6250	In full	3.84 (c)	3.82 (c)	19.10.92
2% Index-Linked 2006	150	16.10.92	16.10.92	To Bank	155.5000	In full	3.92 (c)	3.91 (c)	20.10.92
2½% Index-Linked 2016	150	16.10.92	16.10.92	To Bank	129.0000	In full	3.95 (c)	3.94 (c)	20.10.92
7¼% Treasury 1998	1,000	23.10.92	23.10.92	To Bank	99.5000	Partly paid (d)	7.37	7.19	27.10.92
2½% Index-Linked 2009	150	30.10.92	30.10.92	To Bank	147.7500	In full	3.66 (c)	3.88 (c)	23.12.92
2½% Index-Linked 2024	150	30.10.92	30.10.92	To Bank	106.5000	In full	3.77 (c)	3.96 (c)	23.12.92
8% Treasury 2009 'A'	1,000	6.11.92	6.11.92	To Bank	94.7500	Partly paid (e)	8.60	8.55	11.11.92
8% Treasury 2009 'A'	200	6.11.92	6.11.92	To CRND					
8% Treasury 2003	2,500	24.11.92	3.12.92	Auction	96.8125 (f)	Partly paid (g)	8.48 (h)	8.48	3.12.92
8% Treasury 2002–2006	100	11.12.92	11.12.92	To Bank	95.8750	In full	8.51	8.51	22.12.92
9% Treasury 2008	250	11.12.92	11.12.92	To Bank	103.0625	In full	8.64	8.61	23.12.92
9% Treasury 2012	350	11.12.92	11.12.92	To Bank	102.2500	In full	8.75	8.72	29.12.92
8% Treasury 2002–2006	100	11.12.92	11.12.92	To CRND					
8½% Treasury 2007	100	11.12.92	11.12.92	To CRND					
7¼% Treasury 1998	1,000	30.12.92	30.12.92	To Bank	100.4063	Partly paid (i)	7.15		21. 1.93
7¼% Treasury 1998	100	30.12.92	30.12.92	To CRND					

(a) Gross redemption yield, per cent.
(b) £25% payable on issue, £35% payable on 7.12.92 and balance on 4.1.93.
(c) Real yield, calculated on the basis of 5% annual rate of increase in the retail price index.
(d) £25% payable on issue and balance on 28.1.93.
(e) £25% payable on issue, £35% payable on 14.12.92 and balance on 8.2.93.
(f) Lowest accepted price for competitive bids.
(g) £21.8125% payable on issue, £25% payable on 15.2.93 and balance on 5.4.93.
(h) At lowest accepted price for competitive bids.
(i) £25.90625% payable on issue and balance on 28.1.93.

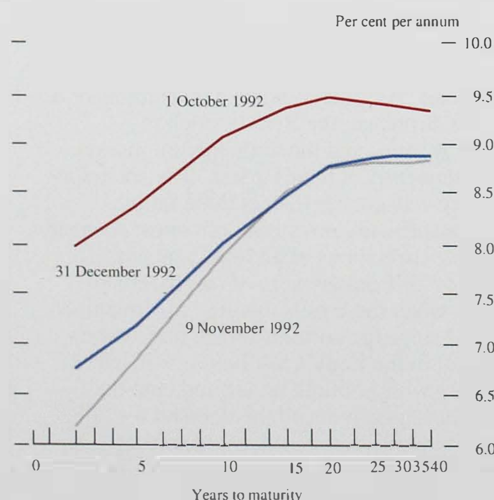
Table C
Official transactions in gilt-edged stocks

