Operation of monetary policy

This article covers the period from April to June 1993.

Monetary policy continued to be directed at the inflation target, taking into account a wide range of economic and monetary indicators. The Bank's central forecast during the quarter was that inflation would approach, but not exceed, the top of its target range in 1994, while the current and prospective pace of activity was such that no further reduction in interest rates was judged appropriate, or desirable given the limited scope for the exchange rate to depreciate without risk to the inflation target.

Data released early in the quarter showed that output had increased more strongly in the first quarter than expected. Net exports made a substantial contribution to growth in the first quarter while consumption also increased and turnover in the housing market picked up. But the most notable indicator was the decline in unemployment which began, in February, at a very much earlier stage in the cycle than expected, and which could not be explained by growth in employment.

Although there was no evidence that the increased pace of activity caused price pressures in the first quarter, the probability that growth would be more rapid than previously forecast increased the risk, which already existed, that retail price inflation would move above the target range. Sterling's appreciation in April was therefore welcome.

Subsequent data suggested that activity might have slowed in the second quarter. Falling unemployment and a rise in house prices—albeit rather surprising at still modest levels of housing turnover—encouraged a large rise in consumer confidence; but retail sales volumes fell back in April and May and housing market activity apparently slowed. It did not appear, however, that recovery had faltered to a degree which justified a further reduction of interest rates.

Narrow money contracted in the second quarter, but the twelve-month growth rate of M0 remained above its monitoring range—except in May when it was depressed by quite a large, though erratic, fall in bankers' operational balances at the Bank. Notes and coin grew rather faster in the first quarter than could be explained by retail sales and lower interest rates; their slower twelve-month growth rate in April and May, however, was more consistent with retail sales values, which grew by 4.8% in the twelve months to May. Broad-money growth was more firmly within the monitoring range in April and May than earlier in the year; its monthly increases were boosted in February and March by the public sector contribution but sustained by increased lending to the private sector in April and May.

M4 lending increased in April and May as lending for house purchase increased. Yet lending for consumption remained weak, as it was in the first quarter. Although personal sector savings fell as expenditure increased in the first quarter, this was reflected not in increased borrowing but in a reduced build-up of personal sector deposits. Lending to industrial and commercial companies was very weak as they continued to raise substantial funds in the equity market and to reduce gearing by repaying outstanding borrowing.

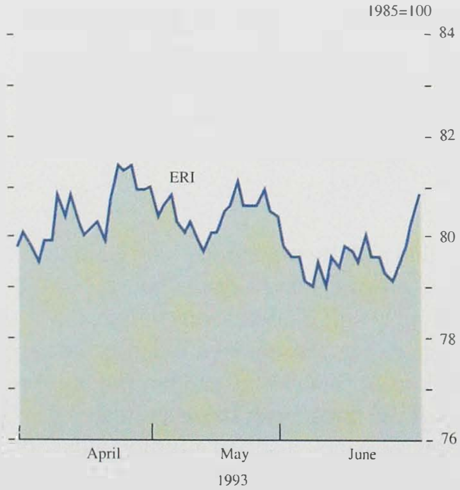
The domestic money market generally shared the Bank's view that the prevailing level of interest rates was appropriate. But the market was concerned at the same time that a significant strengthening of the exchange rate might endanger recovery. As a result, it was sensitive to actual and expected movements in overseas interest rates and their effect on sterling; and in June, when it seemed that activity had slowed in the second quarter, the Bank occasionally resisted the downward movement of market interest rates.

Technical conditions in the money market remained difficult at times, not least because of overfunding during the period; in addition to the three auctions which were held, it seemed right to take advantage of the funding opportunities which arose so as to get well ahead of the large funding requirement for 1993/94. Gross official sales of nearly £21 billion had been secured by the end of June, including the proceeds of the auction held on 30 June.

Foreign exchange market developments

Sterling's effective rate remained in a relatively narrow range during the quarter as its appreciation against the weaker deutschmark and other European currencies was largely offset by depreciation against the dollar and yen. Although sterling benefited greatly from the improved domestic economic outlook, particularly relative to that in Europe, it remained susceptible to recurring expectations of an interest rate cut—particularly when political concerns mounted—and suffered from time to time from market speculation that the authorities might wish to restrain its appreciation.

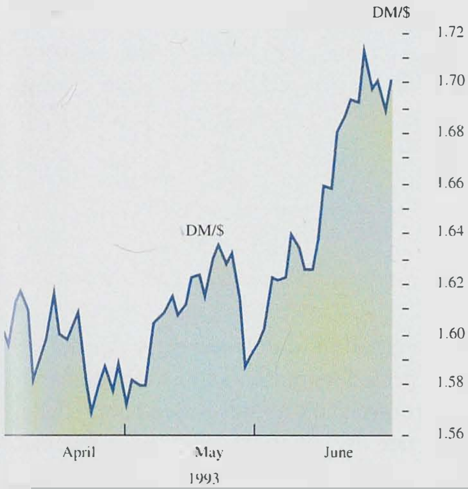
Sterling effective index



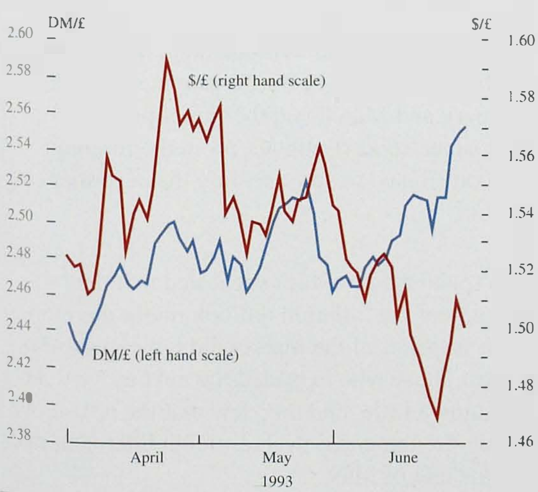
The deutschmark weakened during the quarter as the economic situation in western Germany deteriorated and activity was forecast to decline further in the remainder of 1993. The Bundesbank repo rate eased during April and the discount rate was unexpectedly reduced by 25 basis points to 7.25% on 22 April (and the Lombard rate by 50 basis points). This cut, and the larger than expected adjustment to the repo rate the following week, encouraged expectations of further, faster cuts. The repo rate fell to 7.60% on 12 May, but easing then halted as data showed that the growth of M3 had exceeded its target range in April; the repo rate remained virtually unchanged for the rest of the quarter. Nevertheless, the market retained the view that a substantial easing was inevitable at some time in order to sustain activity. This view was realised on 1 July when the discount rate was cut by 50 basis points to 6.75% and the Lombard rate by 25 basis points to 8.25%.

Despite the actual and expected reduction in German rates, the dollar failed to make a sustained advance against the deutschmark in April and May, as new data cast doubt on the pace of the US recovery; there were also rumours in the market of dollar sales by the Bundesbank.

Deutschmark/dollar exchange rate



Sterling exchange rates



But the dollar began a substantial rally at the end of May, propelled by stronger expectations of a further narrowing of the DM-$ short-term interest rate differential. Expectations of a monetary tightening in the United States grew as a result of better than expected output indicators, while the market became more confident that substantial easing in Germany would occur at some time, and German officials appeared not to be concerned by the dollar's rise above DM 1.60.

Against this background sterling gained against the deutschmark throughout April—as it had through much of the previous month—on a run of almost uniformly positive economic data which weakened expectations of a further reduction in sterling interest rates. The fear that recovery might in due course lead to faster inflation led the market to believe that the authorities would welcome some strengthening of the exchange rate. Consequently interest rate cuts in Germany were not expected to be followed in the United Kingdom. In effective terms, sterling rose to its highest point during the quarter towards the end of April as it also gained against the dollar. But it met profit-taking at around DM 2.50, and there were rumours that the Bank was intervening at that level to restrain its appreciation.

The local elections, the Newbury by-election and the parliamentary debate on the European Communities (Amendment) Bill weighed on sterling at the beginning of May; and after the Government's losses in the elections, the market came to the view that another interest rate cut, to sustain recovery, could not be ruled out.

But sterling benefited from the Danish 'yes' vote in the referendum on the Maastricht Treaty on 18 May, which caused flows out of the deutschmark, and from the passage of the European Communities (Amendment) Bill through the House of Commons. Furthermore, continued signs of growth in the United Kingdom, albeit patchy, and the Bank's *Inflation Report*, which was interpreted as implying little room for further interest rate cuts, were supportive and sterling breached DM 2.50 on 20 May for the first time since January.