£ billions: *not seasonally adjusted*

	1992/93 Apr.-Sept.	Oct.	Nov.	Dec.
Gross official sales (+)(a)	+20.6	+2.0	+0.7	+2.2
Redemptions and net official purchases of stock within a year of maturity(-)	-5.4	—	—	-0.1
Net official sales (b)	+15.2	+2.0	+0.7	+2.1
of which, net purchases by:				
Non-funding sector	+2.3	+0.4	+0.2	—
Banks (b)	+1.7	+0.4	+0.1	-0.4
Building societies (b)	+0.7	-0.1	+0.1	+0.4
Funding sector	+12.9	+1.6	+0.6	+2.1
Overseas sector	+0.3	-0.1	+0.3	+0.1
M4 private sector (b)	+12.7	+1.6	+0.3	+2.0

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

Time/yield curves of British government stocks(a)



(a) Calculated par gross redemption yields on British government stocks.

inflation. Medium and long conventional yields also fell, long yields having initially risen on fears of greater inflation. And sterling assets generally benefited from their relative cheapening following sterling's depreciation. There was some market expectation that a move to underfunding might be announced either at the Mansion House Dinner or in the Autumn Statement. New issues of short-dated conventional and index-linked stocks worth £2,500 million (nominal) (see Table B) were placed with Issue Department and largely sold in October. In order not to exacerbate already tight money-market conditions, the payments on the two tranches of conventional stock were spread as far as January, with only £25% payable on issue.

Linked to the issue of the new, current-coupon stock—7¼% Treasury 1998—was the early redemption of 9% Treasury 1992–96 which enabled the existing debt to be refinanced on more favourable terms. On 20 October the government issued a new DM 5 billion 5-year eurobond (plus DM 500 million retained by the Bank for use in sale and repurchase operations to assist the liquidity of the market in the bonds) on fine terms, at a yield of 10 basis points over the corresponding German 5-year government bond. This formed part of the foreign currency borrowing programme announced on 3 September. The proceeds were added to the foreign currency reserves to be used to refinance short-term debt incurred in September.

After the Mansion House Dinner, when neither an interest rate cut nor a move to underfunding were announced, attention shifted to the Autumn Statement. A tranche of long-dated stock was issued into the pre-Statement rally in conventionals, with a final payment at the beginning of February; this was exhausted the day before the Statement.

Medium and long yields rose sharply after the Statement as the PSBR forecast was revised from £28 billion to £37 billion (6¼% of GDP) for the current financial year, and to 7% of GDP in 1993/94, and as no move to underfunding was announced.

(a) Gross redemption yield.
(b) Real yield assuming 5% RPI inflation.

Given the market uncertainty around the time of the Mansion House Dinner and the Autumn Statement, and the reduction in the funding requirement in September, an auction was not held before mid-November. But the need to press ahead with gilt funding in view of the higher PSBR forecasts for this year and next made it desirable to hold another auction, provided that payments could be sufficiently spread. Accordingly, an auction of stock in the 2001–2005 maturity range was announced on 17 November, to be held on 2 December. Although details of the stock—£2,500 million of 8% Treasury 2003 —were well received, with the current coupon attractive and the spreading of payments into next financial year helping to reassure the market that good progress had been made with the current year's funding, yields rose significantly. In when-issued trading, demand was steady but unspectacular and the auction itself was covered 1.26 times. Bids were highly concentrated, however, and so there was no tail.

The number of non-competitive bids, amounting to £2.7 million, was the highest ever and reflected the extent of retail interest which had first become manifest in early November because of switching out of the 9% Treasury 1992–96 stock and the increased attraction of gilts at a time when savings rates were falling. Indeed the number of small gilt bargains trebled early in November, causing the gilt-edged market makers together with the Bank and the Stock Exchange to increase capacity to avoid a substantial backlog in the secondary market.

The government's ECU 10 billion foreign currency borrowing programme was completed on 30 November by the issue of a $3 billion 10-year eurobond which was also to be used to refinance short-term foreign currency debts incurred in September. It became the largest international dollar bond in issue and was issued on fine terms—22 basis points over comparable US Treasury securities.