Signs that recovery had slowed and the change of Chancellor at the end of May once again increased expectations that domestic interest rates might still be reduced. And, as the market came to the view that the gradual easing of German rates had paused, sterling weakened. But although it softened against the dollar and in effective terms, it was then pulled higher against the deutschmark in June and ended the quarter on a positive tone in anticipation of a near-term reduction of German short-term interest rates.

Official money-market operations

The authorities did not judge that monetary conditions warranted any adjustment to the level of interest rates during the quarter and the domestic money market generally shared this view. In the absence of downward pressure on market rates, the Bank was able to relieve sometimes difficult technical conditions, but it offered some resistance to the fall in market rates which occurred in June as expectations of an interest rate cut revived.

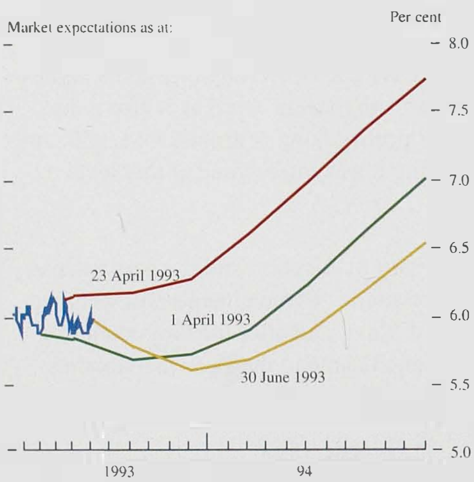
Interbank and futures rates had begun to firm after the Budget in mid-March, in which the Chancellor expressed the view that the prevailing level of interest rates was consistent with recovery. This

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

1993	Interest rates (per cent per annum) Sterling interbank rates 1 month	3 months	6 months	12 months	Short sterling future (c) 3 months	Gilt yields (b) (per cent per annum) Conventionals Short	Medium	Long	Index-Linked Long	Exchange rates ERI	$/£	DM/£
1 April	5 29/32	5 15/16	5 7/8	5 7/8	5.84	6.77	7.71	8.37	3.51	80.1	1.5242	2.4444
13 April	5 27/32	5 27/32	5 27/32	5 27/32	5.75	6.66	7.62	8.22	3.51	80.7	1.5590	2.4643
29 April	5 15/16	6 3/32	6 5/32	6 11/32	6.10	7.23	8.14	8.62	3.67	81.0	1.5752	2.4841
27 May	5 13/16	5 7/8	5 7/8	6 1/32	5.97	7.08	8.02	8.52	3.63	80.7	1.5527	2.5045
1 June	6	5 13/16	5 13/16	5 29/32	5.68	7.09	8.07	8.58	3.64	80.2	1.5564	2.4765
30 June	5 31/32	5 15/16	5 29/32	5 29/32	5.77	6.84	7.61	8.09	3.59	80.6	1.5005	2.5516

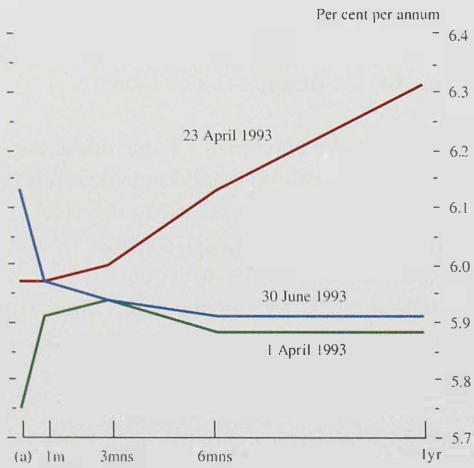
(a) Close of business middle-market rates in London.
(b) Gross redemption yield. Representative stocks: short—7¼% Treasury 1998; medium—8% Treasury 2003; long—9% Treasury 2012; index-linked—2½% Index-Linked Treasury 2016 (real yield assuming 5% inflation).
(c) Implied future rate: until 31 May, the June contract, thereafter the September contract.

Sterling interest rate expectations(a)



(a) Three-month Libor implied by short sterling futures contracts.

Sterling interbank rates



(a) For one week.

view was reinforced by data released in March and early April, which showed a faster than expected increase in consumer demand and output. By mid-April therefore market rates reflected the belief that the bottom of the interest-rate cycle had probably been reached. Moreover, the fear that rapid recovery might in due course re-ignite inflation was strengthened by the increase in retail price inflation in March which, although slight, was contrary to some market expectations of a fall. Attention therefore began to focus on when interest rates might have to rise, and the interbank yield curve consequently assumed a mildly upward slope. This movement continued as further evidence of recovery accumulated and, in the futures market, a rise of more than 50 basis points by March 1994 was fully discounted by 23 April, with rates of nearly 7¾% discounted by the end of 1994. The Bank did not resist this movement or the accompanying tightening of monetary conditions which resulted from sterling's appreciation.

The slope of the interbank curve began to moderate, however, as doubt was expressed about the nature of the decline in recorded unemployment in February and March and the run of positive economic data was not expected to continue. As in the foreign exchange market, this contributed to some feeling that a further rate cut could not be ruled out.

The April activity data (published in May) suggested that the recovery had slowed and that the inflation outlook might therefore be better. Although the majority of the market did not expect rates to move in the short term, those who expected the next move to be upwards deferred its timing a little, and the view that the next move might be downward was strengthened; twelve-month interbank rates fell back below 6% at the end of May.

Economic data published in June confirmed that the pace of activity might have moderated a little in the second quarter and that recovery would be uneven. The market also believed that the newly appointed Chancellor (who took office on 27 May) might be more ready than his predecessor to lower rates if there were signs that recovery had faltered. Consequently a number of small rallies developed, mainly in the futures market. When the rallies did not run out of steam themselves, the downward movement in interest rates required some resistance from the Bank in its money-market operations. By the end of June, after the Chancellor had indicated in an interview that there was no immediate prospect of a rate cut, the most bullish expectations had subsided, although further rate cuts were still discounted, conditional upon sterling strengthening

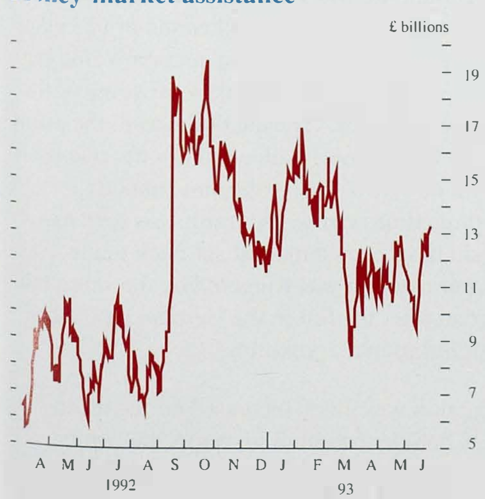
Table B
Influences on the cash position of the money market

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

	1992/93	1993/94		
		April	May	June
Factors affecting the market's cash position				
Under/overfunding (+/-)	+1.2	-0.9	-0.7	-2.2
Central government net debt sales to banks and building societies(a)(b)(-)	-6.7	(c)	(c)	(c)
Other public sector net borrowing from banks and building societies(-)(d)	-2.0	-0.4	—	+0.2
of which, local authorities' deposits with banks and building societies(+)	*+0.4*	*-0.3*	*+0.1*	*+0.2*
Currency circulation(-)	-0.9	-1.1	-0.3	+1.0
Other	+2.4	-1.0	-0.2	+0.4
Total	**-6.0**	**-3.4**	**-1.2**	**-0.6**
Increase (+) in the stock of assistance	+1.9	+3.3	+1.3	+0.3
Increase (-) in £ Treasury bills outstanding (e)	+4.2	+0.1	-0.1	+0.2
Increase in bankers' balances at the Bank	+0.1	-0.1	—	-0.1

(a) Other than sterling Treasury bills.
(b) Excluding repurchase transactions with the Bank.
(c) Included in funding from 1993/94.
(d) From 1993/94 banks' and building societies' transactions in local authorities' and public corporations' listed sterling stocks and bonds are included in funding.
(e) Other than those held outright by the Bank and government accounts but including those purchased by the Bank on a repurchase basis.

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.

appreciably further, recovery faltering or some tightening of fiscal policy in the Budget in November.