The Bank was keen not to miss funding opportunities even if they were only for (fully-paid) tranchettes of stock, so a package of £700 million of tranchettes was issued to the Bank on 11 December into the rally which followed the release of better than expected RPI data for November. There was good demand for long-dated stocks by UK institutions ahead of the year-end and the last of the tranchettes was exhausted on 29 December. Index-linked gilts had continued to be weak during December, requiring some Bank support, but as the market appeared to steady the Bank was able to cut the prices of the two outstanding taps, which were then exhausted.

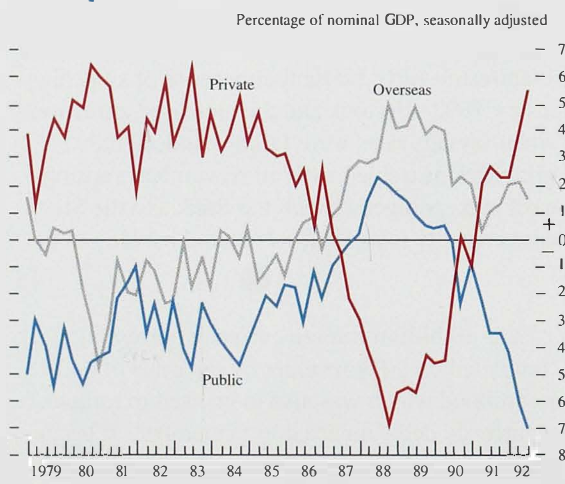
The final new issue placed with the Bank in December was a £1,000 million tranchette of 7¼% Treasury 1998, the probable 5-year benchmark for 1993. Given that there was only £1,000 million outstanding (from 23 October) this tranchette substantially increased its appeal as a benchmark. To be immediately fungible with the parent stock, the new stock was issued as a tranchette, thus becoming the largest ever. But, as the parent stock was still only partly-paid, the tranchette also had to be partly-paid and became the first ever partly-paid tranchette.

Recent sectoral financial behaviour[1]

Introduction

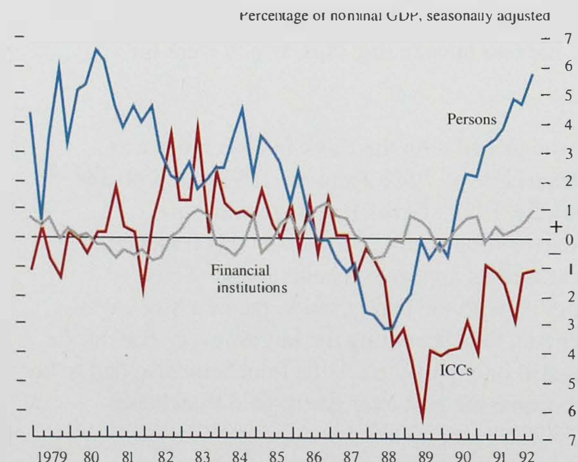
Movements in the sectoral financial balances are influenced by a common set of economic factors. The prolonged economic downturn, which began in 1990, continued to dominate these movements in 1992. The easing of monetary policy since last autumn is unlikely to have affected sectoral financial balances significantly in 1992 as a whole.

Chart 1
Net acquisition of financial assets



It is evident from Chart 1 that the private sector as a whole continued its adjustment, following large financial deficits in the late 1980s, by moving further into surplus in the first three quarters of 1992. Within the private sector, this adjustment was largely owing to persons (see Chart 2). The principal counterpart to this continued adjustment was a

Chart 2
Composition of private sector financial balance



substantial increase in the public sector financial deficit. The financial surplus of the overseas sector also increased in 1992, mirroring the widening of the current account deficit of the balance of payments.

Overseas and public sector

The financial surplus of the overseas sector increased in the first three quarters of 1992, following a substantial fall in 1991. Some of this was due to domestic expenditure on imports increasing by more than the value of exports. But the scale of the increase in 1992 was exaggerated by the ending of Gulf War contributions from overseas governments, which had narrowed the current account deficit during 1991.