Technical conditions continued to be made difficult at times during the quarter by the high level of money-market assistance. The stock of assistance at the end of March was around £8.4 billion, but it seemed right to take advantage of the strength of the gilt market to get ahead of the funding requirement, and the resulting within-quarter overfund of £3.8 billion combined with other influences (see table) to increase the stock of money-market assistance to £13.3 billion by the end of June (see chart).

A large stock of assistance complicates money-market operations by adding to daily shortages when it matures and by reducing private sector holdings of assets which may be sold to the Bank in its money-market operations. The temporary facilities (available to the largest banks and building societies and to the gilt-edged market-makers), which were first introduced in September, took some of the pressure off private sector bill holdings by providing assistance through the purchase of gilts for future resale and the provision of finance against promissory notes relating to sterling export credit and shipbuilding paper. The longer maturity of the facilities also reduced the rate at which the assistance turned over. The facilities were therefore reoffered on 4 May to mature on 6 July and the take-up was slightly greater than in March, at £3.1 billion.

Despite the temporary facilities, large daily shortages remained and had to be managed through bill operations. The pressure on private sector holdings of eligible bank bills was reflected in the increase in the number of Treasury bills sold to the Bank as part of daily bill operations despite the decline in the number outstanding. (The 91-day Treasury bill tender was reduced to a minimal size in September and so the amount outstanding stabilised at the end of 1992.)

When the stock of assistance rose rapidly at the beginning of April the Bank sought to make the relief of the associated shortages easier by offering bill repos with a relatively short maturity, so enabling the mobilisation of a larger range of bills: new bills being drawn were predominantly of one month's maturity. And at the end of April, in order to slow down the rate at which assistance was maturing, the Bank offered two repos, the longer with a maturity of more than one month, which might have attracted some of the longer maturity bills which were then being drawn as expectations of an interest rate cut evaporated. But overnight interbank rates still rose well above official rates on some days when the shortage was not relieved until late in the day; the mismatch between the recipients of government payments and the purchasers of gilts meant that, even when the overfund on any one day was not large, sometimes the shortage did not find its way to the core of the money market until late in the day.

Gilt-edged funding

The PSBR forecast for the financial year beginning in April was £50 billion. In order to meet the correspondingly large gilt funding requirement the Bank had announced after the Budget in March that auctions would be held at broadly monthly intervals during the year. The first auction had been held on 31 March and, together with other calls carried forward to 1993/94, had already contributed

Table C
Official transactions in gilt-edged stocks

£ billions: *not seasonally adjusted*

	1993/94		
	April	May	June
Gross official sales (+)(a)	+6.5	+5.4	+5.7
Redemptions and net official purchases of stock within a year of maturity(-)	-0.9	—	—
Net official sales (b)	+5.6	+5.4	+5.7
of which, net purchases by:			
Banks (b)	-0.4	+1.0	+1.5
Building societies (b)	+0.4	+0.1	+0.1
Overseas sector	+1.6	-0.1	+1.1
M4 private sector (b)	+4.0	+4.5	+3.0

(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.

some £6 billion to sales in 1993/4. Substantial tap sales were possible during the quarter in addition to the three auctions, particularly in June when they totalled nearly £3.8 billion. Sales of debt to banks and building societies were no longer excluded from funding and, with purchases of £2.6 billion during the quarter, the monetary sector contributed to a within-quarter overfund of £3.8 billion. Although this overfunding contributed to large shortages in the money market, in view of the large funding task it was prudent to sell stock as and when demand emerged.

The auction at the end of March had been very successful and, given the good market reception, especially to the extent of cover in spite of its size, further tap sales were possible in its aftermath, including sales of the tranchettes issued in the following days.

As in the money market, the evidence of quite rapid economic recovery in the first quarter eliminated expectations of further interest rate cuts; this set back the short end of the market. The long end was affected by nervousness about inflation if the pace of recovery was sustained, so the rise in retail price inflation in March, although small, triggered quite a sharp upward adjustment in yields. This adjustment was exacerbated by the weakening of overseas bond markets and precluded further funding through tap sales for the rest of April.

An auction of £3 billion at the end of April maintained the pace of funding. A short-dated stock was generally expected by the market and, after the 1996–99 maturity range was announced, 7¼% Treasury 1998 was the preferred stock. There was substantial demand for five-year current coupon sterling debt—as witnessed by the volume of private issues in April which were easily absorbed—and it was appropriate to build up the five-year benchmark gilt, even though the new tranche would not be fully fungible until its first dividend date in August. Demand for 7¼% Treasury 1998 was such that there was some market disappointment that the auction was not larger. Against a reasonably steady background, the when-issued price traded in a narrow range until the day before the auction when the price began to rise as gilt-edged market-makers believed the auction would be substantially oversubscribed; but this rally choked off some of the incipient demand at the auction itself. The auction was in the event very satisfactorily covered (1.77 times) with a tail of only one basis point and an average yield of 6.98% but, with some market expectations of around three times cover, the result was seen as disappointing. This might have been a modest set-back to the market, but a much sharper reaction was triggered by the sharp fall in the German bond market after the fall in the German repo rate had raised concern about inflationary pressures.

Retail demand for the auction was much increased by the recent publication of the Bank's booklet for retail investors and wider advertising; there were more than 2,000 non-competitive bids for stock, worth more than £12 million, compared with a previous highest total of £3 million.

It was not possible to issue further stock in the immediate aftermath of the auction and only a limited amount of further funding was possible in May. There was one opportunity early in the month to issue new stock, but thereafter the market traded in a narrow range as attention was already focused on the next auction which was expected at the end of the month.

Table D
Issues of gilt-edged 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
8% Treasury 2013	3,000	23.3.93	1.4.93	Auction	94.9063(b)	Partly paid (c)	8.53 (d)	8.53	1.4.93
2 1/2% Index-Linked 2020	150	2.4.93	2.4.93	To Bank	133.6250	In full	3.54 (e)	3.71 (e)	7.5.93
3 1/2% Funding 1999–2004	50	2.4.93	2.4.93	To Bank	72.8750	In full	7.02	7.44	27.5.93
9 3/4% Treasury 2002	200	2.4.93	2.4.93	To Bank	113.2188	In full	7.74	7.74	7.4.93
7 1/4% Treasury 1998	250	2.4.93	2.4.93	To Bank	102.2188	In full	6.71	6.70	7.4.93
7 1/4% Treasury 1998 'A'	3,000	20.4.93	29.4.93	Auction	101.0625 (f)	Partly paid (g)	6.99 (d)	6.99	29.4.93
8 3/4% Treasury 2017	250	7.5.93	7.5.93	To Bank	101.250	In full	8.63	8.62	10.5.93
8% Treasury 2003	350	7.5.93	7.5.93	To Bank	99.4375	In full	8.08	8.08	10.5.93
7 3/4% Treasury 2006	3,000	18.5.93	27.5.93	Auction	94.9375(h)	Partly paid (i)	8.39 (d)	8.39	27.5.93
2 1/2% Index-Linked 2024	150	2.6.93	2.6.93	To Bank	109.8750	In full	3.67 (e)	3.67 (e)	17.6.93
4 5/8% Index-Linked 1998	100	2.6.93	2.6.93	To Bank	108.3750	In full	2.97 (e)	3.01 (e)	28.6.93
9% Treasury 2012	100	4.6.93	4.6.93	To CRND					
9% Treasury 2012	200	4.6.93	4.6.93	To Bank	104.3125	In full	8.54	8.53	8.6.93
9 3/4% Treasury 2002	200	4.6.93	4.6.93	To Bank	110.3750	In full	8.13	8.11	8.6.93
7 1/4% Treasury 1998	200	4 6.93	4.6.93	To Bank	100.6875	In full	7.07	7.07	8.6.93
8 3/4% Treasury 2017	100	11.6.93	11.6.93	To CRND					
8 3/4% Treasury 2017	700	11.6.93	11.6.93	To Bank	102.5000	In full	8.50	8.49	14.6.93
2 1/2% Index-Linked 2016	150	24.6.93	24.6.93	To Bank	138.9375	In full	3.61 (e)	3.60 (e)	29.6.93
8% Treasury 2013	250	24.6.93	24.6.93	To CRND					
8% Treasury 2013	400	24.6.93	24.6.93	To Bank	98.4063	In full	8.16	8.14	25.6.93
7 1/4% Treasury 1998	300	24.6.93	24.6.93	To Bank	101.4375	In full	6.88	6.88	28.6.93
8% Treasury 2003 'A'	3,250	22.6.93	1.7.93	Auction	101.5313 (j)	In full	7.78 (d)	7.78	1.7.93
9% Treasury 2008 'D'	1,000 (k)	30.6.93	30.6.93	To Bank	108.7500	Partly paid (l)	7.99	7.97	6.7.93