The public sector financial balance moved further into deficit in the first three quarters of 1992. The prolonged economic downturn explains much of the increased deficit, since it has increased expenditure (particularly on unemployment and social security benefits) and, more significantly, reduced tax revenue.

The public sector borrowing requirement, excluding privatisation proceeds, provides a reliable proxy for the public sector financial deficit. Similarly, provisional current account data mirror the overseas sector financial surplus. Collectively, these data make it possible to draw an early inference, by residual, of the private sector financial balance in the fourth quarter. The PSBR excluding privatisation proceeds increased by £1.2 billion on a seasonally adjusted basis in the fourth quarter of 1992, while the overseas financial surplus increased by £1.5 billion, implying that the private sector financial surplus declined by £0.3 billion. This was reflected in the monetary data for the fourth quarter, where sterling net recourse by the private sector to banks and building societies increased by £0.3 billion. Net recourse by the private sector to banks and building societies in foreign currency, however, fell by a substantial £6.4 billion. This is likely to reflect shifts in the private sector's portfolio holdings, rather than changes in its financial balance.

Industrial and commercial companies

The financial deficit of industrial and commercial companies (ICCs) narrowed sharply from the unprecedented levels reached in the late 1980s, falling to only £1.7 billion in the second and third quarters of 1992. This may indicate that the deficit has now been reduced to sustainable levels and would be consistent with the buoyancy of certain items in ICCs' expenditure. Dividend payments, for example, continued to

(1) The data in this note are seasonally adjusted unless otherwise stated. In principle, a real side sectoral financial surplus should equal the sector's identified net accumulation of financial assets. Errors and omissions are captured in a residual balancing item. The sectoral balances referred to in this note are those measured from the real side, which are widely thought to be more accurate than the financial data.

rise in 1992, and capital expenditure, despite weak economic activity, also remained relatively buoyant, falling by only 3.2% in the first nine months of 1992. Sharper cuts in expenditure have been made elsewhere, notably on interest and tax payments, and on labour. These adjustments led to a rise in saving of just over 11% in 1992, and allowed the financial deficit to decline modestly (see Table A).

Table A
Industrial and commercial companies' financial transactions

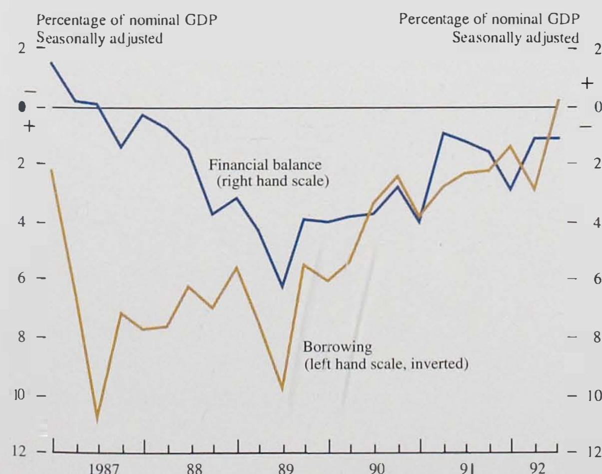
£ billions, *seasonally adjusted*
Increase in assets/decrease in liabilities +

	1989	1990	1991	1992 Q1	Q2	Q3	Q4
Financial surplus/deficit	-22.7	-19.9	-11.0	-4.3	-1.7	-1.7	..
of which:							
M4 borrowing	-29.1	-17.9	-1.4	0.8	-1.5	1.4	-1.3
M4 deposits(a)	8.4	2.9	6.5	0.3	1.2	-1.1	-0.9
Sterling capital issues (b)	-7.3	-5.4	-14.8	-2.2	-2.4	-1.9	-1.8
Others (c)	5.3	0.5	-1.3	-3.2	1.0	-0.1	..

.. not available.
(a) Including notes and coin.
(b) Not seasonally adjusted.
(c) Including balancing item.