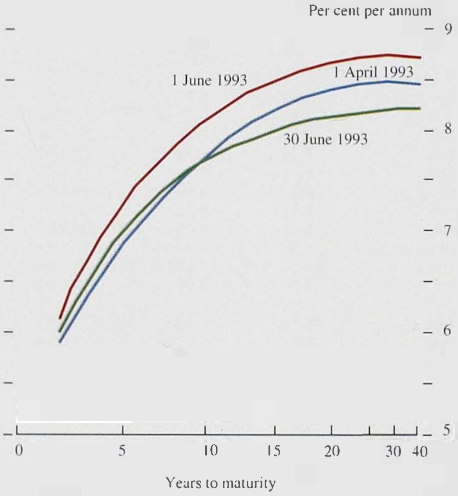
(a) Gross redemption yield, per cent.
(b) Lowest accepted price for competitive bids. The non-competitive allotment price was £94.9375%.
(c) With £44.90625% payable on issue and balance on 17 May.
(d) Yield at lowest accepted price for competitive bids.
(e) Real rate of return, assuming 5% inflation.
(f) Lowest accepted price for competitive bids. The non-competitive allotment price was £101.125%.
(g) With £51.0625% payable on issue and balance on 20 May.
(h) Lowest accepted price for competitive bids. The non-competitive allotment price was £94.9375%.
(i) With £29.9375% payable on issue and balance on 21 June.
(j) Lowest accepted price for competitive bids. The non-competitive allotment price was £101.90625%.
(k) Of which 200 reserved for CRND.
(l) With £30% payable on issue, £35% on 9 August and balance on 2 September.

Although the market was encouraged by signs that the pace of economic recovery was moderating in the second quarter and that the short-term inflation outlook might therefore be improved, it seemed prudent not to exceed the mid-point of the £2–4 billion range for the auction at the end of May. Having auctioned short and long-dated stocks it was appropriate to bring a medium-dated stock which would expand the basket of stocks deliverable into the long gilt futures contract. A new current coupon stock was chosen to mature in 2006, a year which had few other redemptions. The average price at the auction was higher than at the time of its announcement, giving a yield of 8.39%, and no tail. Although the cover, at 1.56 times, was lower than the previous auction it was in line with market expectations and the market subsequently rose, enabling further tap sales, including index-linked stocks. The ten-year index-linked tap issued in mid-March was exhausted the day before the auction and, as prices rose, the Bank took the opportunity to bring two further tranchettes at the beginning of June.

A strong rally developed in June in the conventional market, as in other government bond markets, and into which substantial tap sales were possible. The relatively better economic outlook in the United Kingdom than in Germany meant that sterling was expected to appreciate, which attracted significant overseas demand. Longer yields fell as further data convinced the market that low-inflation growth was in prospect. A package of tranchettes issued on 4 June was soon exhausted, as was a tranchette of ultra-long stock issued on 11 June.

The issue of this long-dated stock was taken to rule out an auction of stock of a similar maturity at the end of June and market expectations came to focus on the seven to ten-year area, with the ten-year benchmark (8% Treasury 2003) favoured, particularly by overseas investors. Given the strength of the market the size of the auction of this stock was increased to £3.25 billion; when the stock

Time/yield curves of British government stocks[(a)]



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

merged it would become the largest stock outstanding and a very liquid benchmark.

The market continued to rally after the auction announcement on 22 June, taking long yields to their lowest levels for more than twenty years and, for the first time, enabling the issue and exhaustion of a package of conventional tranchettes in the when-issued period. The when-issued price of the auction stock had risen by about half a point by the eve of the auction, but at this level the stock was judged expensive with little further rise expected. This dampened demand and bids were sufficient only to cover the stock 1.1 times. The tail was also longer than had become usual, at six basis points, but the average price was twelve ticks above that at the time of the announcement.

Although the market was initially disappointed by the result, the stock was well absorbed and the strong demand evident in the recent rally returned. The market more than recovered initial losses by the end of the day and the Bank was able to respond by bringing an £800 million tranche of long-dated stock that afternoon.