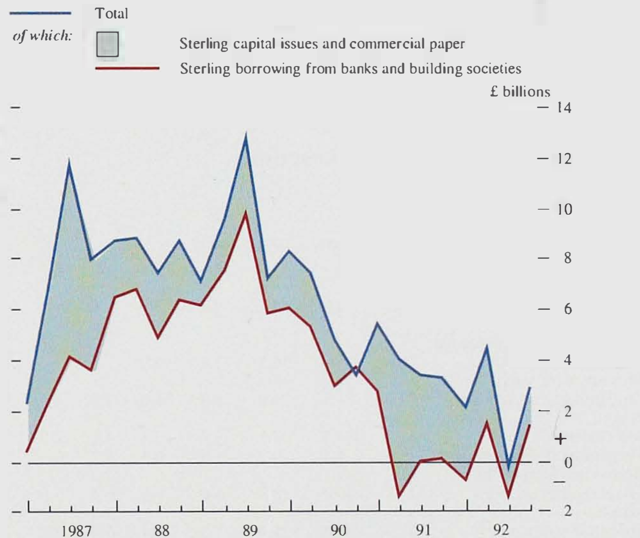
The reduced financing of the ICCs' deficit has been reflected principally in companies' curtailment of borrowing activities. Although the stock of lending by banks and building societies to ICCs rose in the fourth quarter of 1992, it has fallen in four of the past seven quarters. Repayments of this size are unprecedented and have been concentrated in ICCs' borrowings from the banks.(1) Sterling capital issues by companies are an alternative to bank finance. In 1992 these added around £2.1 billion per quarter to total lending to ICCs; this is substantially less than in 1991 when capital issues were running at around £3.7 billion per quarter. In 1992 as a whole, total sterling capital issues by ICCs fell by 44%, so that one of the features of the year was companies' unwillingness to increase their liabilities to the capital markets.

Chart 3
ICCs' total borrowing and financial behaviour



ICCs' adjustment to the deficit is evident on both sides of their balance sheet. Their sterling deposits with banks and building societies fell by £2.0 billion in the second half of 1992, more than offsetting a rise in the first half and producing a *decline* in the year as a whole of £0.4 billion. This compares with an increase in these deposits by

Chart 4
Borrowing by ICCs



£6.5 billion in 1991. Thus in 1992 as a whole, lending to ICCs increased by only £0.6 billion, while the level of their sterling deposits with banks and building societies declined.

With weak activity and demand continuing to depress income, there will have been little incentive for ICCs to raise discretionary expenditures significantly in the fourth quarter. Hence the balance of the evidence so far available suggests that ICCs' financial balance may be little changed, perhaps down marginally, on the third quarter, producing a small decline of perhaps £1 billion—£2 billion in 1992 as a whole.

Other financial institutions

Other financial institutions (OFIs) are a heterogeneous group, including life assurance and pension funds (LAPFs), unit and investment trusts, non-bank finance houses and leasing companies. Total funds available to them increased by £46.1 billion in the first three quarters of 1992, compared with an increase of £41.6 billion in the same period of 1991. This slight rise in the net inflow to the OFI sector reflects mainly an increase of £12.2 billion in new non-bank short-term and other borrowing, offset in part by an £8.7 billion fall in new bank lending to OFIs over this period. *Inter alia*, the shift towards short-term financing reflects changes in the shape of the yield curve over the period. A counterpart to the sharp rise in the PSBR over the last two years has been a marked shift in the distribution of OFIs' new investment away from UK and overseas company securities towards investment in British

(1) ICCs' borrowings from the building societies are in any case very small.

government securities. The share of UK plus overseas company securities in new investment[1] has fallen from 57.5% in the first three quarters of 1991 to 24.1% in the first three quarters of 1992, while that of British government securities has risen from 4.9% to 22.2% over the same period.

Personal sector

The cumulative personal sector financial surplus during the first three quarters of 1992 is, at £22.6 billion, more than the total 1991 surplus, and reflects an increased rate of

Table B
Personal sector financial transactions

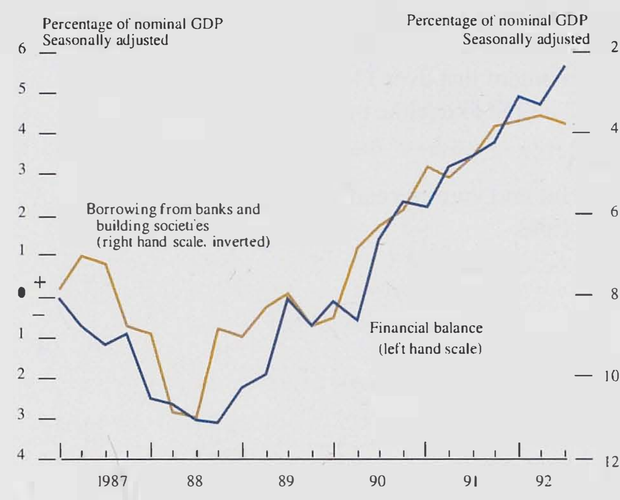
£ billions, *seasonally adjusted*
Increase in assets/decrease in liabilities +

	1989	1990	1991	1992 Q1	Q2	Q3	Q4
Financial surplus/deficit (a)	-6.5	4.0	18.1	7.1	7.0	8.6	..
of which:							
Net claims on life assurance and pension funds	26.5	25.9	26.1	7.8	6.0	7.2	..
Deposits with banks and building societies	39.4	34.5	24.0	6.3	4.0	1.9	4.1
of which:							
Individuals	35.7	33.1	24.1	5.3	3.4	3.1	4.2
Unincorporated businesses	3.6	1.4	-0.2	1.0	0.5	-1.2	—
Borrowing from banks and building societies	-45.8	-40.0	-28.8	-6.0	-5.9	-6.3	-3.0
of which:							
For house purchase	-31.0	-30.4	-25.4	-5.6	-5.4	-6.0	-3.2
For consumption	-5.8	-3.9	-2.4	-0.4	-0.2	-0.6	0.1
By unincorporated businesses	-8.9	-5.6	-1.0	0	-0.3	0.3	—
Public sector debt	-2.8	-0.5	3.0	2.3	2.7	0.7	..
UK company securities and unit trusts	-20.7	-7.8	-5.0	-0.7	1.3	-1.2	..
Others (a)	-3.1	-8.1	-1.2	-2.6	-1.1	6.3	..

.. Not available.
(a) Including balancing item.

adjustment in 1992. The continuing rise in unemployment and weakness in the housing market restrained consumer expenditure, contributing to a slowdown in borrowing. Despite the high surplus run throughout the year, Bank estimates show that the overall capital gearing ratio of the personal sector remained broadly unchanged as falling house

Chart 5
Personal sector borrowing and financial balance



prices eroded the tangible wealth of the sector. Meanwhile income gearing declined in 1992 as mortgage rates fell, although much of this effect came through late in the year. In addition, the weakness of the housing market led to a general tightening of the lending criteria of mortgage lenders towards the end of 1992, increasing the savings required by would-be first-time buyers to borrow a given amount.

Monetary data for the fourth quarter of 1992 offer little evidence that these restraining factors have weakened in influence. Indeed, underlying consumption borrowing from banks and building societies fell by £0.2 billion to £0.1 billion, the lowest quarterly flow of borrowing since 1977.[2] Borrowing for house purchase fell by £2.8 billion to only £3.2 billion in the fourth quarter, a large fall which partly reflects the distortion to the pattern of sales throughout the year caused by the reintroduction of stamp duty in August.

(1) Total identified uses of funds.
(2) These figures take account of transfers of loans between banks and non-banks, which distorted the recorded figures.